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BY THE COMPTROLLER GENERAL



Report To The Congress

OF THE UNITED STATES

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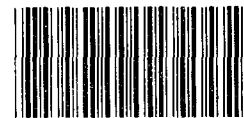
Need For More Effective Audits Of Federal Grants And Contracts Administered By Institutions Of Higher Education

The Federal Government provided about \$14.4 billion to over 2,500 colleges and universities during fiscal 1974 through 1976. The Department of Health, Education, and Welfare is responsible for auditing these funds and for providing the results to the funding agencies.

From its review of HEW's audits at 20 institutions that received the most Federal support during fiscal 1975, GAO concluded that HEW was trying to do too much with too few audit resources. As a result, audits were not conducted as frequently as they should have been and were omitted entirely at a number of institutions.

In addition, and probably associated with the resource problem, GAO noted that certain phases of some audits were not performed in a manner consistent with GAO audit standards.

Finally, while recognizing the difficulties posed by inadequate university accounting systems, GAO believes that HEW needs to do a better job of verifying cost allow-ability.



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FGMSD-79-44

JULY 19, 1979

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548


B-162223

To the President of the Senate and the
Speaker of the House of Representatives

This report recommends procedures for improving the effectiveness of audits of both Federal grants and contracts to institutions of higher education. Approximately 98 percent of such audits are performed by the Department of Health, Education, and Welfare. These audits provide Federal agencies with a principal portion of the information they need to judge whether universities have spent their Federal funds as intended and whether they have maintained effective controls over those funds. Because of this role, these audits must be as effective as possible.

We made this review as part of our current effort to expand and strengthen audit activities of Government agencies.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Secretary of Health, Education, and Welfare.


Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NEED FOR MORE EFFECTIVE AUDITS
OF FEDERAL GRANTS AND CONTRACTS
ADMINISTERED BY INSTITUTIONS OF
HIGHER EDUCATION

D I G E S T

The Department of Health, Education, and Welfare is responsible for auditing Federal funds provided to 2,500 colleges and universities. This support is in the form of grants and contracts for research and development; facilities and equipment; and fellowships and traineeships.

During fiscal 1974 through 1976, support amounted to about \$14.4 billion for over 2,500 schools and was provided by 14 Federal agencies including HEW, Agriculture, Defense, Energy, the National Science Foundation, and NASA. Under a cross-servicing arrangement, HEW is responsible for auditing the funds and providing the results to funding agencies.

From its review of HEW's audits at 20 institutions that received the most Federal support during fiscal 1975, GAO concluded that HEW was trying to do too much with too few audit resources. As a result, audits were not conducted as frequently as they should have been and were omitted entirely at a number of institutions.

In addition, and perhaps associated with the resource problem, GAO noted that certain phases of some audits were not performed in a manner consistent with GAO audit standards.

Finally, while recognizing the difficulties posed by inadequate institution accounting systems, GAO believes that HEW needs to do a better job of verifying cost allowability.

GAO recognizes that a shortage of audit resources has significantly contributed to these shortcomings and thus recommends that the Inspector General reassess the

priorities to which his audit staff is assigned to see if additional effort could be devoted to university audits. In addition, GAO recommends that HEW

- establish a cycle for auditing the institutions,
- audit in greater depth, and
- ensure adherence to GAO audit standards.
(See p. 14.)

AGENCY COMMENTS

The Inspector General of HEW said that:

- HEW has insufficient audit staff to implement a cycle for auditing institutions; however, the agency's methods for deciding which audits will be performed provide reasonably effective audit coverage.
- The audit agency will provide new policy guidance to improve future audits.
- Recently, additional audit work has been done or scheduled at four universities.
- The audit agency will continue to try to develop effective audit procedures to close the accountability gap created by university systems.

Relative to the accountability gap, the Inspector General said that a major program of reform is underway to include (1) simpler Federal regulations without loss of safeguards, (2) improved procedures for the prompt resolution of audit findings, (3) early audit review service on proposed changes in institutions' accounting systems, and (4) sanctions against institutions and individuals when corrective actions are not taken in a reasonable time period.

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ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
GAO	General Accounting Office
HEW	Department of Health, Education, and Welfare
NASA	National Aeronautics and Space Administration
NIH	National Institutes of Health
NSF	National Science Foundation
OMB	Office of Management and Budget

CHAPTER 1
INTRODUCTION

The Department of Health, Education, and Welfare (HEW) is responsible for auditing Federal grants and contracts administered by many institutions of higher education. This report discusses the need to improve the effectiveness of such audits.

FEDERAL SUPPORT

Currently, the Federal Government provides financial support to over 2,500 institutions of higher education for one or more of the following purposes:

- Research and development.
- Facilities and equipment for instruction in the sciences and engineering.
- Fellowships, traineeships, and training grants.
- General support for science.
- Support for nonscience activities, excluding loans.

During fiscal 1974 through 1976, 1/ such Federal support amounted to \$14.4 billion and was provided by 14 Federal agencies including HEW, the National Science Foundation (NSF), the Department of Agriculture, the Department of Defense, the Energy Research and Development Administration (now the Department of Energy), and the National Aeronautics and Space Administration (NASA).

