

THE PERFORMANCE POST AUDIT
IN STATE GOVERNMENT:
AN ANALYSIS OF
ITS NATURE, ITS PURPOSE,
AND ITS POSSIBILITY

Thesis for the Degree of Ph. D.
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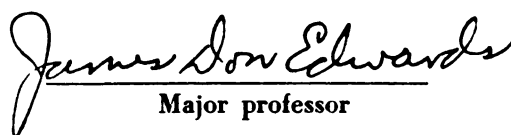
ITS NATURE, ITS PURPOSE, AND ITS POSSIBILITY

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LENNIS M. KNIGHTON

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ABSTRACT

THE PERFORMANCE POST AUDIT IN STATE GOVERNMENT: AN ANALYSIS OF ITS NATURE, ITS PURPOSE, AND ITS POSSIBILITY

by

Lennis M. Knighton

In recent years, almost every state in the nation has undertaken a special study of its post audit program, and two trends have emerged from these studies. The first is a shift from elected auditors or those appointed by the Governor to auditors appointed by and responsible to the legislature. The second is an increased emphasis on broadening the scope of the audit examination, which traditionally has been limited to financial transactions, accounting records, and internal controls.

Michigan, for example, in its 1963 constitution transferred the auditor general from an elective office to one of appointment by the legislature, and it specified that he should conduct both financial and performance post audits. This study is concerned with the latter. Such audits are defined as independent examinations, conducted by the Auditor General, for the purpose of providing the legislature with an evaluation and report of the manner in which administrative officials discharge their responsibilities to faithfully, efficiently, and effectively administer the programs of the state. Faithful performance requires that programs be administered in accordance with executive promises and expressed legislative policy. Effective performance requires that programs achieve their planned objectives. Efficient performance requires that program accomplishment be achieved at a minimum of cost to the state.

An extensive analysis was made of the constitutional convention of Michigan and of the events which preceeded it. It was found that the

provision for a legislative auditor general and that for the performance post audit were inseparably connected. Both were designed to strengthen the legislature relative to the executive, thus restoring and preserving a balance of power in the state. Such strengthening of the legislative branch was necessitated by growth in the size and complexity of state agencies responsible to the executive, which made effective legislative control of state operations a practical impossibility under the existing system.

The role of the auditor in the legislative control system was analyzed, as was the purpose and nature of the control system itself. The performance post audit was found to be an essential and natural part of such a system. An audit of financial affairs alone is inadequate. And to be effective, the performance audit needs the full support of the legislature. Legislative policy must be clearly determined and expressed if faithfulness of performance is to be evaluated. And audit reports and recommendations must be reviewed and enforced by the legislature. Suggestions were made of methods to accomplish each of these items.

If the auditor is to evaluate administrative performance, he must know the areas of administrative responsibility. Therefore, the management function is analyzed. Basically administrators are responsible to plan, execute, and review the programs of the state. Planning includes (1) selecting desirable objectives, (2) programming state activities to accomplish the objectives, (3) identifying relevant standards by which performance may be evaluated in terms of the objectives, (4) assigning responsibility within the organization consistent with programs, (5) developing budgetary and accounting systems on a program basis consistent with the patterns of organizational responsibility, and (6) enunciating executive policies to guide the decisions and actions of operating

personnel. When planning is properly accomplished and management controls are effective, performance will agree with the plans. Consistent with the patterns of state responsibility, the executive must present and justify his program plans before the legislature and report program performance. Finally, he must review performance to determine variances from plans and to take the necessary corrective action. This requires an effective internal audit program.

Finally, an approach to the conduct of the performance post audit is outlined. It consists of five steps: (1) advanced planning, (2) initial survey, (3) evaluation of the management control system, (4) examination of exceptional areas, and (5) the report and recommendations. Major emphasis in the audit is placed upon the management control evaluation. It is not enough for the auditor to report what program performance was during a specified period of time; he must also determine why it was as it was. Thus he must evaluate the adequacy of each element of planning and control to determine the cause of deviations from expectations. Only then can the legislature or an executive official take appropriate corrective action.

This study is primarily a theoretical analysis of the performance post audit, based upon conditions as they exist in the states today and upon the consensus of opinion of leading state and national officials and other noted authorities throughout the country. Its conclusion is that a performance post audit is not only meaningfully possible; it is essential to the continued vitality of state government as known in the United States today.

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CHAPTER I

INTRODUCTION

Purpose of the Study

On April 1, 1963, the citizens of Michigan approved a new constitution which became effective on January 1, 1964. Article IV, Section 53 of the new constitution states in part:

The legislature . . . shall appoint an auditor general, who . . . shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.¹

This constitutional provision is singularly significant in that for the first time in the history of any state in the United States the requirement of a performance post audit is given constitutional recognition and sanction. The purpose of this study, is to provide an analysis of the nature, the purpose, and the possibility of such an audit in state government.

A "performance post audit," as defined in this study, is an independent examination, conducted by the auditor general, for the purpose of providing the legislature with an evaluation and report of the manner in which administrators of the agencies and departments of the state have discharged their responsibilities to faithfully, efficiently, and effectively administer the programs of the state. Faithfulness refers to

¹For a full text of this constitutional provision, see Appendix A.

whether or not programs have been administered in accordance with promises made to the legislature and the expression of legislative will. Effectiveness refers to whether or not planned program objectives have been achieved. And efficiency refers to whether or not program accomplishment has been achieved by using the least-cost combination of resources and with a minimum of waste.

Importance of the Study

In the last twenty five years, the United States has experienced a period of unprecedented growth in both the size and the complexity of state governments. Due to bulging populations and changing social and economic standards, state agencies have faced increasing demands for their services, particularly in the fields of education, public health, and social welfare. And the future shows no sign of a change in this growth trend.

Along with this growth has come the need for bold new concepts and methods for conducting state affairs, both for administrative officials and for the legislature. No longer are the methods which were used a generation ago applicable or adequate. And particularly is this true in the area of state post auditing.

Traditionally state post audits have been limited primarily to examinations of financial transactions and internal controls to determine that funds have been legally and honestly spent. Such an audit is certainly important. But it is far from adequate to meet the needs and purposes of the legislature, which has the responsibility not only to pass laws, to approve programs, and to authorize the expenditure of funds, but also to review administrative performance and to determine that the laws and programs are administered in the public interest.

Likewise, without a more comprehensive review and appraisal of the programs and activities of the agencies, even executive officials cannot know whether their decisions are being implemented adequately and whether programs are achieving the desired results.

Recognizing this problem, almost every state in the nation has, in the last decade, undertaken a study of the adequacy of its post audit program. The result has been a wide-spread shift from the use of elected state auditors, or those appointed by and responsible to the Governor, to the establishment of a legislative post audit system, where the auditor general is appointed by and responsible to the legislature. One of the purposes of this shift has been to make the auditor more independent of the executive branch of government. But equally important has been the objective of having an auditor capable and authorized to conduct audit examinations more in keeping with the needs and desires of the legislature. This objective is no better illustrated than in the provision of the Michigan Constitution quoted above.

Yet in spite of the fact that numerous individuals have noted the desirability of such an audit system, no one has yet undertaken a study to determine what guidelines should be used in conducting such an audit. Neither has anyone defined the nature of the auditor's responsibility as part of the legislative control system or identified the relevant areas of management responsibility properly subject to such an audit review. Without such a study, an orderly approach to the conduct of the audit is impossible.

Also, at the present time, exactly half of the fifty states in the nation have legislative auditors, most of them having been established within the last ten years. And at least a dozen more states have taken steps to move in that direction. No doubt others will follow later.

The importance of this study, therefore, is not limited to the state of Michigan, but rather it extends to every state which now has or which may in the future have a legislative post audit system in which the responsibilities of the auditor general either permit or require a comprehensive approach to auditing.

The Hypothesis

It is the hypothesis of this study that a performance post audit is not only meaningfully possible; it is essential to the continued vitality and effectiveness of state government as known in the United States today. Moreover, such an audit is an essential element of a legislative control system, and therefore it is a logical and natural responsibility of an auditor general responsible to the legislature.

It is further the hypothesis of this study that such an audit is greatly facilitated by the existence of an effective management control system, including program planning, program budgeting, program accounting, and comprehensive internal audits; however, even in the absence of such a control system, performance post audits are still meaningfully possible.

This hypothesis is confirmed in the development of this study.

The Methodology

The research methodology used in this study consisted of the following six parts.

1. An extensive survey was made of the literature in the fields of accounting, public administration, and other related areas. The purpose of this survey was to gain familiarity with current thinking on the subject of state post auditing, to determine what research had already been done in this and related areas, and to obtain information

and insights into the various processes of state government.

2. An extensive investigation was made to ascertain clearly the intent of the Michigan Constitutional Convention when it passed the provision quoted above. First, the official record of the convention was reviewed in detail and copies of all major studies and reports to the convention which in any way related to this subject were obtained and examined. Second, personal interviews were held with principle delegates to the convention who were responsible for introducing and promoting this provision in the convention. Finally, interviews were held with state officials, research consultants, and other persons in the state who were interested and active with the convention proceedings at that time.

3. One of the early steps in this study was to review all materials gathered or prepared by the office of the Auditor General in Michigan which related to this subject. Subsequent reports and statements by that office have also been examined. In addition, personal visits have frequently been made to that office to discuss these problems with the Auditor General, his deputy, and other members of the staff, and to review with them not only their own experiences and thinking but also some of the concepts and findings of this study.

4. Personal visits were made to California, Illinois, New York, and the General Accounting Office in Washington, D.C. In each instance, interviews were held with top audit officials, and reports and audit manuals (when they existed) were examined and discussed. The purpose of these visits and interviews was to become familiar with the development of audit policies and procedures in each of these states and in the Federal Government, and to discuss with these officials some of the concepts and theories developed in this study. Each of the states

selected is noted throughout the country for its audit program.

