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THE INTERNAL CONTROL CONFERENCE
BY
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INTERNAL CONTROLS IN GOVERNMENT-- ARE THEY GOOD ENOUGH TO PREVENT FRAUD?

I would like to express my appreciation to The Institute of Internal Auditors, its Foundation for Auditability Research and Education, and especially to Bob Richmond for giving me the opportunity to be here this morning. I always welcome the opportunity to address internal auditors for I believe they make major contributions to the efficiency and economy of both our private and public institutions. It is doubly a privilege when the visit gives me a chance to underscore the growing concern the General Accounting Office and the Congress have for effective internal financial controls.

As you are likely already aware, we in the Federal Government have been greatly concerned about fraud, waste, and error in Government programs. We are convinced that more attention must be devoted to stopping these fraudulent schemes and scandals so that the likelihood of recurrence can be reduced.

Internal controls are the first line of defense against such abuses. The lack of good internal controls in any organization---public or private--can lead to intentional or accidental

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misuse of assets. Almost daily, we read about the results of poor systems of internal controls in both the public and private sectors.

Therefore, I congratulate both the Institute of Internal Auditors and the Foundation for Auditability Research and Education for sponsoring this conference. The discussions here should help you and the organizations you represent focus renewed attention on internal controls. I also commend the Foundation's recent research efforts to develop guidelines for evaluating an internal audit function, which we all know is an important element in any system of internal controls.

RESURGENCE OF INTEREST IN INTERNAL CONTROLS

Private and public interest in internal controls has undergone a recent resurgence. This conference as well as others held recently by other professional organizations stresses the need to improve internal controls, and many independent public accounting firms have published guidelines to help their clients assess the adequacy of their internal controls over operations.

The main force behind this renewed interest is, of course, the enactment of the Foreign Corrupt Practices Act of 1977, which provides strong penalties for violators. Not only does the act prohibit corrupt payments but it also contains a section requiring corporations affected by the law to devise and maintain an adequate system of internal accounting controls. To be considered adequate, these controls should be sufficient to ensure that transactions are executed according to management's authorization, that transactions are properly recorded, that access to corporate assets is controlled, and that assets and records will be compared and reconciled at reasonable intervals. Penalties for violations of the act's accounting standards provisions are limited to $10,000 for companies and $10,000 plus 5 years imprisonment for company officials.

Furthermore, the act also has a dramatic impact on auditing. According to the rules proposed by the Security Exchange Commission, independent public accountants would have to express an opinion on the adequacy of the internal accounting controls of an organization as well as on the accuracy of management's statement on the adequacy of these controls. Because management is now required to attest to the adequacy of the internal accounting controls, companies are increasing their internal audit staffs and seeking senior-level internal auditors who can evaluate and certify the internal controls.

Although the Foreign Corrupt Practices Act is limited to the private sector, it has been a factor in the renewed interest in internal controls in the Federal Government. On October 12, 1978, the Inspector General Act of 1978 which established Offices of Inspector General in several major Federal departments and agencies. As explicitly stated in the legislation, one of the major objectives of the Inspectors General is to prevent and detect fraud and abuse in programs and operations.

Unfortunately, the Federal Government has had its share of fraud and abuse. Recently, the General Services Administration has received a great deal of publicity about its problems. However, GSA is not alone; many other Federal departments and agencies have also been victims of fraud and abuse. In a review now underway, we have been astonished to find that a total of 130,000 cases of fraud and related types of illegal acts have been alleged against 21 major agencies in the 2-1/2 years ended March 31, 1979. Individual losses range from under $100 to over $1 million. Some involve Federal employees while others involve grantees, welfare recipients, and contractors. Very little information on these cases is available to Washington-level managers, so we had to go to field offices to get the information we needed.

One well-known example of fraud in the Federal Government involved the Department of Transportation. As you may recall, in 1977 an employee of the Department's Urban Mass Transportation Administration was charged with embezzling $800,000. He was a low level employee in the accounting department responsible for preparing public vouchers which listed the names, addresses, and amounts owed individuals, grantees, and contractors.