ACCOUNTABILITY AND AUDIT RESPONSIBILITY

Both the institutions of higher education and the Federal agencies involved are accountable for Federal funds provided to the institutions. The institutions are responsible for establishing financial management systems to account for and report on the use of Federal funds; the Federal Government is responsible for auditing the expenditure of those funds. To

1/Fiscal 1976 comprised the 15-month period between July 1, 1975, and Sept. 30, 1976.

avoid confusion and duplication at institutions receiving grants and contracts from more than one Federal agency, the Office of Management and Budget has assigned one agency the responsibility for all the auditing at multifunded institutions. The designated agency is also responsible for providing the results of the audit to the other agencies concerned. Approximately 98 percent of the institutions of higher education receiving Federal grants and contracts are to be audited by HEW under this arrangement.

TYPES OF AUDITS

The HEW audit agency performs a variety of audits at colleges and universities, including:

- Audits of indirect cost proposals for which each institution is required to submit an indirect-cost proposal for each of the fiscal years in which it operates under a Federal grant or contract providing for the reimbursement of indirect costs.
- Direct-cost audits which are comprehensive audits of the various classifications of cost, such as salaries and wages, fringe benefits, materials and services, travel, equipment, consultants, and stipends. The purpose of the audits is to determine the reliability of total costs charged to Federal grants and contracts and the adequacy of the accounting system for determining future costs.
- System audits which are reviews of a single type of cost, such as salaries.
- Closeout audits which determine the acceptability of total charges against a grant or contract.

REVIEW PURPOSE AND SCOPE

This review was initiated because of the size of the total dollar amount of Federal grants and contracts administered by colleges and universities--\$14.4 billion during the period of our review. Our objective was to determine the adequacy of the HEW audit agency's coverage of Federal grants and contracts administered by institutions of higher education. We reviewed the agency's audit work performed during fiscal 1974 through 1976 at the 20 institutions which received the most Federal support during fiscal 1975. These 20 institutions received over \$3.7 billion in Federal support during those 3 fiscal years. We reviewed HEW's most recent audit reports, working papers, and correspondence files relating to its direct-cost audits of the 20 institutions. In addition, we held

discussions with officials of HEW's audit agency in Washington, D.C., and in eight regional offices; college and university officials; and officials of the certified public accounting firms hired by the institutions to audit their financial operations. We pointed out specific instances in which the audits were not as effective as they could have been and did not have all the characteristics of a quality audit. We illustrated the need to make them more effective.

CHAPTER 2

NEED TO IMPROVE THE EFFECTIVENESS

OF AUDITS

The HEW audit agency devotes a large portion of its staff resources to auditing Federal funds administered by institutions of higher education. According to the audit agency, approximately 20 percent of its total effort, or 165 staff-years, in fiscal 1977 was devoted to auditing nearly \$1.2 billion in Federal contracts and grants to such institutions. During these audits, the auditors found that \$13.2 million had been misspent or misapplied and recommended that the amount be recovered. Also, another \$419.7 million in expenditures was not adequately documented, as required by Federal rules.

In spite of this substantial investment of staff resources, some of these audits were not as effective as they could have been because they (1) were not timely, (2) could not include an opinion on the allowability of a large portion of some funds because university accounting systems were inadequate, or (3) did not have all the characteristics of a quality audit.

TIMELINESS OF AUDITS

To be effective and of maximum use to management, an audit must be timely; that is, it must be conducted with reasonable frequency. The Office of Management and Budget has defined reasonable frequency as annually, but not less frequently than every 2 years. However, we found that some institutions are not audited that often, and others may not be audited at all.

Audit cycle

HEW's audit agency has not established a cycle for auditing institutions over which it has cognizance. Furthermore, audit officials at four of the five regional offices we reviewed said they do not have a cycle for auditing institutions under their cognizance. The fifth region had established a 3-year cycle for auditing large universities but was not maintaining it.

Audit coverage

The agency's Denver office is responsible for auditing approximately 75 institutions. Although it had established

a 3-year cycle for auditing the larger institutions, between 1970 and early 1977, it performed direct-cost audits at only 15, or about 20 percent, of its assigned institutions.

From fiscal 1974 through 1976, the audit agency's Chicago regional office performed 159 direct-cost audits. We did not determine if they were performed at different institutions; even if they were, during those 3 fiscal years, the region would have performed direct-cost audits at only about 47 percent of its assigned institutions. The likelihood, however, that all 159 direct-cost audits were performed at different institutions is remote.

Three of the large universities included in our review are in the Chicago region. The timing of the latest comprehensive direct-cost audits performed by the audit agency at these universities, as of September 30, 1976, is shown below.

<u>University</u>	<u>Period covered by audit</u>
University of Minnesota	July 1, 1972, through June 30, 1974
University of Wisconsin-Madison	July 1, 1972, through June 30, 1975
University of Chicago	July 1, 1971, through June 30, 1973

The Missouri Branch of the Kansas City regional office is responsible for auditing 57 institutions located in the State of Missouri. During fiscal 1974 through 1976, the office audited seven institutions.

The New York regional office is responsible for auditing approximately 300 institutions, about 100 of which have appreciable amounts of research funds. A regional official said that because of other priorities, only two or three direct-cost audits can be performed in any one year.

The Boston regional office is responsible for auditing about 400 institutions, about 50 of which receive substantial amounts of Federal funds. A regional official said that, per year, only eight or nine institutions are audited at all, and few receive a direct-cost or system audit.