5. Contact was made either by personal visit or by mail with other leading state, local, and national authorities throughout the country to obtain their opinions on selected items in this study and to acquire copies of research studies and other relevant reports on the subject of post auditing in the states. Included in this group of authorities were the auditors of Colorado, Hawaii, New Mexico, Maryland, and Texas; research groups in New York City, Montana, Washington (state), Kansas, and Chicago; members of the Bureau of the Budget in Washington, D.C. and in Michigan; and leading authorities in governmental accounting and auditing in the public accounting profession.¹

6. Selected audit reports were obtained and/or reviewed to obtain a better understanding of state auditing problems and to determine the type and scope of audit reports as presently prepared by the following states: Michigan, California, Illinois, New York, Texas, Colorado, and Hawaii. Several reports from the General Accounting Office were similarly reviewed.

From the six steps above, some important elements of the performance post audit system have been identified, some conclusions concerning the approach to the audit have been reached, and a theoretical description of the nature, the purpose, and the possibility of the audit has been developed in this study.

The Scope of the Study

The subject of performance auditing is indeed a very broad and comprehensive area for research. Thus it was necessary to restrict the

¹A list of the interviews held and the printed materials received which were helpful and significant in this study is contained in the bibliography.

scope of the study in order to insure that a meaningful contribution could be made and the objective of the study achieved.

The study is designed to provide a theoretical analysis of the nature, the purpose, and the possibility of performance post auditing in the state. This analysis is based upon empirical facts, established patterns of responsibility, and the consensus of opinion of the authorities contacted in this study.

This study is not designed to serve as a guide for the establishment of a legislative control system, although such a system is described and analyzed in order to define the role and the responsibility of the auditor general in that system and thereby determine the purpose of the performance post audit. Likewise, in the discussion of administrative or executive responsibility, the concepts of planning, programming, performance standards, program budgeting, program accounting, and other related areas are discussed. But again, this study is not designed to serve as a guide to programming or to any other of these items, but only to describe them in theoretical terms and to identify their functions and characteristics so that the auditor will understand them when he reviews and evaluates them as part of the management control system.

Also, the discussion of the conduct of the audit itself is necessarily general. It is designed to identify the basic approach to the audit, not provide a detailed step-by-step procedure. To become more specific would require an analysis of individual and specific agencies or departments, and this is not within the design of this study.

Finally, this study is limited to an analysis of state auditing systems. Many of the concepts and policies described herein may prove useful to auditors in other governmental audit groups, but they have not been developed for that purpose. Likewise, these procedures relate

only to audits of the departments, agencies, or other organizations of the state, and not to county audits, tax audits, or any other type of special investigation.

Organization

This study is divided into six chapters, each with a specific purpose and an important contribution. The subjects discussed in each of the chapters have been arranged in a logical order so that basic building blocks needed in the theoretical development of later chapters are themselves developed in the earlier ones.

In the chapter which follows, the fundamental relationships and historical trends that characterize state governments in the United States today are outlined, and the events and circumstances leading up to the Michigan Constitutional Convention are described. The constitutional provision requiring performance post audits is then analyzed in light of these trends and relationships to determine the clear intent of the convention when it adopted this unique provision.

Chapter III describes the legislative control system of which the auditor general is a significant part. All elements of the control system having important bearing on the ability of the auditor to conduct a meaningful audit and to make an effective evaluation of the quality of administrative performance are discussed. Likewise, the need for effective review and enforcement of audit recommendations and reports is noted, and suggestions are made of ways in which this can be done. The most significant contribution of this chapter, however, is the development of the role of the auditor general as a part of the legislative control system and the identification of the implications of that control system for the conduct of the audit.

In Chapter IV the subject matter of the audit is developed. If the auditor is to examine and evaluate administrative performance, he must know what are the areas of administrative responsibility to the legislature and which of these areas are legitimately subject to performance post audit review. Furthermore, the auditor must know what constitutes acceptable performance in each of the areas which he is expected to evaluate before he can judge the quality of performance. This chapter is an attempt to develop the area of administrative responsibility with these purposes in mind.

Chapter V is a description of the approach to be used in conducting the audit. The approach described is a theoretical approach based upon the material developed in the preceding chapters. Moreover, it is one which can be used regardless of the state of the development of the management control system, and it is specifically designed to test those areas which most affect the efficient, effective, and faithful conduct of state programs.

Finally, Chapter VI summarizes the contributions of the study and provides some recommendations and suggestions for both the researcher who wishes to pick up the torch and continue the study and development of these important concepts and problems and for state auditors who are faced with the practical problems of implementation of the audit approach described.

CHAPTER II

THE BIRTH OF PERFORMANCE POST AUDITING

Introduction

The idea of a performance post audit, while unique to the Michigan constitution, did not suddenly appear on the scene nor was it something which just happened to catch the fancy of the convention delegates. Rather, seen in its proper context, it becomes clearly a natural consequence of the major developments and trends that have recently occurred in state government. And far from being a threat to existing power structures in government, this audit is as an important tool in the preservation of the democratic state system. This chapter will examine the background of events leading up to this provision, and will point out important implications of performance auditing as it relates to the system of government used in the United States.

Separation of Powers

The doctrine of the separation of powers is as old as democracy, and it forms the foundation upon which all state governments in the United States are organized. The division of power into the legislative, executive, and judicial branches of government constitutes a fundamental part of American constitutional theory and practice. Under this principle, a broad system of checks and balances has been established in each of the states to insure that one branch of government does not assume excessive power relative to the other two branches. This system of checks

and balances is clearly portrayed in the budgetary process, and it is from this system of basic and fundamental balance-of power relationships that the need for and the purpose of performance post audits is born.

The Budget Cycle

The importance of this power relationship is clearly demonstrated in the budgetary process in what has been termed "the budget cycle." Basically, this cycle consists of four parts--budget preparation, budget authorization, budget execution, and performance review or audit.¹ And although budget procedures vary widely from state to state, these four steps are generally characteristic of the process.

The first step consists of all of the methods and procedures used in compiling the budget request in the executive branch of government. It includes the determination of priorities of programs, the adoption, deletion or modification of activities within each agency and department, and the setting of over-all budgetary policy by the Governor and his staff. It further includes the defense and justification of proposals before the legislature.

The second step is legislative. It consists of the enactment into law of the programs proposed by the Governor and the appropriation of funds sufficient to carry out the programs enacted. In this step, the legislature has complete freedom to amend, delete, modify, or add to the programs and budgetary requests of the Governor; and in the process of the hearings both on programs and on fiscal matters, and in the language of the laws and appropriation bills themselves, the legislature is able to express its intent and dictate its policy for execution.

¹Jesse Burkhead, Government Budgeting, (New York: John Wiley & Sons, Inc., 1956), p. 88.

The third step is budget execution, and the responsibility for this execution centers primarily in the executive branch. The degree of discretion allowed the department or agency heads in the execution of the programs may be broad or narrow, and if not specified constitutionally, is generally subject to legislative modification and review. In either case, the executive is generally held responsible to the legislature for the proper expenditure of funds and implementation of programs as set forth in the laws of the state.

The final step is the audit, and on this step there has always been much confusion in state government. The purpose of the audit is to review the execution of the budget as approved by the legislature. The nature and purpose of this review together with the function and authority of the auditor is the subject of this study.

Patterns of Responsibility

This cycle or system of budgeting suggests two significant generalizations concerning the distribution of state responsibility.

First, this system has developed as an instrument or means of democratic control over the executive. By requiring that the executive obtain from the legislature both the authorization for programs and the appropriation of funds, the executive is prevented from imposing willful and arbitrary taxes upon the people and from dictating programs at his own will. As Burkhead notes, "The budget is an expression of ultimate legislative authority."¹

Second, a dual responsibility on the part of the executive is implied by this system. The first involves a line of administrative responsibility running from the executive to the administrative agencies. It requires

¹Ibid., p. 83.

that the executive be charged with the general supervision of administrative affairs and that his authority be sufficient to enable him to control administration. The Hoover Commission, for example, said, "Responsibility and accountability are impossible without authority--the power to direct. The exercise of authority is impossible without a clear line of command from the top to the bottom, and a return line of responsibility and accountability from the bottom to the top."¹ In the absence of such authority, it is impossible for the chief executive either to prepare and propose a meaningful financial plan or to implement and execute such a plan if adopted by the legislature.

Another line of responsibility runs from the executive to the legislature. This responsibility is explained by Burkhead as follows:

In every democratic government the legislature may approve or reject the proposals of the executive; in some governments the legislature may also modify executive proposals. In the exercise of this authority the legislature must be able to hold the executive accountable--both for the execution of last year's financial plan and for the comprehensiveness of this year's program.²

Within this two-way pattern of responsibility, the question of the location and responsibility of the auditor become vitally important. Before turning to this problem, however, it will be helpful to look at some historical trends and developments in state government.

Implications of Growth in Government

Over the past half-century, both the size and the complexity of government activities have vastly increased. The consequences of this growth have important implications in this balance-of-power relationship.

¹Commission on the Organization of the Executive Branch of Government, General Management of the Executive Branch (Washington, D.C.: Government Printing Office, 1949), p. 1.

²Burkhead, op. cit., p. 84.

First, it is important to recognize that an increase in the size of government activities is almost synonymous with an increase in the size of the Executive branch of government. As new programs are instituted or old programs expanded, the work of the legislature is certainly increased. But the major impact is felt in the establishment of new executive agencies to administer the programs or in the expansion of present agencies and departments. It is the responsibility of the Executive branch to administer the programs, and it is precisely in the administration and implementation of such programs that these growth pains are felt most keenly.

Second, it must be recognized that the larger the executive branch of government becomes and the larger the budget it has to work with gets, the more powerful the executive becomes relative to the legislature. When programs are few and reasonably simple, it is not difficult for legislators to keep a close watch on the activities and administration of departmental programs. When it becomes evident that budget execution has deviated or is deviating from the policies as set down by the legislature, legislative investigations and hearings can quickly and effectively establish responsibility for such deviation, and appropriate action can be taken to insure future compliance. But when programs number in the hundreds or thousands and budgets run in the billions, the possibility of close legislative control over executive operations is lost. As a consequence, much of the legislature's work in budget authorization becomes an analysis of changes or additions to existing programs, and seldom if ever are major established programs called into serious question. To a great extent, state legislatures have over the years come to be rubber stamps for executive requests.