Apparently, after preparing the voucher, the employee forwarded it to the certifying officer who would verify its authenticity and correctness. Next, the voucher was submitted to the Department of the Treasury where checks were prepared and mailed to those appearing on the vouchers. The employee knew that the certifying officer did not closely check the vouchers before signing. He also knew that the vouchers didn't have the customary markings that prevent additional entries. Apparently he simply added his own name to the legitimate payees on the vouchers, sometimes before signature and sometimes afterward.

The amounts listed on the vouchers were charged to legitimate accounts and the embezzlement might not have been detected if an alert bank employee had not questioned the sizable Federal checks this individual was depositing in his personal account--those checks ranged in amounts from $55,000 to $315,000. Before he was caught, the individual used much of the money to buy several Lincoln Continentals, and to make personal loans to friends at the Office. One humorous but ironic twist to the affair is that he purchased a bar which the Government became the temporary owner until the employee was convicted and the Government could sell the evidence.

There is little doubt that an embezzlement of this type could have been avoided if established internal control procedures had been effectively followed and if the certifying officer had reviewed the vouchers carefully before signing and had marked them so additional entries could not be made. Furthermore, since the employee in question prepared the vouchers, he should not have had access to them after signature. All signed vouchers should have gone to another individual who would have forwarded them to Treasury for payment.

Another case of fraud in the Federal Government involves an alleged $1.8 million embezzlement of medical care funds. The Federal Government provides financial assistance for medical care rendered by non-Government hospitals and doctors to individuals eligible for Government medical care but who do not have access to Government medical facilities. These include dependents of military personnel on active duty, retirees and their dependents, and dependents of deceased members of the uniformed services.

Because of inadequate internal controls in the processing of claims sent to the Federal Government for reimbursement, an administrator in one foreign country was able to falsify over 3,300 claims forms which he then certified as correct. Later, the claims were paid in full.

The administrator was responsible for processing and approving all claims received from providers of medical services. He would review the claim form to ascertain whether the charges were correct and whether the beneficiary was authorized to receive the care. The administrator also served as the certifying and approving officer for all the claims and as such, prepared another form which certified the correctness of the claim and approved it for payment. Both forms were then forwarded to the Finance and Accounting Office which issued a Government check and sent it by registered mail to the address shown on the claimant's form.

In his position, the administrator was able to instruct hospitals to submit claim forms which left blank section II--the address, the cost of the service, and sometimes the authorized provider's signature. In completing the forms, the administrator claimed inflated amounts and listed mailing addresses that he controlled. He then forwarded these forms to the Finance and Accounting Office. Once the checks were delivered to his mailboxes, he cashed the checks, paid the hospitals the actual cost, and kept the rest of the money.

A thorough investigation revealed that the administrator was able to commit the alleged fraud because he was the only person receiving and adjudicating the claims submitted. He was also the sole certifying and approving officer for all claims, thereby eliminating the standard double check which should be done before submitting the claim for payment. The investigation revealed other management control weaknesses, including

--weak management supervision over the administrator,

--no verification by the Finance and Accounting Office of claimants' mailing addresses, and

--no onsite audit to determine if established procedures existed and if they were being followed.

As important as detection of fraud and abuse may be, detection should not be our primary concern as managers. Our efforts should be devoted to constructing systems of internal control that will prevent fraud and abuse and decrease the likelihood of error and waste. When it comes to fraud and abuse, the old axiom "an ounce of prevention is worth a pound of cure" is most appropriate.

For a moment let us examine some of the benefits of preventing rather than detecting fraud and abuse and punishing those involved. The first thing is the obvious advantage of reducing expenditures. Fraud and abuse always cause an outflow of the dollars that managers are supposed to use sparingly. To the extent we prevent fraud and abuse with good management systems, we stem this source of unauthorized expenditures and thus carry out our stewardship responsibilities more effectively.

However, the loss of dollars--important as that may be--is not the only cost of fraud and abuse. Equally important is the toll in human suffering that occurs when fraud and abuse, or even sometimes errors, are discovered. While it is true that some perpetrators of fraud and abuse are hardened criminals, a great many become criminals when opportunities which they are not strong enough to resist are presented to them. When such persons are caught, they suffer humiliation, they lose their jobs, and frequently are alienated from friends and family. In short, their lives are ruined. Often, they go to prison--which results not only in a high cost in human suffering but a high dollar cost in apprehending offenders and bringing them to trial.