INABILITY TO RENDER AN OPINION

One of the purposes of auditing Federal research funds administered by institutions of higher education is to determine whether the costs charged to research grants and contracts

are allowable. To be allowable, costs must be (1) reasonable, (2) allocable to research agreements under the standards and methods provided in an Office of Management and Budget circular, (3) subject to generally accepted accounting principles that are appropriate to the circumstances, and (4) conform to any limitations or exclusions as to types or amounts of cost items as set forth in the OMB circular or in the research agreement.

Some of the audit agency's audits are not as effective as they could be because, as a result of inadequate university accounting systems, the auditors are unable to determine the amount of unallowable costs charged to Federal grants. In such situations--in accordance with GAO standards--the auditors simply report that they cannot render an opinion on the allowability of the funds. In some cases, the amount of the funds on which the auditor could not render an opinion is significant. For example, we reviewed a direct-cost audit for one university that covered 3 fiscal years between July 1, 1972, and June 30, 1975. During this period, the university administered over \$111 million in Federal grants and contracts. The purposes of the audit were to determine if costs incurred were (1) reasonable and allowable under applicable Federal regulations and the terms of the grants and contracts and (2) accounted for in accordance with generally accepted accounting principles.

In its final report, the audit agency stated that the university could not adequately support personal service costs of \$53.7 million charged to Federal grants and contracts because such charges were based primarily on budget estimates and anticipated efforts rather than on, as required by Federal regulation, after-the-fact certification by knowledgeable personnel. As a result, the audit agency was unable to render an opinion on the allowability of these costs. Because this audit could not reach a conclusion on the allowability of 48 percent of the audited funds, there is no certainty that valid charges were made to Government grants.

This problem was not limited to one university. At another university the audit agency reported that it could not render an opinion on the propriety of \$34 million of salaries and wages charged to Federal grants and contracts during the period July 1, 1969, through June 30, 1972. At a third university the audit agency's draft report stated that it was unable to express an opinion on the allowability of approximately \$58 million in payroll charges to grants and contracts during the period July 1, 1971, through June 30, 1975.

Officials of the audit agency informed us that they were seriously concerned about their inability to render an opinion on the allowability of cost items because of inadequacies in the accounting systems of some educational institutions. In fact, the Assistant Inspector General for Audit informed us that HEW is considering imposing sanctions when institutions do not correct system deficiencies causing auditors to disclaim an opinion on the allowability of charges to Federal grants.

AUDIT QUALITY

Auditing standards concern the quality and scope of audit efforts and the characteristics of a professional and meaningful audit report. Standards are used as both a guide for and a measure of quality audit performance. Thus, auditing standards are the key to audit quality. The American Institute of Certified Public Accountants (AICPA) 1/ and the Comptroller General of the United States 2/ have issued separate statements of auditing standards.

The AICPA standards apply to audits made to express an opinion on statements that present an organization's financial position and results of operations. Such audits are called financial attest audits and are a test of accounting and related records. The extent of the test is determined by the auditor, based on professional judgment and experience.

GAO standards incorporate AICPA standards. However, the GAO standards recognize that the users of Government audit reports have broader interests than those that can be served by financial attest audits. For this reason, the GAO standards stress that auditing the use of public resources should concern not only the objective to which resources are devoted, but also the manner and effect of their application. GAO requires a broader inquiry into grantee compliance with Federal laws and regulations than is required by AICPA standards.

1/"Statement on Auditing Standards, issued by the Committee on Auditing Procedures," American Institute of Certified Public Accountants, 1973.

2/"Standards for Audit of Governmental Organizations, Programs, Activities & Functions, by the Comptroller General of the United States," 1972.

In evaluating the quality of HEW's audits of institutions of higher education, we used the GAO standards because Federal audit policy 1/ requires performance in line with those standards.

Some of HEW's audits of Federal funds administered by institutions of higher education are not as effective as they could be because they lacked some characteristics of a quality audit with respect to such matters as audit scope, amount of evidence gathered, the completeness of audit reports, and supervision of audit staff. This lessened the usefulness of the audit results.

Audit scope

The GAO Standards specify that the scope of Government audits should be broad enough to fulfill the needs of all potential users of the results of such audits. More specifically, the standards provide that audits shall include sufficient audit work to determine whether the audited entity is (1) maintaining effective control over revenues, expenditures, assets, and liabilities, (2) properly accounting for resources, liabilities, and operations, and (3) complying with the requirements of applicable laws and regulations.

In our opinion, some of the HEW audits we reviewed did not fully comply with the GAO standard relating to audit scope. For example, during a recent direct-cost audit of one university, the audit agency used 45 staff-days to audit expenditures of nearly \$29 million. The agency restricted testing to 1 of 4 fiscal years covered by the audit, to two cost categories, and to expenditures made under four out of hundreds of grants.

During the audit of another university covering 2 fiscal years and during which the university expended over \$76.6 million in Federal funds, the audit agency spent 64 staff-days and covered two major categories--review of costs and cost transfers. During the review of costs, the auditor traced the total costs of selected projects from a computer run to the university's records; however, the auditor did not establish the validity of the recorded costs. During the review of cost transfers, the auditor tested 32 of 683 fiscal 1973 transactions which resulted from costs being transferred from one project to another when potential overruns existed.

1/Federal Management Circular 73-2, "Audit of Federal Operations and Programs by Executive Branch Agencies," Sept. 1973. (Reissued as OMB Circular A-73, Mar. 15, 1978.)