A third and perhaps an even more important trend in the power relationship

in state government has been the explicit granting of additional powers to the chief executive to enable him to administer the broader programs as enacted by the legislature. One of the primary objectives sought in the Michigan constitutional convention, for example, was a clarification of the authority and responsibility of the Governor and other executive officials and the consolidation of the numerous state agencies into a few major departments where programs could be administered and controlled more effectively.¹

One of the major recommendations generally made by constitutional authorities to strengthen administrative leadership is the establishment of a department of administration. For example, Lambert says:

As an aid in providing administrative leadership, the governor should be served by a department of administration headed by a chief director and composed of such divisions as budget, personnel, planning, purchasing, accounting, and preauditing, each headed by a director. Since they will work in an intimate relationship with the governor, the chief director and the division directors should be appointed by the governor (without senatorial confirmation) and should serve at his pleasure.²

This recommendation is always made with the view of strengthening the governor by giving him power sufficient to provide more effective leadership in state government. Yet, as Lambert notes, when the powers of the executive are increased and expanded, the question arises; "Will a governor with such powers be controllable by anything other than his own character and personal integrity? Will such a concentration of authority in one office affront our concept of limited government?"³

¹Michigan, Constitution, Art. 5, sec. 2.

²Louis E. Lambert, "The Executive Article," Major Problems in Constitutional Revision, ed. W. Brooke Graves (Chicago: Public Administration Service, 1960), p. 195.

³Ibid., p. 197.

Executive Accountability

"Power and strict accountability for its use," said Woodrow Wilson, "are the essential constituents of good government."¹ This concept is very fundamental to students of constitutional development in the United States. Seldom can one find a recommendation for improving the power and control of the chief executive without some mention of the need for also insuring that he be held accountable for the increased authority.

The first and most important curb on the executive is the power of the legislature. Yet, as pointed out by the Citizens Research Council of Michigan:

There has been little . . . emphasis on the creation or improvement of legislative tools to enable the legislature to keep abreast of developments in the executive branch, in order to make prudent legislative policy with respect to it. While it is not intended here to suggest that the legislative branch should keep pace with the executive branch in growth of personnel and expenditures, it is clear that the expansion and increasing complexity of the executive branch challenges the legislature's ability to maintain its role as a separate and equal branch of government exercising effective checks on the executive branch.²

It is the general recognition of this dilemma which has caused authorities to turn to the post audit function as the one tool still available to the legislature to insure executive compliance with the legislative policies and to hold administrative officials accountable for their conduct. And at this point it becomes clearly apparent that if the auditor is to fill this important role in the legislative-executive power relationship, some important modifications are necessary in traditional government auditing procedures. In addition, the location of the auditor in the structure of state government is of critical importance.

¹Woodrow Wilson, Congressional Government (New York: Meridian Books, 1956), p. 187.

²"A Legislative Auditor General," Council Comments, No. 728 (Lansing, Michigan: Citizens Research Council of Michigan, February 7, 1962), p. 1.

Choosing The State Auditor

There is a variety of methods of appointing or electing state auditors, but for the most part, they can be lumped into three categories: those appointed by the Governor, those elected by the people, and those appointed by the legislature. The arguments for and against each of these methods will be examined in light of the above discussion and the nature of the auditor's responsibilities.

The Executive Appointment: Although a few states continue to use this system of choosing a state auditor, it finds little acceptance in theory. It clearly violates the concept of independence in that it requires the auditor to audit the work of the man who employs him. And even though the personal character of the auditor himself may never be questioned by the legislature, it is difficult to see how an effective evaluation of executive activities can be made in a manner wholly acceptable to the legislature unless more independence is provided. Perhaps the one case in which this system seems to have worked fairly well in spite of this weakness is in the General Accounting Office, but critics are unanimous in their agreement that this is one provision which ought to be changed.

The Elected Auditor: Still the most widely used method of choosing the state auditor, this method has also fallen under heavy criticism in recent years. Proponents of this method claim that one of its advantages is that it provides more "dollar honesty" in government, since the auditor general must return regularly to the people who can judge the adequacy of his performance and hold him responsible for any irregularities.¹ Furthermore, by making the auditor directly responsible to the people,

¹For example, see the minority report recorded in Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 1673.

he supposedly is not subject to as much influence by the Governor or the legislature as might otherwise be the case.

The problem with these arguments, however, is that they fail to recognize that the people have no way of judging the performance or competence of the auditor. The Citizen's Research Council of Michigan reports, for example, that tests made in Michigan when Michigan had an elected auditor general showed that "less than one percent of a sample of voters selected the auditor general as an officer best known to them, and that only two percent could name the occupant of the office."¹ Furthermore, this lack of voter familiarity with the incumbent auditor general may well be an incentive for him to seek sensational news through questionable tactics of investigation and reporting just prior to election time in order that people may know who he is and recognize that he is doing something. It is a well-known fact that in our society a routine audit where findings confirm full compliance and proper reporting on the part of an agency is hardly the kind of report likely to bring personal fame and popularity to the auditor.

Perhaps an even more important point, however, is the fact that an elected state auditor is virtually independent of the legislature, while it is the legislature which has the greatest need for the function which the auditor performs--the post audit of executive activities.

Thus, neither the elected auditor nor the auditor appointed by the executive are acceptable arrangements in the context in which we are considering them. In commenting on these two methods, John P. Wheeler of the National Municipal League explains:

". . . The demands of the short ballot principle would be reason enough to disparage the election of an official with as

¹"A Legislative Auditor General," op. cit., p. 3.

technical an assignment as that of auditor. His appointment by the executive is indefensible as the primary responsibility of the auditor is to render an independent review of the activities of the executive branch.¹

The Legislative Auditor: One cannot survey the literature nor visit with constitutional authorities without being impressed with their unanimity of opinion in favor of a legislatively appointed state auditor. The National Municipal League, for example, says unequivocally, "A post auditor should be appointed by the legislature and accordingly should report to that body."² The Citizen's Research Council of Michigan concluded in its study that "the legislative function can become uniformly effective only if all of the post-audit function is made a legislative responsibility."³ Likewise, the Model Constitution contains the suggested provision that "the legislature shall appoint an auditor . . .," and in the discussion which follows, the comment is made that "the auditor should, of course, be directly responsible to the legislature and be chosen by that body."⁴ This has also been the unmistakable conclusion of every other study dealing with this problem which has been reviewed in the research for this thesis.⁵

In view of the above discussion of the separation and balance of power concepts and in light of the patterns of responsibility implied

¹John P. Wheeler, Jr. (ed.), Salient Issues of Constitutional Revision (New York: National Municipal League, 1961), p. 146.

²Ibid. ³"A Legislative Auditor General," op. cit., p. 2.

⁴Model State Constitution (6th ed.; New York: National Municipal League, 1963), p. 62.

⁵For another vigorous defense of this position, see Harvey Walker, "The Role of the Legislature in Government," State Government (Spring, 1960), pp. 96-102.

by those concepts, it is certainly not difficult to understand why such an unanimity of opinion exists on this subject. The desirability of a legislatively appointed auditor becomes even more apparent when one remembers that the responsibility and authority of the auditor general cannot be defined apart from the type of audit he is expected to conduct.

Traditional State Audits

Traditionally state auditors have been primarily concerned with the legality of expenditures and the honesty of fiscal affairs. One writer, for example, declares that "when properly used, the term 'auditor' designates a public official responsible for determining the fidelity and legality of the manner in which money has been spent," and he emphasized the words as quoted.¹ Speaking before the annual convention of the National Association of State Auditors, Comptrollers and Treasurers, Billie S. Farnum, who at the time was the Auditor General in Michigan, explained the situation in these words:

Scrutinizing the handling of public funds seems to have become an ingrained habit and tradition of the state auditor. He has been preoccupied with following the trail of cash, in one door and out another; from hand to hand and from pocket to pocket. With an eagle eye he has followed the paper trail wherever it has led. Were all receipts properly accounted for? Was the expenditure authorized? Were the proper signatures on the authorized documents in the right places? In the end, were all expenditures made according to legal authorization? These are the questions and the problems with which state auditors have been chiefly concerned.²

It is obvious that such an audit is not sufficient to meet the needs of the legislature for an objective appraisal of executive performance.

¹Russell W. Maddox and Robert F. Fuquay, State and Local Government (Princeton, New Jersey: D. Van Nostrand Company, Inc., 1962), p. 391.

²Billie S. Farnum, "Performance Auditing," an address presented to the Annual Convention of the National Association of State Auditors, Comptrollers and Treasurers, November, 1964. (processed)

If the executive is to be held truly accountable to the legislature as required under the present system of government, the report of performance and the audit of executive activities must clearly go beyond a statement that the funds were spent legally and honestly. One authority explains it this way:

The post-audit function is crucial not only to insure honesty among administrative officials but also to insure that officials of the executive branch have made their expenditures in line with policies established by the legislature.¹

Truly there is a vital need in state government for a legislative post auditor with powers broad enough to conduct not only financial audits, as has been done in the past, but also to render a report on executive performance and compliance with legislative policies. And to some this may seem to be a point of minor significance, yet it represents in fact a major change in the perception of the role of the state auditor and his authority in state government. Every state in the nation is currently faced with growth problems and the resulting shifts in the balance of power between the legislative and the executive branches of government, and most are trying to improve the situation and preserve or restore that balance while maintaining a powerful and effective chief executive. But the state of Michigan is the only state which has recognized in its constitution the need for a legislative auditor general with explicit powers to conduct such "performance post audits" of the executive agencies and departments.

In the discussion of the development of this provision of the Michigan Constitution which follows, it will be noted that the arguments and explanations given to support this provision were for the most part identical with those already discussed. Thus, while Michigan has a unique constitutional

¹Model State Constitution, op. cit., p. 62.

provision, it has not been alone in its recognition of these problems or in suggesting such a solution. It has, however, given constitutional birth to the expression "performance post audit."

Michigan History

Since its inception as a state in the union, Michigan has always had an official of the state bearing the title of Auditor General.¹ The first state constitution, adopted in 1835, provided for an auditor general and specified that he should be appointed by the Governor subject to the advice and consent of the state Senate to a two-year term of office. In 1849, however, this provision of the constitution was changed and the auditor general became a state officer to be elected along with the Governor and other state officials in popular state elections, and this system was continued unchanged in the constitution which was adopted in 1908. Thus, for 115 years Michigan elected its auditor general.

