U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF THE FEDERAL ENERGY REGULATORY COMMISSION'S OFFICE OF CHIEF ACCOUNTANT

Report No.: CR-B-95-05
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Capital Regional Audit Office
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DISCLAIMER

AUDIT OF THE FEDERAL ENERGY REGULATORY COMMISSION'S OFFICE OF CHIEF ACCOUNTANT

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OFFICE OF AUDIT SERVICES

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SUMMARY

The Federal Energy Regulatory Commission has the responsibility for ensuring that rates charged by regulated electric, gas, and oil pipeline companies are just and reasonable. The Office of Chief Accountant performs financial related audits of the regulated companies to ensure compliance with Commission accounting, reporting, and rate-making requirements.

The Office of Chief Accountant did not have assurance that audit resources were used in an efficient and effective manner. Specifically, the materiality of expected findings was not considered when determining the extent of audit work to be completed, and some reports were not issued in a timely manner. There were also problems with the accuracy of final reports and the adequacy and completeness of the supporting working papers. These conditions existed because the audit approach did not require an evaluation at the end of the survey on the materiality of expected audit results to determine if the audit should be continued, and there were no established timeframes to issue reports after the field work was completed. Also, the audit process did not ensure that final reports issued were accurate and that the working papers were adequately prepared. We recommended that the Chief Accountant streamline the methods used to perform financial audits and establish timeframes for issuing audit reports. We also recommended that a quality assurance policy be established to ensure accurate reports.

The Office of Chief Accountant agreed with the recommendations and recognized the need for improvements. Management plans to provide guidelines addressing the use of various criteria, including materiality in determining the extent of audit testing. Management also plans to reemphasize the timeliness of reporting and the need to ensure adherence to the auditing standards.

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PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Federal Energy Regulatory Commission's (Commission) mission is to oversee America's natural gas and oil pipeline transportation, electric utility, and hydroelectric power industries to ensure that consumers receive adequate energy supplies at just and reasonable rates. To carry out this mission, the Commission issues regulations covering the accounting, reporting, and rate-making requirements of the regulated utility companies. The Commission's Office of Chief Accountant performs financial related audits at companies to ensure compliance with these regulations.

The purpose of this audit was to evaluate the Office of Chief Accountant's audit performance. Specifically, the objectives were to determine if the most appropriate audit approach was used and if a quality assurance process was in place to ensure reports were accurate and supported by the working papers.

SCOPE AND METHODOLOGY

The audit was performed from April to October 1994. Discussions on the audit process were held with individuals from the Office of Chief Accountant located in Washington, D.C. and the branch office located in San Francisco. We visited four electric utility and gas pipeline companies located in Montana, Massachusetts, Georgia, and Texas; and three related state public utility commissions that shared rate jurisdiction with the Commission for the companies visited.

We reviewed the audit policy and guidance manuals and obtained a list of the 70 reports issued during Fiscal Year 1993. From this listing, we judgmentally selected nine audit reports for a detailed review of the supporting working papers and analyzed the findings to determine their impact on rates approved by the Commission. We did not include the impact on the state rates in our analysis as the Office of Chief Accountant does not cover this area.

The audit was made in accordance with generally accepted Government audit standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objectives. Accordingly, we assessed the significant internal controls with respect to the Office of Chief Accountant's audit process. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. It was not necessary to rely on computer-processed data to satisfy the objectives of the audit.

An exit conference was held with the Deputy Chief Accountant on March 9, 1995.

BACKGROUND

Under the authority of the Federal Power Act, Natural Gas Act, and Interstate Commerce Act, the Commission established requirements for a Uniform System of Accounts. These systems were designed to provide common accounting to all companies in the industry which facilitated rate-making activities and for comparison of industry-wide data. The Commission requires regulated utility companies to submit annual financial filings prepared in accordance with the system of accounts.

Publicly held companies are also subject to Securities and Exchange Commission rules which require independent public accounting firms to perform an annual financial audit of the companies' financial records and provide an opinion on compliance with generally accepted accounting principles. Commission regulations also require the public accounting firms to provide an annual certification that the regulated companies' financial statements are presented fairly and conform, in all material aspects, with the Uniform System of Accounts.

In Fiscal Year 1993, the Office of Chief Accountant issued 70 reports--60 financial audit reports and 10 refund or other type reports--and had a budget of about $6 million. There were 81 employees, of which 59 performed financial-type audits, and four audit branches; three located in Washington D.C. and one located in San Francisco. Audit responsibility for the regulated utility companies was assigned to the branches based on a geographic basis.