Sufficiency of evidence

The GAO standards provide that conclusions be supported by enough objective evidence to demonstrate or prove the basis for the matters reported and their accuracy or reasonableness.

In our opinion, the conclusion reached as a result of the audit agency's audits of some universities was not based upon sufficient evidence. As a result, the audit reports were not as useful as they could have been. For example, as a result of its audit of one university, the audit agency concluded that although the university needed to strengthen controls over retroactive transfers of payroll costs from one grant to another, such transfers made during the period under audit, totaling approximately \$618,000, were valid. This conclusion was based on university-prepared explanations of eight transfers that were questioned by the auditors.

In our opinion, those explanations do not sufficiently support the audit agency's conclusion. For example, one explanation stated that one transfer in question was a reversal of a June 1972 transfer of salaries earned between December 1971 and May 1972. We could find no evidence that the auditors verified that explanation.

Furthermore, the National Institutes of Health (NIH), the HEW agency responsible for resolving questionable expenditures identified in audits of most educational institutions, also was not able to accept the audit agency's conclusion. In this regard, on November 20, 1974, NIH notified this university that it was unable to accept the auditor's conclusion that the \$618,000 of retroactive payroll transfers from one grant to another was valid. NIH also stated that certain audit workpapers and copies of transfer documents strengthened the inference that considerable cost transfers had been made without adequately explaining why the revised transfers should displace charges made through earlier, timely certifications of time or effort reports. The notification letter also requested that cost transfers be documented. Based upon the documentation that was provided and on subsequent negotiations, the university agreed to refund \$225,000 to HEW as a full and final settlement of any and all questionable direct salaries, wages, and related costs, and of salaries transferred to HEW grants and contracts during the period July 1, 1971, through December 31, 1974.

The recovery of \$225,000 by NIH indicates that the auditor's conclusion that the retroactive payroll transfers were valid was not based upon sufficient evidence. This conclusion may have misled other users of the report. For these

reasons, the audit of this university did not conform with GAO's standard relating to sufficiency of evidence.

At another university, the audit agency did not gather sufficient evidence to conclude that the university generally handled retroactive salary adjustments in an acceptable manner and that the impropriety of such adjustments was not significant. This conclusion was based upon a review of the university's explanations for 13 retroactive salary transfers. In our opinion, the explanations that were contained in the workpapers for five transfers--although later substantiated by the audit agency--did not support or justify the auditor's conclusions. The explanations presented were that:

- \$591 was transferred to another unit so that expenditures could be reported the same way they were budgeted. (This explanation does not establish the validity of the transfer.)
- \$14,594 was transferred to State funds which would have had to be returned if not used in the current year and to provide additional Federal funds for the next year's program. (The pending expiration of a program is not a valid reason for charging costs to it.)
- \$7,690 was transferred by the Medical Dean's office to another unit even though the employee worked in the department that was originally charged.
- \$3,016 was transferred by the Medical Dean's office to another unit without explanation.
- \$711 (No explanation for the transfer was obtained from the university.)

In our opinion, this audit does not meet GAO standards on sufficiency of information because the audit agency's workpapers do not support the auditor's conclusions that the university properly made such transfers.

Retroactive salary transfers were not the only area in which the audit agency's workpapers did not contain adequate or acceptable evidence upon which the auditor could base his opinion. For example, after testing nine principal investigators' expenditure reports, the auditor concluded that investigators generally submitted timely expenditure reports to the National Science Foundation. However, the workpapers showed that six of the nine investigators submitted their

reports from 1 to 4 months late. The audit agency later informed us that their conclusion was based upon 90 reports related to eight Federal agencies. In our opinion, this evidence should have been included in the workpapers.

At another university, after reviewing 25 travel vouchers, each of which exceeded \$1,000, the auditor concluded that all 25 vouchers had proper approval, had prior approval where applicable, were allowable within the contract or grant budget, and were pertinent to the objectives of the grant or contract. We found, however, that the auditors' workpapers did not show that the expenditures were within the contract or grant budgets or that they met the objectives of the contract or grant. In addition, the workpapers (1) contained no evidence that three vouchers had been approved, (2) contained no evidence that the expenditures included in the vouchers had been budgeted for, and (3) contained evidence that actual charges exceeded budgeted amounts for three vouchers. Subsequent work by the audit agency showed that its conclusion was correct; however, additional information should have been recorded in the workpapers. The audit agency agreed that its workpaper documentation should have been more complete.

Incomplete reporting

The GAO standards require that reports resulting from governmental audits be clear and complete enough to be understood by the users and to identify and explain issues and questions needing further study and consideration by the auditor or others. We found that some HEW reports did not include all pertinent information and, as a result, were not as useful as they could have been.

The audit agency's reports on its direct-cost audit of one university are a case in point. Separate reports on this audit were provided to HEW and 20 other Federal agencies, and, based upon the audit agency's reports to HEW and NSF, NIH negotiated a \$225,000 refund for HEW. These reports stated that a continuing need existed for strengthening controls over retroactive transfers of payroll costs and included details pertaining to those transfers. However, the reports sent to 19 other Federal agencies providing funds to the university did not contain the statement about salary transfers. Their reports stated that the university's accounting system and internal controls were generally acceptable for allocating, identifying, and recording costs incurred under Government contracts. None of the other Federal agencies made recoveries similar to those of HEW. Had the audit agency provided the salary transfer information to all the Federal agencies providing funds to the university, they would have

found the reports of greater use, and conceivably could have made recoveries as well. Because these reports did not contain all the pertinent information available to the audit agency, they did not meet GAO reporting standards.