From time to time over the years, special commissions and research groups conducted studies of Michigan government and made recommendations for changes and improvements. Perhaps the most extensive of these studies, and certainly the one with the greatest impact prior to the constitutional convention in 1961, was known as the Little Hoover Commission study made in 1950 and 1951. This study occurred immediately following the report of the first Hoover Commission report to the Congress of the United States in 1949,² and undoubtedly the federal report had considerable influence on the state study.

¹For a summary of this history, see: Staff Report to the Michigan Joint Legislative Committee on Reorganization of State Government, General Management of Michigan State Government, Report No. 30, Part II (November, 1951), pp. 55-56.

²The Hoover Commission Report (New York: McGraw-Hill Book Company, Inc., 1949).

Out of this study came several important recommendations, one of which was directly to the point of the subject being discussed here. In its study on the legislature, this commission made the following comment:

Because the appropriations process involves the determination of policy, it is necessary that the legislature hold the executive responsible not only for the honest expenditure of all funds but also the efficient use of public money in accordance with policies prescribed by law. This is known as an operational audit or a performance audit, and it too should be undertaken by a staff responsible to the legislature.¹

Following from this observation, the commission recommended "strengthening the legislature's means for effective control, particularly through establishment of a legislative auditor general to be appointed by and responsible to the legislature" whose responsibility it would be "to undertake performance as well as fiscal audits of all state agencies." Such an auditor, the commission argued, would "equip the legislature with its own means to hold the executive branch responsible for the execution of the program prescribed by the legislature."²

This seems to be the first appearance of the term "performance audit," and there are some who feel that it was coined from the term "performance budget" as used by the first Hoover Commission in 1949. Whether or not that is true is unimportant. What is important is the recognition of a need for something more than a fiscal audit, and this the commission designated as a "performance audit." The purpose of the performance audit is to provide the legislature with an appraisal of executive performance, and in that sense the term seems entirely appropriate.

Furthermore, it is significant that the commission also called for an auditor responsible to the legislature, for as noted above, these two

¹Staff Report to the Michigan Joint Legislative Committee on Reorganization of State Government, The Legislature, Report No. 11, (March 1951), p. 5.

²Ibid.

concepts both stem from the same underlying considerations and needs in the legislative-executive framework. On this particular point, the commission specifically declared that "the plain fact is that if any semblance of balance between the legislature and the executive is to be retained, the Michigan legislature must be greatly strengthened in its operations."¹

It is significant also to note that the term "efficient" was used in the commission's recommendation. In another report the commission commented:

Audits should not only be concerned with legal compliance and fidelity but with efficiency as well. Efficiency of administration means not only that the activities are carried on at the lowest possible cost. It means also that the state is collecting all of the money to which it is entitled.²

These quotations are significant in that from them and others like them in the commission's reports came the ideas that eventually resulted in the constitutional provision.

Other than the Little Hoover Commission reports, the only mention of performance auditing in reports used by the convention appears in two brief reports made by the Citizen's Research Council of Michigan, and in both cases, the similarity of these reports with those of the staff report are striking. In the first, which was titled A Primer in State Government Organization in Michigan, a brief and surprisingly simple argument was advanced calling for a clearer designation of executive responsibility and accountability, and the explanation was made that under the system then in operation in Michigan, the legislature had "little means of checking into the way in which laws were being carried out by executive agencies." The solution to this problem, the council declared, was to "give the legislature authority to appoint a legislative auditor to oversee how well state

¹Ibid., forward.

²Staff Report on the Michigan Joint Legislative Committee on Reorganization of State Government, Revenue Administration, Report No. 6 (December 1950), p. 15.

laws were being administered, and to make fiscal and performance audits of state agencies."¹ And then in summing up its argument, the council made this significant statement:

The executive should have the tools and the responsibility. Your legislative representatives should have the co-equal power to see that what is being done is what should have been done, in order to provide the results sought by checks and balances.² (emphasis in the original)

In the second publication of the Citizens Research Council, titled A Legislative Auditor General, the Council briefly discussed a few of the arguments in favor of having the auditor general responsible to the legislature and then set out a classification of government audits, and in doing so, described the "performance audit" in language almost identical to that of the Little Hoover Commission as quoted earlier.³

A final report which seems to have had some influence in the constitutional convention is an article titled "The Auditor General of Detroit," which says in part:

The Office of the Auditor General should be given power to investigate the results of operations and the details of administrative practices to such an extent and in such cases as the Auditor General deems advisable. . . .Post-auditing, even when restricted to financial transactions and position, inherently is a review of the results of administrative performance.⁴

The Michigan Constitutional Convention

With this background of constitutional theory and historical developments, one is prepared to look at the constitutional convention in context with the events and circumstances in which it occurred. In doing so, it

¹A Primer on State Government Organization in Michigan (Lansing, Michigan: Citizens Research Council of Michigan, October 1960), p. 18.

²Ibid.

³"A Legislative Auditor General," op. cit., p. 2.

⁴Ralph W. Michener, "The Auditor General of Detroit," GRA Reporter, Vol. 3, No. 9, (January-February 1959), p. 2.

is important that one remembers that the provision within the constitution concerning the office, power, and duties of the Auditor General is but one of hundreds of matters treated in the constitution, and as judged by the limited research and debate on this provision, it must have been regarded as one of the less controversial issues of the convention. It is doubtful that most of the delegates gave more than a cursory review to this provision, and no major study was made on this subject by the convention or any of its committees. A few members, however, took a very keen interest in this provision, and one of those who did was John B. Martin, a former Auditor General in Michigan and the chairman of the Committee on the Executive Branch in the convention.

In discussing the history of the convention, it is not the purpose of this study to describe the mechanics or chronological history of the various aspects of this provision. Rather an analysis will be made of the supporting arguments to determine the intent of the convention delegates who supported the various aspects of this provision. Many of the minor details are necessarily omitted in the discussion, and numerous speeches and arguments are ignored since they add nothing to the committee explanations or those of other delegates used in this discussion.

The Initial Proposal

The initial proposal to the convention on this subject was submitted by Eugene G. Wanger and Walter DeVries, and it proposed in part that "the legislature . . . appoint an Auditor General who . . . shall conduct comprehensive post-audit investigations, . . . into all matters relating to . . . public funds, including the efficiency and legality thereof. . . ." ¹

¹Eugene G. Wanger and Walter DeVries, "A Proposal to Create the Office of a Legislative Auditor General; to Provide for His Appointment and Term; and to Describe His Powers and Duties," Delegate Proposal 1109, dated October 25, 1961. (processed)

This proposal was referred to the Committee on Legislative Powers since it clearly involved legislative power, and it also was referred to the Committee on the Executive Branch since the Auditor General under the old constitution was a part of the executive branch of government. Testimony was heard in each of these committees on the proposal. Representative of the testimony before the Committee on Legislative Powers was that of Eugene G. Wanger,¹ one of the co-sponsors of the proposal. First he distinguished between the pre-audit and post-audit functions, and noted that "the former includes direct internal supervision of expenditures, budget control, and preparation of an executive budget. This," he continued, "obviously is a function of the Executive branch and should reside there." The post-audit function, however, including tests of efficiency and compliance with statutory policy, properly resided in the legislative branch. He listed three reasons for this conclusion:

- (1) Because the Legislature bears the burden of raising and appropriating the public revenues and is thus most directly concerned in seeing that they are properly spent;
- (2) Because those performing this "watch dog" function should not be responsible to the Executive branch whose activities they must continually investigate;
- (3) Because the Legislative branch must be strengthened, within its proper constitutional limits, as a check and balance to an Executive branch whose power and complexity has greatly increased in recent decades.²

Wanger then noted that in spite of considerable support for a legislative Auditor General, "regrettably little consideration seems to have been given to the vital question of what his status, duties, powers

¹Eugene G. Wanger, "Testimony before Sub-Committee No. I of the Constitutional Convention Committee on Legislative Powers Regarding the Proposed Legislative Auditor," Michigan Constitutional Convention, 1961. (processed)

²Ibid., p. 1.

and qualifications should be," and he proceeded to discuss some of these details which were later to become the subject of debate on the convention floor. Some of this testimony will be referred to later in this study.

In hearings before the Committee on the Executive Branch, the question of shifting the office of the Auditor General to the legislative branch was discussed with several witnesses, including the Governor then in office and several former governors. In a memorandum to Wanger on this subject, John Martin, chairman of the Committee on the Executive Branch said in part:

Without exception this change in the constitution was favored. Governor Swainson and former Governors Brucker, Kelly, Williams and Van Wagoner were all in agreement on the desirability of this action. . . .I should add that as a former Auditor General, I am in full accord with this proposed change which would strengthen the legislature and provide an independent post-audit of the Executive Branch.¹

Thus, the proposal for a legislative auditor came to the floor of the convention with the full support of both of these powerful committees, and in the process of debate on the floor, additional light was spread on the intent of the provision. Particularly was this true of the specific requirement of a performance post-audit and its dependence on the provision of a legislatively appointed auditor general.

Debate and Clarification

The proposal to provide for the office of a legislative auditor general came to the floor of the convention for debate on March 15, 1962. After the reading of the proposal, known as Committee Proposal 78, the chairman of the committees on legislative powers and the executive branch submitted jointly a statement of reasons in support of the proposal. They

¹John Martin, "Memorandum to Mr. Wanger re Testimony on the Subject of a Legislative Auditor," Michigan Constitutional Convention, 1961. (processed)

noted that the state operating expenditures had increased from less than \$13 million in 1910 to nearly \$1,200,000 in 1961, and that in the 25 years prior to the convention, at least 30 additional executive agencies had been created. They then made the following significant statement:

If any semblance of balance between the legislature and the executive administrative area is to be retained, the Michigan legislature must be greatly strengthened in its power to oversee the conduct of executive operations. Giving the legislature the oversight of the audit function both as it respects dollars and cents and as it respects the performance and efficiency of the conduct of services, would be one large step in this direction. The legislature, in effect, now lacks any effective means of its own for determining whether or not the intent of the policy decisions it makes is being honestly and effectively translated into action.¹

They went on to argue that the independent elected office of auditor general then in use did not, and in the opinion of the committees, probably could not, provide the legislature with the adequate and timely tools which they felt it needed. They concluded that "A legislative auditor general offers an effective solution to a serious problem of maintaining a desirable, if not actually necessary, balance of power between these two major coordinate branches of government."²

It should be noted that this proposal came to the floor of the convention on the one-hundreth day of formal proceedings, and prior to the introduction of this proposal, the delegates had worked many weeks trying to streamline and improve the lines of executive authority in an effort to provide more effective administration and better operating control in the executive department. In terms of the budget cycle, as one delegate noted, the convention had already adopted "the executive budget idea," granting broad powers to the executive branch in the area of budget

¹Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 1672.