As of March 1994, the total audit universe was 485 companies; the number of utility companies has not varied much from year to year. This universe included 125 gas pipeline companies, 207 electric companies, and 153 oil pipeline carriers. Each gas pipeline and electric company was audited on a recurring cycle over a 3 to 6-year period. Most oil pipeline carriers were not audited because they had market based rates.

OBSERVATIONS AND CONCLUSIONS

The Office of Chief Accountant's audit approach did not consider materiality of findings at the end of the survey to determine if the audit should be continued. Also, guidelines were not established on the timeframes to issue the audit reports after field work was completed. As a result, the Office of Chief Accountant did not have assurance that audit resources were used effectively.

Also, the Office of Chief Accountant did not perform an adequate quality review of the final reports prior to their issuance. In some cases, the final reports had incorrect amounts and the working papers did not support the final reports.

The internal control weaknesses related to the quality and performance of audits done by the Office of Chief Accountant should be considered by Commission management in preparing its yearend assurance memorandum on management controls.

The Office of Chief Accountant agreed with our recommended improvements. Part II of this report provides details on our findings and recommendations. Part III of this report includes detailed management and auditor comments.

PART II

FINDINGS AND RECOMMENDATIONS

1. Financial Related Audits

FINDING

Auditing standards require the audit approach to consider materiality when planning the extent of audit procedures and to issue audit reports in a timely manner. However, the Office of Chief Accountant's audit approach did not consider materiality when justifying additional audit work at the conclusion of the survey phase. Also, some audit reports were not issued timely. The planned and actual field work were essentially the same because the audit approach did not include an evaluation of the materiality of expected audit results to determine if the audit should be continued after the survey. Also, the office had not established policies concerning timeframes to issue audit reports after field work was completed. As a result, the Office of Chief Accountant was not optimizing the use of its audit resources and a reduction in financial and compliance audit work may be possible.

RECOMMENDATIONS

We recommend that the Chief Accountant, Federal Energy Regulatory Commission, streamline the methods used to conduct audits of companies' financial information by:

- Performing interim evaluations of audit survey results and curtailing audits not expected to result in material findings affecting utility rates.

- Establishing timeframes for issuing audit reports.

MANAGEMENT REACTION

Management concurred that materiality is important in selecting issues and areas for audit but stated that in some areas considerations other than materiality necessitated audit testing. Management recognized, however, that some efficiencies could be realized in this area and intends to provide additional written and oral guidelines to the staff that addresses the use of the various criteria, including materiality, in determining the extent of audit testing. See Part III for detailed management and auditor comments.

DETAILS OF FINDING

AUDIT STANDARDS

The American Institute of Certified Public Accountants and the Comptroller General of the United States have issued auditing standards that provide guidance for performing audits. The Office of Chief Accountant has adopted these standards with some modification.

Auditing standards define a financial related audit as determining whether financial reports and related items, such as accounts, are fairly presented and the entity has adhered to specific financial compliance requirements. These standards require audit work to be adequately planned and involves consideration of audit objective, scope, and methodology as well as materiality and audit risk. Audit materiality is defined as the weight that evidence plays in influencing the auditor's decision concerning selection of issues and areas for audit and the nature, timing, and extent of audit tests and procedures. Other factors such as results of prior audits, level and extent of other independent reviews, amounts of transactions tested, and changes in operations should be considered when determining audit risk and materiality.

Audit standards also require reports to be issued promptly so that the information is made available for timely use by interested parties. Therefore, the auditor should plan to conduct the audit and issue the audit report with this goal in mind.

AUDIT APPROACH

The Office of Chief Accountant's audit approach did not consider materiality when justifying additional work at the conclusion of the survey phase, and some audit reports were not timely. The Office of Chief Accountant performed financial audits of regulated companies to obtain information on compliance with the Commission's accounting, reporting, and rate-making requirements. In performing these audits, auditors were required to document the end of survey results but were not required to terminate the audit when survey results did not indicate the probability of potential findings with a material rate impact.

Audit Results

The survey process was not used as a decision point to determine whether the materiality of the survey results justified continuing the audit. The Office of Chief Accountant's audit approach involved an initial evaluation of the company operations called a preliminary survey. In certain cases, this survey involved several companies within a corporation that were each subject to the Commission's jurisdiction. The survey included a review of the company operations including the working papers of the prior audit at the company and a review of the independent public accountant's working papers. The survey involved a preliminary review of the individual areas to be included in the audit. The survey results were used to determine additional work needed for the verification phase of the audit and to prepare the audit program for this additional work.

Of the nine audit reports reviewed, three contained findings that had a significant impact on the utility rates that the public pays. The other six reports contained findings on accounting matters that did not have a significant impact on utility rates. For example, on one audit, the company used the wrong account to classify certain construction costs totaling $323,100. The auditors recommended an adjustment to reclassify these costs to the proper account. However, this accounting adjustment would not impact the company's rate structure because it did not change the company's total asset level on which rates were based.