We considered the direct-cost audit report for another university to be incomplete because the report did not disclose the limited scope of audit work performed, as required by our standards. In the scope section of this report, the audit agency stated, "We also reviewed costs claimed for reimbursement during the period of our audit under selective grants and contracts." The report also stated that the audit period was from July 1, 1969, to June 30, 1973. In our opinion, a reader would assume that claimed costs for all years were reviewed during the audit; however, testing was restricted to fiscal 1973 transactions. Because the report did not clearly describe the scope of the audit, it did not meet GAO standards of reporting.

Supervision of staff

The GAO standards provide that assistants are to be properly supervised. Thus, the auditor or audit organization is responsible for ensuring that less skilled members receive appropriate supervision in performing their work. This supervision is to be exercised from the start of the preparation work to the completion of the report draft.

During the most recent direct-cost audit at one university, the HEW auditors did little audit work but rather relied upon nine previously performed audits of specific matters, such as payroll, travel, and letter-of-credit transactions to support the conclusions reached. Our review of these audits showed that, in some cases, supervisory reviews were not timely and as a result the work performed did not satisfy the audit objectives. Specifically, supervisory reviews of audit programs as well as the actual audit work were not made, in some cases, until the audits were finished. In fact, the supervisory reviews of one audit were not made until 12 months after the audit was completed.

The agency's audit of travel expenditures is an example of what can happen when supervision over an assignment is not performed promptly. Although the audit was completed in November 1973, a supervisory review of the work performed was not made until September 1974. The comments of the auditor-in-charge indicated that he believed the audit program, as well as the audit itself, needed to be improved. He suggested

to the HEW branch manager that a new survey and audit of travel procedures and expenditures covering a more recent period be made. The branch manager advised against such an audit at that time; however, he concluded that

"This audit certainly did not accomplish the audit objectives. The reviewer is left hanging with unanswered questions throughout the W/Ps [workpapers]."

In our opinion, the delay in reviewing the workpapers was the major contributing factor to the inadequacy of this audit.

The audit agency stated that the 12-month delay in the supervisory review was caused by a special audit of public assistance programs mandated by the Secretary of HEW. However, at this university, the travel audit was not the only one in which we found delays between the completion of the audit and the date of the review by the auditor-in-charge. For example, he reviewed the audit of expenditure reports 2-1/2 months after the audit was completed. After that review, the auditor had to spend additional time completing the work the auditor-in-charge identified as necessary. Furthermore, the auditor-in-charge reviewed the letter-of-credit audit 6 months after it was completed and the audit of General and Clinical Research Center Grants 12 months after it was completed.

CHAPTER 3

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

The HEW audit agency is responsible for auditing approximately 98 percent of the institutions of higher education that administer Federal grants and contracts. Our evaluations of audits made at 20 institutions showed that some of the audits performed were not as effective as they could have been because they were not timely and because they lacked some characteristics of a quality audit with respect to such matters as (1) audit scope, (2) sufficiency of evidence, (3) completeness of reporting, and (4) supervision of staff. In addition, because of inadequacies in university accounting systems, some of the reports did not include opinions on the allowability of a significant portion of the funds expended by some universities, thus giving the Government little certainty that valid charges were made to Government grants. GAO recognizes that a shortage of audit resources has significantly contributed to these shortcomings.

RECOMMENDATIONS TO THE SECRETARY OF HEW

We recommend that the Secretary of Health, Education, and Welfare direct the Inspector General of HEW to

- reassess the priorities to which his audit staff is assigned to see if additional audit staff could be assigned to university audits,
- establish a cycle for auditing the institutions assigned to the audit agency,
- provide for audits of sufficient depth to establish the allowability or unallowability of costs claimed by institutions, and
- require that audits of institutions be conducted in accordance with the GAO standards.

AGENCY COMMENTS AND OUR EVALUATION

The Inspector General of HEW responded to the recommendations contained in our draft report as follows.

Establish a cycle for auditing institutions assigned to its audit agency.

The Department has not been able to implement a cycle for auditing institutions of higher education because of insufficient audit resources. The gap between present audit resources and the audit agency's total workload requirements on a cyclical basis is over 1,000 staff-years. For universities, a recent prudent estimate shows that an additional 114 staff-years would be required annually to conduct these audits on a 2- to 4-year cycle; this would be in addition to the almost 20 percent of the agency's staff time now expended on these audits.

In selecting entities to be audited, the agency is largely guided by experience when deciding which audits are consistently the most productive in terms of dollars saved, the magnitude and relative significance of problems previously disclosed, the need for followup review, as well as the total Federal dollars involved and the needs of awarding agencies. The Inspector General stated that the agency's methods for deciding which audits will be performed provide reasonably effective audit coverage.

During fiscal 1976 (most current available data) \$2.4 billion was awarded to universities and colleges for research and development. HEW's fiscal 1978 audit reports covered \$1.6 billion. Of this sum, \$8.2 million in costs were questioned and \$70.6 million were "set aside" for later determination of eligibility by program staff and to alert awarding agencies of the need for systems improvements.