²Ibid.

preparation and control. "The question we are now debating," he continued, "is: who should appraise the results of this budget? Who shall determine whether the program and financing were carried out by the executive as directed by the legislature? Whose job is it? This is the issue."¹

Considerable debate followed the introduction of this proposal, but in the final voting, the concept of a legislative auditor received overwhelming support.

Performance Auditing Debated

Also in their statement of reasons supporting Committee Proposal 78, the chairmen of the committees on legislative powers and the executive branch defined the duties of the legislative auditor general stating that they "are to conduct comprehensive fiscal postaudits and performance postaudits and to make investigations pertinent to the conduct of such audits."² They went on to define a performance post audit as "an examination of the effectiveness of administration, its efficiency and its adequacy in terms of the program of the departments or agencies as previously approved by the legislature."³

This definition of performance audits seems possible of multiple interpretations when viewed by itself, and it is necessary to go beyond this statement to understand more fully the precise grant of authority intended in the provision.

Not Unlimited Authority

Today one of the immediate worries of executive officials, as it was to many convention delegates, is the extent to which this provision

¹Ibid., p. 1689. See speech by Delegate Rajkovich.

²Ibid., p. 1672

³Ibid.

of authority permits the auditor to become involved in the management function and to question policies and decisions which have always been considered to be subject to management or executive discretion.

On at least two occasions, delegates in the convention introduced amendments the purpose of which was to specifically restrict the auditor in these areas. The first was a minority amendment calling for the defeat of the whole proposal on the grounds that the "language is so broad that it might permit such an auditor to interfere with the academic operations of constitutionally established universities. . . ." Furthermore, they argued, "A performance audit could include a review of the entire academic operation of what, to date, has been Michigan's constitutionally independent system of higher education."¹

In response to this suggested amendment, Martin addressed the convention as follows:

The meaning of "performance postaudit" is a look to see whether the agency has performed in the manner in which it presented its proposals to the legislature. It is not designed to direct the body or the agency to do any particular thing; it is simply to see and to report to the legislature whether the agency has performed as it stated to the legislature it would perform.²

A second incident involved a proposed amendment to "exempt civil service and judicial functions" from the performance audit.³ Speaking for this amendment, one of the delegates explained that "if a juvenile court were attempting a rehabilitation program or something like that," he "would not want the legislative auditor to use the performance concept to review the rehabilitation function."⁴

Once again Martin explained that "the performance postaudit relates

¹Ibid., p. 1673.

²Ibid., p. 1674.

³Ibid., p. 2276.

⁴Ibid., p. 2777. See Speech by Delegate Downs.

only to whether the money was spent for the purposes for which it was appropriated. . . .It does not have to do with whether the court is trying the case correctly or not."¹

On still another occasion, Martin was asked specifically by another delegate, "What does the term 'performance postaudits' . . . mean?" In answering, Martin again referred to the definition given in the statement supporting Committee Proposal 78 as quoted above, and then added:

In other words, the department or agency goes before the legislature and presents its program and says, "This is what we are proposing to do." The auditor may make a fiscal audit, as is provided, which is to determine whether the money which is expended by the agency . . . is spent properly and for proper subjects within the cope of the bill. And, secondly, he may take a look to determine whether the agency has carried out its commitments to the legislature which were made when the agency appeared before the legislature to ask for its budget or its appropriation in the last preceeding year.²

These statements clearly relate the audit function to the area of executive responsibility and accountability to the legislature, and suggest another important point which will require additional attention later in this study--the nature of executive promises to the legislature and the corresponding determination of legislative intent. For now, however, it will be assumed that such promises and intent are objectively determinable by both the agency and the auditor, an assumption which will be questioned later.

Also speaking on the extent to which the auditor's authority permitted him to become involved in the management function, Wanger reminded the convention that the legislative auditor was specifically limited to the post-audit area. He further noted that "all of the preaudit functions are left with the executive branch . . . where they certainly belong," and added:

¹Ibid.

²Ibid., p. 1681.

. . . thus decisions made by executive officers in the exercise of their discretion pursuant to value judgments which they alone by application of expertise are capable of making are not proper objects of the legislative auditor general's scrutiny, and he may not conduct investigations the purpose of which is to criticize such decisions. The wisdom of such a discretionary policy decision may--if at all--be called into question by the legislature alone.¹

Thus, it was clearly intended by the proponents of this provision that there be some definite limits on the extent to which such a performance audit could question management prerogatives. The clear intention is that the authority is as broad as the requirement of accountability by the executive branch to the legislature, and no broader. Clearly the convention was after a procedure which would provide an objective evaluation of whether or not what is being done by the executive agencies is what the legislature wants done. Expressed simply, the question is: "Is the performance of the department or agency meeting the legislature's expectation?"

In one's determination to emphasize the inseparability of the performance audit concept and the legislative auditor, he must not overlook the fact that the audit must be of benefit to the agency as well and must be accepted and supported by agency management or else the whole effect and purpose of the post-audit function will be lost. Thus, as shall be discussed in detail later, the methods and procedures used in conducting a performance audit and the nature of the performance audit report are matters which deserve extremely careful consideration.

No Other Duties

It has become customary in many states for the legislature to assign by law a number of duties to the auditor general which are unrelated to state auditing. These include serving on various boards or commissions,

¹Ibid., p. 1675.

controlling the sale of lands for delinquent taxes, approving plats, and auditing counties and other local authorities.¹ In addition, many states require that the state auditor be responsible for prescribing uniform accounting systems, installation of data processing systems, and preauditing invoices for major purchases prior to payment. Clearly, the nature of the legislative auditor's work should not include these items, and thus the Michigan Constitutional Convention included the provision: "He shall be assigned no duties other than those specified in this section."

Also in this connection it is imperative that one recognize that the grant of authority to the Auditor General is specifically confined to the post-audit function. This fact Martin emphatically declared to the convention when he said, "The proposal comprehends that the auditor general would not--and I want to emphasize this--would not get into the business of preauditing."² He further contrasted the post-audit process in business with that of the independent post-audit rendered by a public accountant in industry, and noted that it was the responsibility of the department of administration to see that the preaudit function was filled. He also pointed out the need for internal auditors in the executive branch to improve internal control and insure proper accounting, a subject which will be examined in a later chapter.

This distinction is painfully obvious to an experienced public accountant, but the point is very well taken in this case since one of the major weaknesses in state government today is a failure to clearly

¹Michigan, Department of Auditor General, Orientation Manual, 1965, p. 1. Also see Michigan, State of Michigan Constitutional Convention: Official Record, 1961, pp. 1672-1674.

²Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 1673.

distinguish between the pre-audit and post-audit functions.¹ In this connection, one authority argued that "undoubtedly the least defensible practice" concerning the state auditor and his duties "is a constitutional provision or a statute providing for an independent . . . auditor to exercise pre-audit and post-audit controls."² Yet a majority of the states suffer from an organization and policy confusion regarding these matters, as did Michigan prior to the convention. And the proponents of this provision of the new constitution left no doubt of their intention to correct the matter.

Independence

To provide a maximum of independence for the auditor general, the Convention approved several additional provisions in the Constitution. First, the term of the auditor general was extended from two years, as provided under the previous constitution, to eight years. Three reasons for this provision were noted in the convention record. First, it would attract persons of high caliber; Second, it would provide for a "substantial degree of freedom from extraneous influences in the performance of his duties;" and third, it would "provide for a reasonable degree of job security."³

A second provision to insure independence on the part of the auditor was the provision that he can only be removed from office "for cause" and then only "by a two-thirds vote of the members elected to and serving

¹Wheeler, op. cit., p. 146.

²Public Administration Service, Constitutional Studies, a Study prepared on behalf of the Alaska Statehood Committee for the Alaska Constitutional Convention, 1955, pp. 32-33.

³Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 1672.

in each house." Such a provision protects the auditor from the threat of removal from office merely because of partisan bias or other such reason, and allows him to conduct his audit fairly and competently without fear of whimsical repercussions.

Still another provision designed to insure his independence is the provision making him "ineligible for appointment or election to any other public office in this state from which compensation is derived while serving as auditor general and for two years following the termination of his service." This provision is designed to remove the temptation from the auditor to use his office to build and promote his own political career within the state either through the abuse of his powers or the neglect of his auditing duties in favor of other image-building political activities.

A fourth provision to provide independence to the auditor is that which permits him, upon direction by the legislature, to "employ independent accounting firms or legal counsel and make investigations pertinent to the conduct of audits." Perhaps the most significant item in this provision is that which permits him to employ independent legal counsel. As Wanger stated in his testimony to the convention, "The power to contract for legal counsel of his choice is essential to the legislative Auditor General's independence from the Executive branch. Otherwise he would have to rely upon the Attorney General to define the extent of his powers."¹ Thus this provision clearly permits the Auditor General to ignore the opinion of the Attorney General if that opinion differs from the opinion expressed by his independently employed counsel. There is thus no executive authority or official who has the power or the

¹Wanger, "Testimony . . .," op. cit., p. 5.

right to interfere in any way with the conduct of the office of the Auditor General or to prescribe policy by which he is bound.

Finally, the convention considered the question of civil service status for the staff of the Auditor General. As Martin explained, the committee "felt that some independence by virtue of tenure should exist in the staff . . . because of the difficult job of making reports on agencies of government. . . .We want them to make honest reports based upon their best judgment as to what the facts and figures show."¹ The convention then adopted the provision exempting the Auditor General, his deputy, and one other member of his staff from classified civil service but requiring that all other members of his staff should have classified civil service status.