Reporting Timeframes

Audit reports were not issued in a timely manner. The time taken to issue the final report ranged from 5 to 17 months after the end of field work. Five final reports were issued 11 months or more after the field work was completed. For example, the field work on one audit was completed in March 1992, but the final audit report was not issued until May 1993.

AUDIT GUIDANCE

The Office of Chief Accountant did not have audit guidance which included consideration of discontinuing the audit at the end of the survey. Also, the audit approach did not include an assessment of the materiality or significance of anticipated findings to be developed in the verification phase of the audit. We believe the verification phase should be limited to developing findings with a material rate effect identified in the survey phase. Also, the Office of Chief Accountant had not established definitive timeframes to ensure that the audit report was issued promptly.

This practice of not assessing materiality contrasted with the practices followed by public accounting firms. The public accounting firms performed broad scope reviews that considered materiality in making certifications with respect to the regulated firm's financial statements. One certification is that the financial statements filed with the Commission conform in all material respects with the requirements of the Commission as set forth in its applicable Uniform System of Accounts. In all cases where the Office of Chief Accountant performed audits, the public accounting firms had provided this certification.

At the end of the survey, the Office of Chief Accountant determined what areas should be given additional audit coverage but did not terminate audits based on the certification by the independent public accountants or the lack of materiality of the expected audit results. Instead, the audit staff considered the work of the public accounting firms to determine what areas should be given additional coverage. This determination was made to avoid duplication of audit coverage but did not require justification for additional audit work at the conclusion of the survey phase to be based on the materiality of expected findings.

AUDIT RESOURCES

As a result of not requiring justification for continuing audit work at the conclusion of the survey phase, the Office of Chief Accountant was not optimizing the use of its audit resources. Audit resources could be used more efficiently and effectively by assessing the need to continue an audit beyond the survey phase when material findings affecting utility rates are not expected. Also, staff time could be more effectively used if each audit report had an established timeframe against which to track its progress after field work is completed. More effective use of audit resources possibly could result in a reduction of financial and compliance audit workload.

2. Quality Assurance Processes

FINDING

Auditing standards require reports to be accurate and working papers to fully document the basis for auditor's conclusions. However, we found problems with the accuracy of final reports and the adequacy and completeness of the evidence in the supporting working papers. These conditions occurred because the Office of Chief Accountant did not have an adequate process to ensure that final reports issued were accurate and the audit work performed was adequately and completely supported in the working papers. In addition, supervisory reviews did not identify problems with working paper preparation. As a result, audit reports were issued that had incorrect or unsupported amounts.

RECOMMENDATION

We recommend that the Chief Accountant, Federal Energy Regulatory Commission, implement quality assurance policies and procedures to ensure that final reports are accurate and supported by the working papers.

MANAGEMENT REACTION

Management agreed that the audit disclosed one report that contained an incorrect amount and that reasons for modifications to initial audit findings should be documented in the working papers. Management plans appropriate actions to ensure compliance with auditing standards. See Part III for detailed management and auditor comments.

DETAILS OF FINDING

AUDIT QUALITY STANDARDS

The Office of Chief Accountant issued its "Policies and Procedures for the Documentation, Review and Reporting of Audit Results" in August 1991. Included in this manual are the standards for due professional care, completeness and accuracy, clarity and understanding, and appropriateness of content. The manual also describes what should be in the working papers, how the information should be portrayed, and what the audit supervisor's responsibility is once the field work is completed and the auditor-in-charge is no longer assigned to the audit.

DOCUMENTATION OF AUDIT WORK

Our review of nine audit reports disclosed several issues involving the accuracy of the audit reports and the accuracy and completeness of working papers. One report contained a finding with an incorrect amount. The auditors found that the company used the wrong account to classify amortization and depreciation expenses. The draft report contained the correct amount of $795,113 which was supported by the working papers. However, the final report was issued with the incorrect amount of $68,024. We found no evidence that the final report was checked to the draft report or the working papers for accuracy. Included in the audit branch files was documentation from the company highlighting the error. However, a revised report or errata sheet to correct this error was not issued.

Adequacy of Working Papers

Two audit reports had findings that were not supported by the working papers. For example, in one report, the working papers described $136,359 in travel expenses which were capitalized. However, the Office of Chief Accountant and the company subsequently agreed that the amount capitalized should be reduced to $76,870. This revision was included in the final report but was not documented in the working papers. Although the manager was able to explain how this difference occurred, audit standards intend for the working papers to adequately describe the audit results.