While we agree that additional audit effort will be required to meet a 2- to 4-year audit cycle for universities, we do not agree that reasonably effective audit coverage is now being achieved. Our section on audit coverage shows that audits are not being conducted as frequently as they should be and at a number of institutions are omitted entirely. (See pp. 4-5.) While the statistics cited by the Inspector General are impressive, they are also misleading. There is no relationship between the funds covered by fiscal 1978 audit reports and the dollar value of awards to universities and colleges for research and development during fiscal 1976.

Provide for audits of sufficient depth to establish the allowability or unallowability of costs claimed.

The Inspector General responded that the audit agency will continue to try to develop effective "extended" audit procedures to close the "accountability gap" created by unaudited university systems. However, increased emphasis on

achieving basic systems improvements and eliminating the causes of "disclaimers" is a more productive approach. A major program of reform is underway to include (1) simpler Federal regulations without loss of safeguards, (2) improved procedures for the prompt resolution of audit findings, (3) early audit review service on proposed changes in institutions' accounting systems, and (4) sanctions against institutions and individuals when corrective actions are not taken in a reasonable time period.

Require that audits of institutions be conducted in accordance with GAO standards.

The Inspector General acknowledged some shortcomings in past audits, particularly incomplete statements of audit scope in audit reports, weaknesses in working papers, and inadequate documentation. He also stated that since our audit, additional audit work has been done or scheduled at four universities, and that to improve future audits, he plans to provide new policy guidance on the following audit technicalities:

- Expanded statements in audit reports on the scope of the testing and periods covered.
- Extent of transaction testing to be done in each year of multiyear audits.
- Working paper presentation and documentation.
- Issuance of complete audit reports to all Federal funding agencies involved.

On May 30, 1979, the Assistant Inspector General for Auditing brought the problems disclosed in our report and our suggestions to the attention of his regional audit directors and key headquarters staff so that suitable arrangements could be made to monitor performance and carry out improvements.

The Inspector General's response to our report as well as his Assistant's memorandum are included as appendixes I and II.

The Deputy Director of the Office of Management and Budget responded that the Office is concerned about the inadequacy of university accountability, and the practices described in our draft report will have to be further examined

by HEW and other involved agencies of the Government. In addition, he stated that OMB is moving to strengthen university accountability by revising Circular A-21, "Cost Principles for Educational Institutions." The Circular was issued on February 26, 1979, and shall be effective on October 1, 1979. OMB's comments on our draft report are included as appendix III.



DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20201

February 15, 1979

Mr. Donald L. Scantlebury, Director
U. S. General Accounting Office
Financial and General Management
Studies Division, Room 6001
441 G Street, N. W.
Washington, D. C. 20548

Dear Don:

Enclosed are our comments on your draft report entitled "Need for More Effective Audits of Federal Grants and Contracts Administered by Institutions of Higher Education".

We appreciate the cooperation of your staff in helping the Audit Agency improve its operations in this important area of its responsibility.

By far the most serious problem discussed in the draft report is the "accountability gap" created by unauditible institutions' systems for accounting and documenting expenditures of Federal funds. While our auditors will continue to try to develop effective "extended" procedures to fill this gap, increased emphasis on achieving basic systems improvements at the institution, and eliminating deficient accounting practices, is a more productive approach.

We would welcome GAO support in dealing with this long-standing problem.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "TDM".

Thomas D. Morris
Inspector General

Enclosure

Comments of the Department of Health, Education, and Welfare on a General Accounting Office draft report "Need for More Effective Audits of Federal Grants and Contracts Administered by Institutions of Higher Education."

While we agree with the General Accounting Office that accountability problems exist with respect to Federal funds at institutions of higher education, we strongly disagree with the basic thrust of the draft report that the problems can be resolved by simply modifying or changing the ways in which we plan and carry out our audits at these schools.

From our perspective, the information in GAO's draft report relates to three separate matters:

- o timeliness of audit effort
- o adequacy of the institution's records
- o quality of audit work performed

The timeliness of audit effort is adversely affected by the huge size of the Audit Agency's total workload and by competing audit requirements in other HEW areas for our limited audit staff. We have had to prioritize the audit workload, resulting in less audit coverage than attainable under a cyclical approach, but nevertheless providing reasonably effective coverage in relation to total funds awarded to universities and colleges.

By far the most serious problem discussed in the draft report is the "accountability gap" created by unauditable university systems for accounting and documenting expenditures of Federal funds. GAO itself has reported that the accounting practices used by the institutions do not provide a reliable basis to verify the validity of many direct costs charged to research.

We have carefully reviewed each of the GAO criticisms of the quality of audit work performed. While certain shortcomings are acknowledged and will be remedied, we do not share GAO's generalized conclusion as to lack of high quality.

GAO Recommendation

- establish a cycle for auditing the institutions assigned to the Audit Agency

The Department has not been able to implement a firm cycle for auditing institutions of higher education because of insufficient audit resources. There is over a thousand staff-year gap between present audit resources and the Agency's total workload requirements on a cyclical basis. For universities, a recent prudent estimate shows it would require an additional 114 staff years annually to conduct these audits on a 2-4 year basis; this staffing would be in addition to the near 20 percent of our staff time now expended on these audits.

In selecting entities to be audited, we are guided by such factors as experience as to which audits are consistently the most productive in terms of dollars saved, the magnitude and relative significance of problems previously disclosed, the need for follow-up review, as well as total Federal dollars involved and the needs of awarding agencies.