Opportunities to commit fraud and abuse usually present themselves when internal controls that should eliminate such opportunities have not been established; or, if established, have fallen into disuse. If, by establishing good internal controls we can remove the temptation to commit fraud and abuse, we have served not only the organization but also the employee who may be a potential abuser. Even errors can cause extreme embarrassment, and if serious enough, may threaten a person's employment.

HOW GOOD ARE FEDERAL INTERNAL CONTROLS?

While we are not in a position to know the extent of specific control problems throughout the private sector, we do know that internal controls in the Federal Government are in need of immediate and extensive improvement. The General Accounting Office has always emphasized the importance of an effective system of internal controls. Moreover, we have often been appalled by Federal managers' apathy regarding internal controls. While it is true that departmental and agency written procedures usually provide for adequate controls, managers frequently do not require employees to follow those controls, so the result is the same as if no controls existed.

To be specific, over the last 3 years, we have checked internal controls over cash and receivables at 145 fiscal offices of 10 Federal agencies. At these and other agencies we visited in the course of our audit work, we have found a host of problems with internal controls. Here are just a few examples:

--Cash collections are not logged in when received so no one can be sure that all the money is accounted for.

--People who collect cash have access to the accounts receivable records--in other words, there is no separation of duties.

--Collections lie around for days and even weeks before being deposited. Thus, ample opportunity is allowed for someone to lose or misuse the funds, not to mention the lost interest on these funds.

--Limitations on amounts of disbursements that may be made from petty cash are ignored, making embezzlement of large sums possible.

-- Blank Government checks lie around easily accessible to anyone during and after business hours.

--Overpayments to or refunds due from grantees or vendors are not set up as receivables and controlled.

The inadequacy of Federal internal controls was emphasized in our September 1978, report entitled, "Federal Agencies Can, and Should, Do More to Combat Fraud in Government Programs." We attempted to ascertain whether Federal agencies had instituted effective policies and procedures for combating fraud that might exist in their programs, whether committed by Federal employees, by recipients of Federal assistance, or by others. We audited the Departments of Agriculture, Labor, Transportation, and Housing and Urban Development; as well as the Veterans, General Services, and Small Business Administrations.

While there were exceptions, the agencies we reviewed were not doing nearly enough to prevent and detect fraud. Federal programs involving grants, contracts, and loan guarantees are exploited as we found

--false claims are submitted for benefits or services,

--false statements are made to induce contracts or secure goods or services,

--public employees and officials are bribed or otherwise corrupted,

--false payment claims for goods and services that are not delivered, and

--collusion occurs involving contractors.

The extent of fraud against the Federal Government is not known. Hidden within apparently legitimate undertakings, it can go undetected and/or unreported. Opportunities for fraud, however, are tremendous when you consider the number of Federal programs, the inadequate controls in place and the size of the annual budget--currently over $600 billion, a large portion of which is disbursed in the form of grants, contracts, and payments to individuals.

Because of the problems noted in our September 1978 report, I established a Special Task Force for the Prevention of Fraud and Abuse in January 1979, giving it a three-fold mission. First, it was to establish the scope of the problem of fraud and other illegal activities against the Federal Government, and highlight where existing procedures for dealing with fraud are inadequate. This portion of the Task Force's activities has been termed the "Overview Assessment." Second, the Task Force was to offer citizens, nationwide, a toll-free number, which we refer to as the "hotline," to call and report, anonymously if they so desire, instances of fraud or wrongdoing. Third, the Task Force was to conduct an expanded assessment of the adequacy of internal controls at four departments and agencies--the Department of Labor, Naval Material Command, Community Services Administration, and the Small Business Administration. This phase was labeled "Vulnerability Assessment."

Based on the Task Force's work to date, we believe that all the agencies visited are vulnerable to fraud and abuse because Federal headquarters, regional offices, and other field locations, as well as grantees have inadequate internal controls over their operations. During our testing of selected internal control systems, we found Federal funds and equipment had been misused at many locations visited.