One proposal which was made to the convention and defeated there would also have added significantly to the power of the auditor general, and would probably have been of valuable assistance in the area of performance audits. It would have provided that the auditor general could not only contract for legal counsel of his choice, but could also, "after public hearings establish minimum standards for annual reports to be issued by any and all departments, offices and agencies of the state government."² Under this provision, the auditor general could have first conducted hearings, thus guaranteeing that any department or agency affected would have the fullest opportunity to be heard, and could then have set minimum standards of reporting including the preparation and submission of performance reports which would undoubtedly have facilitated the conduct of the performance audit. In the absence of such a provision in the Constitution, the responsibility falls to the legislature to provide by law

¹Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 1674.

²Ibid., p. 1673.

some means for requiring such performance reports if, in fact, the legislature is desirous of receiving such reports from the executive departments and agencies.

A Certified Public Accountant

The provision that the auditor general be a Certified Public Accountant was first introduced in the convention in the original delegate proposal concerning the office of the auditor general,¹ but somewhere in the process of the committee hearings it was deleted. It was again introduced on the floor of the convention and was defeated there on March 15, 1962. Finally it was introduced again on April 24, late in the convention, and was vigorously defended by Richard Austin, a Certified Public Accountant himself and a delegate from Detroit. At this time it passed with a large majority.

From the beginning, this proposal was advocated as a means of providing the best qualified person possible for the office. This in defending his original proposal, Wanger argued that the "C.P.A. requirement is desirable because (1) it establishes a minimum requirement of professional competence for the office and (2) it sets out an objective standard which will promote public confidence in this vital area of public finance."² He further contended that the auditor should possess great administrative skill and, in addition, should have a thorough understanding of modern accounting. Only then could he effectively supervise and evaluate the work of his staff and be held personally responsible for that work.

In his dramatic appeal to the convention, Austin reminded the delegates that they had previously approved provisions requiring persons of high professional standing for other important state offices. In part

¹Wanger and DeVries, op. cit.

²Wanger, "Testimony . . .," op. cit., p. 4.

he said:

If we take the position that a legal background is necessary for persons involved in the legal province in the state, supreme court justices, state attorney general, prosecuting attorneys, assistant prosecutors, city attorneys, is it not inconsistent to hold that it is not necessary to require that an expert in the field of auditing be the only person qualified for the office of auditor general? And again, when we consider that we expect the highway commissioner to be a highway engineer, is it not inconsistent to say that the holder of the highest audit office in this state should not be especially qualified in his field.¹

He continued to point out that a variety of "specialists" could be found in auditing such as Certified Public Accountants with law degrees, with Ph.D. degrees, or with other special qualifications if needed, and he noted that there were 3000 Certified Public Accountants from which to fill this one audit position as contrasted with 9000 lawyers from which all of the above named legal positions must be filled. He concluded by arguing that the state would benefit by increased activity and participation of Certified Public Accountants in public affairs and noted that by the nature of their training, they were already accustomed to the standard of independence of mental attitude required in such an important office.

From the standpoint of this study, it is significant that at no time in the debate of the convention was the requirement that the auditor general be a Certified Public Accountant ever linked to the specific requirement of the performance audit. The performance audit was clearly something which, in the view of those who sponsored the provision, could be conducted by an auditor who was not an accountant. In fact, both Wanger² and Martin³ denied that these two provisions were ever seen as complementary to each

¹Michigan, State of Michigan Constitutional Convention: Official Record, 1961, p. 2775.

²Eugene G. Wanger, in personal interview, February 17, 1966.

³John B. Martin, in personal interview, February 25, 1966.

other, and had it not been for the personal prestige of Richard Austin, the provision that the auditor general be a Certified Public Accountant would never have become a part of the Michigan Constitution.

Conclusion

This chapter has traced with considerable detail the birth of performed auditing. The background which gives rise to the need for such a provision has been noted, and the course of history which has brought the issues into sharper focus in recent years have been examined. The constitutional convention of Michigan was then carefully and deeply analyzed in an attempt to understand the intent of the provision of the constitution requiring such audits, and several other factors which relate to and clarify the issue have been noted. Clearly this provision is unique but natural, for far from being a product of wild imagination, it represents the explicit recognition of a basic and fundamental need of modern state government.

CHAPTER III

THE POST AUDIT IN A SYSTEM OF LEGISLATIVE CONTROL

Introduction

The specific role of performance auditing in state government can best be understood when viewed as a component part of a legislative control system. Such a system is inherent in the structure of state government which follows the concept of separation or balance of power as outlined in the previous chapter. Furthermore, such a system of control is the specific product of the patterns of responsibility which result from such a structure of government. Thus to contextualize the performance post-audit function and to show it in relation to the other components of this control system, it is necessary to have an understanding not only of the conceptual or theoretical power relationships but also of the actual legislative and executive processes in which such a system operates.

Yet the purpose of this study is not to undertake an exhaustive examination of the politics or procedures of government. Indeed to allow this discussion to wander into the many areas of difficulties and concern in these governmental processes would defeat the very purpose for which they are here examined. The purpose of this discussion is to provide an understanding of such processes sufficiently but only to the extent necessary to determine the implications for post auditing which arise from them.

The Control System

Legislative control of administration consists of all of the methods and procedures used by the legislature to secure faithful, efficient, and effective administration of government programs. Although such control is accomplished through a wide variety of methods and procedures, it is convenient to separate them into two broad categories.

The first of these categories is policy setting. Whenever the legislature enacts a law, reviews a budget request, or authorizes a program, it sets policy. Policy, as used here, is simply the expression of legislative intent. It is the legislature's expression of its will through the planning, programming, and budgeting processes. Policy is the planned expression of the legislature's official attitude toward the range of behavior within which it expects administrators to act. As such, policy setting is not only important; it is imperative if legislative control is to be established.

The second part of legislative control is administrative oversight. All methods of reviewing the conduct of executive officials and agency administrators are included in this oversight, including the performance post audit. As noted in the previous chapter, the performance post audit is intended to provide the legislature with an independent report on the degree to which its policies are being followed and on the adequacy or effectiveness of such policies and programs.

Thus, both parts of legislative control are dependent on each other. Policies must be determined and expressed if administrators are to follow them and if administrative performance is to be evaluated against them, but so also must there be a feedback of information on the adequacy and effectiveness of such policies if the legislature is to properly modify and improve such policy expressions. Too often in the past, this important

fact has been ignored or forgotten, and the system of legislative control has disintegrated into an uncoordinated series of activities and procedures which have failed to achieve their desired effect.

The manner in which legislative control is achieved and the methods used in its implementation are vitally important to its effectiveness, its acceptability, and its survival. The legislature cannot undertake a detailed supervision of every facet of administrative activity without stifling the initiative and creativity of administrative officials. Effective administration requires that administrative officials be allowed to exercise discretion and to apply expertness in pursuing the intent of the law in circumstances which the legislature cannot possibly anticipate. At the same time, however, a weak or inadequate system of control is equally dangerous in that it allows for neglect of responsibility and for inefficient use of public resources.

This chapter is an examination of both parts of the legislative control system, for the examination of legislative oversight functions alone would be inadequate to contextualize the role of performance post audits.

In discussing the purpose for such a system of control, it is imperative that one understands that the spirit of such a system is positive, not negative. The purpose is to improve and to give direction to administration, not to restrict or to hinder it. The difficulty in such a system is to devise and maintain methods which will preserve the proper balance by keeping the activities of executive officials under effective scrutiny and control while at the same time preserving the values of administrative flexibility and discretion.

Evaluating the Control Methods

Before turning to the methods by which the legislature achieves control of administration, it will be helpful to note some of the criteria by which such methods themselves can be evaluated both for appropriateness and effectiveness.

In the first place, it is totally erroneous to assert that all that is needed in the states today is more legislative control of administration. This misleading belief has led in some states and even in the national government to the establishment of numerous and detailed restrictions on administrative decisions, with the result that creative and effective administration had often been stifled and program effectiveness has been seriously restricted. Too often, more control is understood to mean more restrictions.

The problem is not so much how legislative control can be increased, but rather how the legislature may exercise appropriate kinds of control without impeding administration or weakening executive authority. In a system of balance of powers, an imbalance in favor of the legislative branch can be just as serious a problem and perhaps more serious than an imbalance in favor of the executive branch. The objective sought by improving legislative control is to improve the quality and efficiency of public programs, not to hold down executive officials. And control methods which are appropriate in this sense are those which facilitate administration while keeping the legislature fully informed on what is transpiring.

Yet it is not easy to secure agreement on the appropriateness of any control method, particularly from those involved. As Harris explains:

Although most executive officers recognize in principle the essential role of the legislature and cheerfully accept some limitations on their own discretion, their natural tendency

is to minimize the need for detailed control; and some officials frankly regard all legislative control as a necessary evil, to be avoided or circumvented whenever possible. Legislators, on the other hand, commonly look on control of administration as a legislative prerogative, to be extended whenever feasible; they regard themselves as guardians of the public's freedom and are not inclined to see constitutional problems in extending their control of administrative detail. Those who have risen to positions of leadership . . . are especially likely to take this view. . . .¹

Thus, in evaluating any type of control procedure or device, it is necessary to have some criteria on which to base judgement. And for the purposes of this study, the following criteria seem appropriate:

1. Is this control procedure constitutional? We have already noted that in Michigan, performance audits are constitutionally required. But a similar type of audit may be implied or permitted by other constitutions. Thus the test of constitutionality not only asks whether or not the control is required by the constitution, but also whether or not it is permitted or specifically prohibited by the constitution. In this connection, Walker has observed that "as to state legislative powers, it may be asserted categorically that they are nowhere listed and enumerated. Being residual in character, they include the authority to solve problems yet unknown."² He compares the state legislature to the Congress of the United States, and asserts that "the legislature does not need, as does congress, to search for and discover a constitutional peg on which to hang its ever act." Rather it needs only to determine that the Constitution of the United States neither grants the power to the national government nor denies it to the states, and that the state constitution does not deny it to the state legislature.

¹Joseph P. Harris, Congressional Control of Administration (Washington, D.C.: The Brookings Institution, 1964), p. 11.

²Walker, op. cit., p. 99.