These prioritizing methods provide reasonably effective audit coverage. During FY 1976 (most current data) \$2.4 billion was awarded to universities and colleges for research and development. Our FY 1978 audit reports covered \$1.6 billion. Of this sum, \$8.2 million in costs were questioned and \$70.6 million were "set aside" for later determination of eligibility by program staff and to alert awarding agencies of the need for systems improvements.

-- provide for audits of sufficient depth to establish the allowability or unallowability of costs claimed by institutions

The issue raised by the report, concerning audits of "sufficient depth", appears to relate solely to our reporting practice of disclaiming an opinion on costs claimed for reimbursement which we cannot effectively audit because of major deficiencies in the universities' systems. A disclaimer of opinion in such cases is required by professional standards set by the Comptroller General and the American Institute of Certified Public Accountants.

We will continue to try to develop effective "extended" audit procedures to close the "accountability gap" created by unauditable university systems. However, increased emphasis on achieving basic systems improvements and eliminating the causes of "disclaimers" is a more productive approach. A major program of reform is underway to include (i) simpler Federal regulations without loss of safeguards, (ii) improved procedures for the prompt resolution of audit findings, (iii) early audit review service on proposed changes in institutions' accounting systems, and (iv) sanctions against institutions and individuals when corrective actions are not taken in a reasonable time period.

-- require that audits of institutions are conducted in accordance with GAO standards

The draft report discusses examples of audit work which GAO believes was deficient in scope, evidential matter, reporting, exercise of due professional care, and other quality standards.

In the comments that follow, we are providing the results of our review of each of the examples cited. In many cases, we disagree with GAO's statements of facts or its conclusions, and we do not share its generalized conclusion as to lack of high quality.

However, we do acknowledge shortcomings as follows: incomplete statements of scope of audit in audit reports -- 5 universities
weaknesses in working papers
and documentation -- 5 universities.

(See GAO note 1, p. 21.)

To improve future audits, we plan to provide new policy guidance on the following audit technicalities.

1. Expanded statements in audit reports on the scope of audit work performed, particularly as to extent of testing and periods covered.
2. Extent of transaction testing to be done in each year of multi-year audits.
3. Working paper presentation and documentation.
4. Issuance of the same audit report to all Federal funding agencies.

Also, additional audit work since the time of GAO's review has been done, or will be scheduled, at 4 universities. (See GAO note 1, below.)

The following comments deal with specific statements in the GAO draft report.

(See GAO note 2, below.)

GAO notes:

1. The names of the universities were deleted to avoid calling undue attention to a particular university because of circumstances over which it had no control.
2. The comments dealing with the specific statements of our report were deleted because they were voluminous and did not affect our findings and conclusions.

MEMORANDUM

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
OFFICE OF THE SECRETARY
HEW AUDIT AGENCY

TO : All Regional Audit Directors and
Key Headquarters Staff;
Associate Directors
(See attached list)

DATE: 30 MAY 1979

FROM : Assistant Inspector General for Auditing

SUBJECT: Audit Management -- University Audits

A recent GAO review of HEW audits of universities reinforces previous observations that there are areas of our work to which greater attention must be given by our managers and staff. There is already considerable previously written guidance: the GAO standards; the HEW Policy Manual; our internal memoranda and audit instructions. Nevertheless, I am bringing these particular problems to your attention to make your staffs aware of the GAO suggestions, and I expect you to make suitable arrangements to monitor performance and carry out improvements where the need is indicated.

As an overall observation, our scope section is generally not as informative as it must be. The report user is entitled to know what we did to justify the the conclusions reached in our reports. One continuing problem has centered around entity audits, where the results of recent partial audits (such as contract closings) are relied upon to form part of the basis of our conclusions and recommendations in the current report. Where applicable, suitable reference should be made in the Scope section to this other work.

Another problem area is the practice of showing a bracket of years covered (as many as five) in our report when we only tested, in detail, one or two years and relied on subsidiary work (contract closings, etc.) to support our conclusions for the entire period. We are not obligated to include the entire period in our scope. It is more accurate to show only those periods for which we have sufficient support by testing or other means, as outlined in Paragraphs 4-7 of our Handbook. The subsidiary or related work should be discussed but not used by itself to support a year's coverage.

- All RADs, Key Headquarters Staff, and Assoc. Directors

As a minimum, report scopes should include information on the audit's objectives. . . periods covered by the audit, including the periods tested, and the extent of testing done in each period. . . the types of testing done in each period. . . the types of audit procedures/methodology employed. . . the extent of reliance on other audit work for current conclusions and recommendations. . . information on the sites of audit. . . information on the sampling techniques used, and including where appropriate, estimates of their accuracy, and. . . appropriate scope qualifications and/or limitations.

GAO also reported that our workpapers needed improvement. For example, some of our workpapers incorrectly indicated the audit was limited to certain cost categories or to testing of current years. Other workpapers did not present all the evidence available to the auditor. In others, GAO found a lack of an audit trail, and inadequate indexing and cross referencing. Other workpapers did not show appropriate and timely supervisory reviews.

GAO believes the testing of transactions should cover each year of a multi-year audit. For example, GAO was critical of one audit because most of the transactions tested occurred in the final 15 months of the audit period. Another audit was criticized because transactions were tested in only two of three years audited.