In addition, most of the working papers did not contain a purpose or conclusion for six of the nine audits reviewed. The purpose tells why the auditor prepared the working paper and the conclusion tells what was found. Without this information, it is unclear why the working paper was prepared. The lack of purpose and conclusion can lead reviewers to draw wrong conclusions or determine the information does not belong in the working papers at all. On the remaining three audits, we found the working papers generally contained a purpose and conclusion.

Completeness of Working Papers

In four of the nine audits reviewed, findings from the draft reports were deleted from the final report without the reasons being documented in the working papers. The Office of Chief Accountant had a policy statement requiring documentation for withdrawn or modified findings. Depending on when the findings were modified or withdrawn, the reasons should be included in either the working papers or the branch files. For example, one draft report had six findings deleted without the rationale being documented.

QUALITY ASSURANCE REVIEWS

The quality assurance weakness occurred because reports issued by the Office of Chief Accountant did not receive an adequate quality review prior to issuance. There was no process used such as independent referencing to ensure that the numbers and facts in final reports were adequately supported in the working papers. Independent referencing uses an auditor that did not participate in the audit to verify that the working papers support the facts in the final report. If independent referencing had been used, the differences in the figures reported between draft and final reports would have been detected before the report was issued.

There were other quality assurance deficiencies as well. The audit staff did not always follow standards including requirements for a purpose and conclusion on the working papers and did not enforce the requirement to document why findings were modified or withdrawn. Further, supervisory reviews were not identifying and resolving the problems. Future audits generally rely on some of the information in the previous working papers.

IMPORTANCE OF QUALITY ASSURANCE REVIEW

Inaccurate reports can undermine the Office of Chief Accountant's credibility. Unclear or incomplete working papers make it difficult to properly respond to questions raised about a report after it is issued. Also, personnel changes may result in staff not being available to discuss the audit work performed. In performing future audits, unclear or incomplete working papers will hamper the auditor's evaluation of previous coverage.

PART III

MANAGEMENT AND AUDITOR COMMENTS

The Chief Accountant concurred with our findings and recommendations. Management recognized the need for improvements and plans to provide additional guidelines for the issues raised. A summary of management's comments and our responses follows.

FINDING 1. Financial Related Audits

Recommendation 1. Perform interim evaluations of audit survey results and curtail audits not expected to result in material findings affecting utility rates.

Management Comments. Management stated, "...that materiality is important in the selection of issues and areas for audit and the nature, timing and extent of the audit tests and procedures. However, reliance on materiality to the exclusion of other considerations is not appropriate. Some level of testing is usually necessary for sensitive or high risk areas and to meet regulatory objectives irrespective of the materiality of such amounts. For example, the Commission through its orders has indicated that where it has approved rate formulas that permit changes in rates without additional filings, it will require strict compliance with the terms of the formulas. It is the Division of Audits which has major responsibility for reviewing billings made by jurisdictional companies under automatic adjustment clauses and tariffs to ensure they comply with the rate formulas on file and Commission regulations. In order that the Commission can be assured that companies do not abuse their permission to adjust rates automatically and the rates are being adjusted only as the Commission intends, we devote a significant part of our compliance effort in this area."

Management also agreed that it could "...do a better job in some areas in determining whether the results of additional audit work are likely to be a productive use of our limited resources. We intend to provide additional written and oral guidelines to our staff addressing the use of the various criteria, including materiality, in determining the extent of audit testing."

Auditor Comments. Management's planned actions are responsive to the recommendation. While they do not specifically address whether an interim evaluation of audit survey results will be performed, they do indicate that consideration will be given to comparing the expected expense of doing the audit work to the anticipated benefits.

Recommendation 2. Establish timeframes for issuing audit reports.

Management Comments. Concur. Management stated that 6-month and 9-month guidelines are in place for the issuance of uncontested and contested reports, respectively. The guidelines for contested reports have been exceeded in order to resolve disputed matters short of costly trial-type evidentiary proceedings.

Auditor Comments. Management's actions are responsive to the recommendation.

FINDING 2. Quality Assurance Processes

Recommendation 1. Implement quality assurance policies and procedures to ensure that final reports are accurate and supported by the working papers.

Management Comments. Management agreed that the audit disclosed one report that contained an incorrect amount and that reasons for modifications to initial audit findings should be documented in the workpapers. Management stated their written auditing standards stress the importance of ensuring reports are accurate and that the work papers fully document the basis for the auditor's conclusions. Management plans to strengthen existing procedures by using additional steps to ensure all final reports are accurate and complete. Also, management plans to clarify operating procedures to ensure uniformity among staff members in reviewing and documenting the audit work.

Auditor Comments. Management's planned actions are responsive to the recommendation.

Attachment

IG Report No. CR-B-95-05

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