We believe that the reason internal control systems are in a state of disrepair is that top management has devoted most of its concern and emphasis to delivering funds and services and that effective controls over tasks and functions which lead to the delivery of these funds and services has had a low priority. Because of top management's insufficient concern for internal controls, middle management reflects this same indifference. That sentiment is passed down to internal audit staffs which have spent little time evaluating the adequacy of internal controls over all agency functions. Furthermore, when internal auditors have reported weaknesses in controls only over the portion of a task or program audited, management has often dismissed these findings as unimportant. This attitude not only precludes corrective action but also reduces the audit staff's concern for internal controls.

Lest I be accused of not considering cost, I want to add here that all controls have to be weighed in terms of cost effectiveness. Overcontrol is certainly a possibility; however, from what our audits have disclosed, I doubt that most Government agencies have much to worry about in that regard--at least for the immediate future.

THE FEDERAL GOVERNMENT HAS DONE MUCH TO IMPROVE INTERNAL CONTROLS

Recently, the Federal Government has taken several steps to improve internal controls, including the establishment of Offices of Inspector General in 14 major Departments and

Agencies; the President's requirement for Departments and Agencies to assess their vulnerability to fraud, waste, and error; and the General Accounting Office's Government-wide study of the causes of fraud and abuse.

On December 13, 1978, the President sent a memorandum on the subject of Federal fraud and abuse to the heads of executive departments and agencies. In that memorandum he asked agency heads to identify programs and activities they deemed most vulnerable to fraud and to deliver by January 31, 1979, a planned approach for preventing and dealing with problems of fraud, waste, and error in these programs and activities. While this is certainly a step in the right direction, due to the short time allowed these assessments were probably too superficial to identify specific internal control weaknesses. This is our conclusion after reviewing the assessments prepared by agencies visited by GAO Task Force auditors.

Our Task Force's work is nearly finished, and I believe the results of this work can make a substantial contribution to the Federal Government's efforts to minimize fraud and abuse. The Task Force will report the results of its audits to the Congress and those results will be made public.

Our work has shown that many agencies share common internal control weaknesses which may indicate the seriousness of the lack of internal controls Government-wide. For this reason, we plan to issue a standard audit package to the heads of all departments and agencies for their use in evaluating their own internal control systems.

In addition to these efforts, I am aware of a bill currently being drafted for the Federal Government which closely parallels the Foreign Corrupt Practices Act. Essentially, it would require agencies to report on the adequacy of their internal control system. Having seen the positive effects the Foreign Corrupt Practices Act has had on the private sector, we support the objectives of the legislation currently being considered.

WHAT MUST STILL BE DONE?

Although many positive steps have been taken and are planned for improving internal controls in the Federal Government, much remains to be done. Present internal controls still cannot prevent or even really minimize the opportunity for fraud and abuse.

The temptation to employees to violate the system must be removed. Top management must instill in all of its employees an awareness of the need to adhere to good internal control procedures and must maintain high ethical standards to serve as an example to its employees. When employees can sense the trust that management has placed in them, they will be less likely to succumb to fraud's temptations and more aware of and sensitive to others' violations of standards. Therefore, management must see that all responsible officials cooperate in following established procedures and, if necessary, setting up new controls and that the personnel resources necessary to keeping them effective are devoted to the task.

Top management also must take the lead in making sure that its auditors concentrate on internal controls. We have always advocated a balanced total audit effort for the Government; balanced between evaluations of agency programs and evaluations of internal controls. Now auditors within the Federal agencies must increase the time and resources they spend auditing internal controls.

There has been much in the media to the effect that society's confidence in Government is eroding. The widespread belief is that Government should and must be run much more efficiently. Establishing and maintaining strong systems of internal control by Federal agencies can go a long way toward achieving responsible Government by minimizing fraud and abuse and by identifying errors that have plagued so many Government programs. Less fraud and error cannot help but make Government more economical and efficient and thus achieve what society expects of us. You may be assured that we in GAO will be doing all we can to bring about that result.