It is our policy that our audits shall include appropriate tests of transactions in each year covered by the audit. As for workpaper presentation and documentation, explanations shouldn't be needed here. We all know what is expected. Checklists, such as those found in Audit Instruction D-42, should be useful in assuring adequate workpaper techniques. I also expect close supervisory review on all papers to see that they meet standards!

Concerning the issuance of the same audit report to all Federal funding agencies, the GAO stated that some of our reports to other agencies did not include the same information as that contained in the report to HEW. They concluded those reports were less useful and all potential recoveries were not made. To eliminate the possibility of inappropriate reporting to other agencies, it will henceforth be our policy that on each audit the same report (one report) shall be issued to each Federal agency which provided funds to the auditee.

- All RADs, Key Headquarters Staff, and Assoc. Directors

Two matters of increasing importance - "extended audit procedures", and disclaimers and costs questioned - both related to our inability to render opinions in many University audits. The "accountability gap" created by unauditable University systems is the most serious problem discussed in the GAO draft report. Audits which are able to identify all unallowable costs are obviously more effective than those where the auditor is required to issue a disclaimer of opinion. The inability to render a positive opinion is an outgrowth of our findings that the Universities' systems contained major deficiencies related to the allocation of personal services costs to Federal grants and contracts.

Although we feel that most of the underlying problems are with the Universities' systems, not with the auditors or audit reports, the GAO audit standards require that sufficient, competent, and relevant evidence be obtained by the auditor in order to provide a reasonable basis for his or her opinion, judgments, conclusions and recommendations. The standards also require that in cases where sufficient, competent, and relevant evidence is not available, the auditor must disclaim an opinion and state the reasons why.

It is also important to note that audit reports which disclaim an opinion on costs should contain constructive recommendations to University management, to improve their systems to eliminate the specific deficiencies that caused the auditor to disclaim an opinion to begin with, wherever possible. I would further like to point out that supporting the reasons "why" in disclaimers is as important and, must be as fully documented, as is any recommended financial adjustment or any acceptance of costs claimed by the grantee. Discussions are underway at the present time about imposing penalties on institutions in these situations. Obviously the auditor's conclusion about the disclaimer will be crucial.

Last, but not least, we are continually striving to improve our audit techniques and procedures. The extended audit procedures we have already used include reconstruction of records, interviewing employees, and the like. Our experience to date has been that extended audit procedures do not usually result in sufficient competent and relevant evidence that would enable us to identify unallowable costs in accordance with the GAO standards, despite extensive audit time and effort. Nevertheless, we are continuing to try to develop effective "extended" procedures as recommended by GAO. Some of you have been contacted

- All RADs, Key Headquarters Staff, and Assoc. Directors

for your suggestions and views of possible new ways to "get around" an inadequate accounting system. One trial is already underway in Region I and centers on a highly controlled sampling process combining the best parts of floor samples and periodic "perpetual inventory methods" that have, in differing forms, been in fairly widespread use by independent accounting firms.

Any additional views on this entire paper are most welcome.

E. W. Stepnick

Edward W. Stepnick

cc:

GAO (Mr. Scantlebury)

Addressees:

Mr. Kropatkin
Mr. Beaudet
Mr. Butherus
Mr. Ferris
Mr. Henry
Mr. Lehrer
Mr. Majka
Mr. Wells
Mr. Wilkerson

Mr. Parigian
Mr. Luger
Mr. Rafalko
Mr. Trefzger
Mr. Tenner
Mr. Taylor
Mr. Stanford
Mr. Milner
Mr. Witt
Mr. Sill



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON D. C. 20503

FEB 2 1979

Honorable Elmer B. Staats
Comptroller General of
the United States
General Accounting Office
Washington, D.C. 20548

Dear ~~Mr. Staats~~ *Elmer*:

This is in reply to your draft report, "Need For More Effective Audits of Federal Grants and Contracts Administered by Institutions of Higher Education," submitted to us December 20, 1978.

Like you, we are concerned that Federal audits of universities are falling short of the quality contemplated by your Standards for Audit of Governmental Organizations, Programs, Activities, and Functions. As you know, we incorporated those Standards in our Circular A-73, "Audit of Federal Operations and Programs," and the Congress recently endorsed them in the Inspector General legislation. We intend to follow up with the Department of Health, Education, and Welfare to see what can be done to bring their audits of universities up to the Standards.

We are concerned about the inadequacy of university accountability as reflected in the draft report. We are disappointed to see that some of America's finest institutions of education and research have such lax financial controls. Many of the practices described in the draft report are highly questionable, and will have to be further examined by HEW and other appropriate agencies of the Government.

In the meantime, we are moving to strengthen university accountability by revising Circular A-21, "Cost Principles for Educational Institutions." The Circular has been completely overhauled, based on recommendations made by HEW, after urging by the House and Senate Appropriations Committees. The Committees expressed concern that the existing cost principles were not sufficiently clear to "bring spiraling indirect cost rates under control." We believe the revised cost principles are clear, and that they will significantly improve university accountability. We were

assisted in this revision by extensive public comment, and by consultation with your staff, other Federal agencies, universities, State and local governments, and other affected parties. We intend to work closely with the agencies on implementation, and would welcome the assistance of your staff in this effort.

We appreciate the opportunity to comment on the draft report.

Sincerely,



John P. White
Deputy Director

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