2. Does this control correspond to the pattern of responsibility implied in the division of power between the two branches? The assignment of the preaudit function to an official of the legislative branch, for example, would generally be considered a violation of this test since preaudit is clearly a management responsibility and therefore rightly belongs in the executive branch of government. This problem was discussed in the previous chapter.

3. Does this control provide the legislature with information which it needs to discharge its basic responsibilities? In other words, does it help the legislature do a better job? In this respect, the legislature needs to know, for example, whether or not a certain program is having its desired effect? Thus, a control device which requires that a report of program achievement be submitted to the legislature may be an appropriate control device. Yet rarely do state legislatures today require formal statements on program achievement other than a statement of expenditures. Certainly the performance audit will be greatly facilitated if performance or achievement reports are required by the legislature from the agencies and departments subject to audit.

4. Does the control impede or promote administrative effectiveness? In some ways, this may be a corollary of test (3) above. A performance report can be a valuable administrative tool as well, but if the legislature undertook to prescribe accounting and information systems and to set by law the exact procedures to be used in preparing such reports, the result might well be to burden administrative officials with a cumbersome set of rules that would neither prove satisfactory for the purpose intended nor permit the flexibility necessary for executives to adjust and improve such systems if and when it became desirable to do so. Government is full of such out-dated and bureaucratic procedures which have long since lost

their effectiveness as meaningful control devices.

5. Does this control strengthen and enforce the control systems within the executive branch or does it duplicate and/or weaken them? This question is particularly relevant to the performance post audit as a control device. Within the systems of executive control and internal control, provision should be made for an internal audit and administrative policy review. Such reviews, if conducted effectively within the executive branch, need not be repeated by the legislative auditor. Rather, the independent auditor in government, as in business, has a function to fulfill which does not include a duplication of the work of internal auditors.

6. Finally, is this control device one that can properly be exercised within the competence of the legislature or the legislative branch. As Harris explains, "A large portion of governmental decisions are of the kind that can be made wisely and within an effective time span only by officers who have appropriate information, expertness, and experience."¹ Executive officers are expected to have these special qualifications, and it is highly important that the legislature makes sure that they do. However, such decisions themselves are not properly within the competency of the legislature to make, and even if it did make them, it is not organized to put them into action.

Unfortunately it is not always possible to determine whether a given control technique violates any or all of these criteria. Often such a determination involves a value judgement, and in most cases honest men may have differing opinions. Yet competent, efficient, and effective administration of state programs has never been more important, and

¹Harris, op. cit., p. 13.

appropriate controls must be established which will continue to promote such administration. Properly devised and applied, a system of legislative control does not become an end in itself. Rather, it is one of the means of achieving the ends described above.

Policy Formation

As noted earlier, policy formulation occurs within the planning-programming-budgeting process. There is no policy expression in the absence of plans or programs; in fact there is no policy. The purpose of policy is to serve as a guide to the actions or decisions of responsible people with respect to planning or executing programs with which they are involved. Policy formulation itself is a type of planning. Properly conceived, policies are extremely useful in decision-making in that they provide a basis for relating actions to objectives, thus helping to assure that administrative decisions result in successfully coordinated activities and programs.

Yet in government, the legislature does not simply assemble and formulate policy which it then communicates to the executive. Rather, the legislature relies very heavily on the executive for the planning of government activity and the development of meaningful programs as well as for the preparation of the budget to achieve the desired objectives. Planning and programming are management functions and are, for the most part, left to administrators whose expertise renders them more capable to accomplish these tasks. Theoretically, the legislature acts as an intermediary or arbitrator between management and the public to secure for the public in general the best programs possible and to prevent abuse of executive power. As one writer stated, "Contrary to popular impression, modern lawmakers are not so much lawgivers as law

reviewers."¹

Thus, legislative policy to a great extent is the product of the legislature's reaction to executive proposals, a reaction which is based on the ideologies of the various interest groups which legislators seek to satisfy and on the personal opinions of influential legislators.²

The Legislative Process

The legislative process among the states differs in many respects. As one former member of a state legislature writes, "All legislatures pass laws, respond to and resist interest groups, party leaders, governors, bureaucrats, and others who urge approval or rejection of particular measures. Yet the differences among state legislatures are striking."³ Legislatures reflect widely differing sets of social and political forces, traditions and practices. And while the legislature is always the focus of the law-making process, there is nothing inevitable about the character of the demands made, the manner in which they are made, or about the nature or kinds of maneuvering and bargaining that takes place in response to them.

One of the biggest difficulties in the legislative process is for the individual legislator to become sufficiently informed to competently judge the merits of proposed legislation. One problem is the volume of proposals. One writer explains this problem as follows:

¹Walker, op. cit., p. 98.

²For a very interesting discussion of how these ideologies are formed and the roles they play, see R. Joseph Monsen Jr. and Mark W. Cannon, The Makers of Public Policy (New York: McGraw-Hill Book Company, 1965).

³Duane Lockard, The Politics of State and Local Government (New York: The MacMillan Company, 1963), p. 272.

The very volume of legislative proposals and the wide diversity of the subject matter are in themselves staggering. Mastery of the meaning and potential consequences of much proposed legislation requires not only intensive study but also technical competence that few but the specialist can hope to achieve. Ability aside, in terms of available time it is impossible for the legislator to comprehend these proposals, earnest as he may be in his desire to do so.¹

Most legislators are reasonably good men. Some of them are excellent technicians, many are lawyers with excellent training and long experience with the law, and others are experts in other fields. But in the overall legislative process, they are, in the words of Clapp, "merely babes in the woods, called upon to pass technical legislation in a wide, wide variety of fields."² Obviously it is impossible to become an expert in all areas, and the miracle of government is that legislatures do as well as they do considering the complexity of their job and the diversity of the demands on their time and attention.

Perhaps it is presumptuous to assume that there exists an identifiable legislative policy or intent. Certainly there is seldom an issue on which all legislators are able to express an informed opinion and thus intelligently weigh together the alternative policies and programs and arrive at a majority intent. The more common practice is for legislators to accept the advice of a trusted colleague when evaluating proposed legislation. This dependence on colleagues for advice, however, does not mean that the individual legislator thereby abdicates his responsibility to reach his own decision regarding legislation or to seek for himself to ascertain the facts relevant to that decision. It is merely one method by which he attempts to meet that responsibility.

¹Charles L. Clapp, The Congressman (Washington: The Brookings Institute, 1963), p. 104.

²Ibid.

Other sources of advice or information are party caucuses, interest groups, outside authorities such as academicians or professionals, and very importantly, members of the executive branch. On any given proposal one of these sources may predominate or any combination of them may be used, but the fact remains that on most issues, legislators are never able to become very well informed. The consequence of this fact is that legislative policy is difficult to determine and interpret. The complexity of such policy is well described by Bailey in his discussion of this problem at the national level as follows:

Legislative policy-making appears to be the result of a confluence of factors streaming from an almost endless number of tributaries; national experience, the contributions of social theorists, the clash of powerful economic interests, the quality of Presidential leadership, other institutional and personal ambitions and administrative arrangements in the Executive Branch, the initiative, effort, and ambitions of individual legislators and their governmental and non-governmental staffs, the policy commitments of political parties, and the predominant culture symbols in the minds of both leaders and followers in the Congress.¹

Truly, legislative policy formulation and expression is complex. Yet its complexity, for all the problems it may cause, cannot be allowed to serve as an excuse for failure to recognize its existence and its importance and to devise means of making it more explicit, more effective, and better understood in state government. Without it, legislative control is virtually impossible, and the performance post audit is difficult if not impossible to perform.²

¹Stephen Kemp Bailey, Congress Makes a Law (New York: Columbia University Press, 1950), p. 236. This book describes the story behind the passage of the Employment Act of 1946.

²For an excellent discussion of the development of the legislative process in the United States together with an examination of the many proposed reforms relating to it, see Bertram M. Gross, The Legislative Struggle (New York: McGraw-Hill Book Company, Inc., 1953).

Policy Enunciation

The legislature has several methods of communicating policy decisions to administrative officials in the executive branch.

The predominant formal method is by writing into the statutes an expression of its policy. Every law that is passed by the legislature is an expression of its intent. Some statutes, of course, are more explicit in that expression than others. In some cases, the legislature goes into considerable detail in expressing its will and in doing so, sets down numerous detailed guidelines to direct and control administrative activity and to limit or channel administrative discretion. On the other hand, the legislature may prefer to leave much of the decision to the administrator, recognizing in him an expertise not possessed by the legislature, and the statute may be broad and general in its expression of policy. In such cases, the competence of the administrator, as judged by the legislators, becomes an element of the legislative control system.

The legislature may also enact statutes creating additional executive agencies, prescribing their form of organization, and providing for their principle officers. In this way the legislature may express an intent or policy which may continue unchanged as long as the agency survives, thus rendering unnecessary the continual expression of policy with each additional appropriation or authorization affecting the agency or department. The implied policy in subsequent legislation is one of continuing the present or established policy as formerly enunciated.

Still another method of securing legislative control is through formal committee hearings on proposed legislation. It is the practice of most legislatures to divide each house into several committees whose purposes are to examine and investigate proposed legislation and administrative

activities in specified areas. In some states these committees are further divided into subcommittees, similar to the system used in the federal government. Representatives of the respective executive departments and agencies are called before these committees or subcommittees to testify on the proposed programs or budget requests and to defend such requests. In the process of conducting such hearings, the committee, and individually each of the members on the committee, may express an opinion on the proposal or request being considered; and thus both formally and informally, the administrator is made aware of the wishes of committee members. The importance or significance of these committee hearings cannot be minimized, for it is a well-known fact that with few exceptions, legislators other than committee members seldom express publically or privately an opinion on matters before the legislature.

Still another means of communicating legislative policy to the administrative agencies is through the informal contacts between members of the agency and members of the legislative committee responsible for the agency. Through this mutual relationship much information is exchanged and many ideas are communicated which not only influence current action but shape the boundaries or limits within which the agency is likely to present its formal requests to the legislature for future programs or budget requests.

The Inadequacy of Policy Expression

From the forgoing discussion, it would seem that all the auditor would have to do to determine legislative intent would be to obtain copies of all laws pertaining to the creation of each agency and the authorization of its programs, read the minutes of the committee and subcommittee hearings, examine the record of debate, and review the files of

correspondence between the agency and relevant committees or committee members of the legislature. Such is not the case. In fact, the limitations and inadequacies are so great that in some cases it may be impossible to do more than obtain a general idea of relevant policy or intent.

One of the biggest problems comes from the lack of a written record of legislative committee or sub-committee hearings. An extensive inquiry in connection with this study failed to reveal a single state which keeps a verbatim record of hearings and testimony given before legislative committees. Furthermore, most states do not even provide a written summary or any other such indication of the action and will of the legislature as expressed by the committees or of commitments made by administrators who present testimony. Usually the only record that can be located is a roll-call record of those present and of the votes that are taken, and some states do not even provide that. Yet committee hearings are without doubt the single most significant element in the development and expression of legislative policy or intent, for on a majority of the issues that come before the legislature, most legislators ask the advice of committee members whose opinions weigh very heavily in the final decision of their colleagues.

Another weakness in the legislative process is the lack of formal debate on vital issues which come before the legislature. As one authority noted, "It is most unfortunate that we cannot approximate real debate. Under the rules it is absolutely impossible to have a case argued in a manner approaching the way it should be argued, even on important issues."¹ Certainly the large number of bills that require the attention of legislators over a relatively short period of time constitute an important

¹Clapp, op. cit., p. 124.

reason why debate is held to a minimum, but even if more time were available, legislators still disagree regarding the extent to which debate affects the fate of legislative proposals. It is generally felt that speeches rarely influence many votes, that their main effect is to reinforce views already held. And in many cases their purpose is to make a record for the speaker. Yet, for whatever the reason, this lack of debate, together with the lack of formal expression of the issues, constitutes another barrier in the path of the auditor who must determine legislative intent.

Some authorities feel that the auditor should not attempt to go beyond the written statute in attempting to determine legislative policy or intent. These authorities argue that the statutes are the only legally binding and enforceable expressions of legislative will. And in a narrow sense this argument may be true. However, one cannot long be associated with the realities of the government process without realizing that the statutes, in most instances, do not contain an adequate expression of legislative will. For example, one familiar with the decisions of the courts will readily recognize that judges and juries must frequently go far beyond the wording in the statutes to determine the intent of the legislature in passing a given law. If administrators are to be held accountable before courts of law on matters not wholly expressed in the words of the written statutes, they must obtain a clarification of the statutes either through committee hearings, formal legislative debate, or informal contacts with members of the legislature. And it is therefore only reasonable to argue that if the auditor is to express an opinion as to whether or not an agency or its administrative officials have faithfully, efficiently, and effectively implemented legislative policy or intent, the auditor too must go beyond the

words of the written statutes, as important as they are, and must more precisely identify both legislative intent and executive commitments.

A final difficulty in determining legislative intent or policy results from the fact that in many and perhaps most states the Governor is so powerful that he dominates the legislative process. It is not uncommon for the legislative intent on some bills to be recorded as simply agreement with the Governor or opposition to him. And since the Governor usually wants as free a hand as possible in administering state programs, he is not likely to be any more specific or detailed in the expression of his will or intent than is necessary to secure legislative approval of his programs. Even in those states with relatively strong legislatures, the influence of the Governor in the legislative process is considerable. One writer described this situation as follows:

The state legislature of today finds itself in a strange posture vis-a-vis the Governor. The Constitution describes him as the chief executive, but often he is also the chief legislator. This is due to many factors: (1) his uniqueness as head of the executive branch, which makes him a prime source of news; (2) his power of veto; (3) his power to send messages to the legislature and to secure wide publicity for his recommendations; (4) his exclusive power to convene special sessions . . . and even to determine the agenda for such sessions; (5) his power of appointment . . . ; and (6) his power to initiate budget estimates. . . .¹

In addition, the Governor is usually the leader of his political party, and particularly if his party is the majority party in the legislature, he may control the legislative process almost exclusively through party caucuses and partisan political maneuvering. In such cases, the expressed legislative intent may be something quite apart from the underlying motives for some bills that are passed. In fact, throughout the whole process of government, party politics plays an important role, a role which cannot be ignored without distorting reality.

¹Walker, op. cit., pp. 99-100.

The Direction of Change

If state legislatures are to provide effective control of administration, it is imperative that some improvements be undertaken in the process of formulating and enunciating legislative policy. Since policy formulation is largely a matter of reviewing executive proposals, and since executive proposals or requests result primarily through the planning-programming-budgeting process, a discussion of such policy formulation will be deferred to the next chapter where these functions are examined more carefully. However, based upon the above analysis, some improvements in policy enunciation can be suggested. The importance of these improvements to the performance post auditor will become even more apparent as the audit function is more fully developed.

First, a written record should be made of legislative committee hearings and should include not only the testimony of witnesses but also the expressions of opinion by committee members. There is considerable merit in recording the proceedings verbatim, but at least a summary of the proceedings should be made which must, as a minimum, include the elements of justification advanced by proponents of legislative proposals, the nature of all commitments made by administrative officials, the counter-arguments given by other witnesses, the particulars of any instructions given by committee members or the committee as a whole which are intended to be binding on administrators, and formal votes and decisions made by the committee together with a statement of the implications of such a decision. Such a record would be extremely valuable to all parties concerned, both in implementing legislative policy as well as in reviewing program execution and in evaluating performance against such policy.

Second, to the extent that open and free debate is not possible on all issues which come before the legislature, a clear statement of the

recommendations of committees, together with any additional or alternative positions openly and actively supported on the floor of the legislative body, should be made available for public record. Such a record would provide a basis for reviewing any changes, modifications, deletions, or additions which are voted on the floor of the legislative body.

Third, an expression of legislative intent should be made in every statute affecting the conduct, organization, or programs of any governmental agency. Such a statement of intent should be sufficiently detailed and specific to permit exactness of interpretation on all major points of any bill. Some states are at the present time attempting to move in this direction. In Michigan, for example, a bill was introduced in the spring of 1966 which would require such an expression of intent on every bill passed by the legislature.

Finally, and perhaps most importantly, it is important that the legislature secure from the Governor and other executive officials a written statement of intent for every program proposed or budget requested. And it is equally important that the legislature act specifically to accept such a statement of intent as being that of its own or state clearly the nature and extent of its disagreement or desire for modification. Such a statement would not only prove invaluable to the auditor, but also to agency administrators, to executive officials, to judges and juries, and to anyone else charged with the responsibility of interpreting legislative will and judging performance against it.

In reviewing any such statement of policy or intent, it is imperative that the legislature first agree upon the objectives sought by the program being acted upon. Such objectives may be given in terms of productivity, level of service, or state of condition. It is also important that the specific standards of achievement or standards of performance to be used

in appraising the results of program accomplishment be identified. It is further necessary for the legislature to require a clear assignment of responsibility, for programs to be clearly defined and properly funded, and for a system to be established to provide adequate reporting and secure accountability for each program and appropriation in terms of the standards and objectives specified. All of these standards and specifications must, of course, be useful in giving direction to administration without in any way stifling initiative on the part of administrators, interfering with proper management functions, burdening officials with unnecessary paper work, or usurping the right of management to bring to bear on their administrative problems the expertise they were hired to bring to their jobs.

The process by which objectives are identified, standards are set, programs are developed, and accountability is secured will be treated in the next chapter. Basically such functions are management responsibilities and are properly carried out in the executive branch of state government. The role of the legislature is to insure that such functions are performed effectively, and this it can accomplish by approving and reviewing these items and by holding proper administrative officials responsible for them.

Legislative Review

So far, this chapter has been concerned with legislative controls that should be operative primarily prior to the execution of programs, and whose purpose is to give direction to such execution. Legislative control, however, does not end with the acceptance of the objectives and standards, with the enactment of specific programs, with the appropriation of funds, or with the enunciation of policy. Legislative control includes

the oversight of administrative activity. This involves a comparison of actual performance with the accepted standards and enunciated policies as well as a review of the appropriateness of the methods by which such performance has been accomplished. Harris explains this responsibility as follows:

. . . The means of government are not politically or philosophically neutral; they are closely related to, or sometimes become, ends themselves. Therefore legislatures must concern themselves with the how as well as the what of executive action. It is not enough for a legislature to enact policies and programs into law; it must check to see how those policies are being executed, whether they are accomplishing the desired results, and, if not, what corrective action the legislature may appropriately prescribe.¹

The methods by which the legislature seeks to accomplish its review of the execution of programs includes formal hearings before the standing legislative committees, informal contact by members of the legislature with administrative officials, the requirement of financial and performance reports, and the post audit. Legislative oversight, then, includes every method used by the legislature to review administration of programs after the fact.

The Objectives of Legislative Review

As previously defined, legislative control of administration consists of all of the methods and procedures used by the legislature to secure faithful, efficient, and effective administration of state programs. Consistent with this definition, the following seems to be an appropriate summary of the objectives of the review function:

1. To determine the extent to which legislative policies are being faithfully, efficiently, and effectively implemented by administrative

¹Harris, op. cit., p. 1.

officials. From this step will come the information necessary for the legislature to take corrective action with respect to administration or to revise legislative policies if they are found to be inappropriate or inadequate.

2. To determine whether state programs are achieving their desired objectives. This step will provide information on the need for changing, deleting, or modifying programs or program elements through additional legislation.

3. To review both the administrative control and executive control systems as established by the agency or department heads and by the chief executive respectively, to determine that such systems are adequate and effective in accomplishing their objectives. Through the review of the control systems the legislature will be better able to judge whether or not an agency is organized and administered in such a way as to be able to competently carry out its responsibility.

4. To hold responsible executive officials accountable to the legislature for their use of public funds and other resources put at their disposal. This step involves not only an examination of the financial statements and of the legality of expenditures but also of the prudence of expenditures and the efficiency of the use of all resources including the elimination of wasteful practices.

5. To ascertain that laws are being administered in the public interest, and to encourage diligence on the part of administrative officials. In a politically explosive environment, it is often extremely difficult to determine when the public interest is being served, for "public" is usually defined in terms of certain interest groups or segments of the total population. Nevertheless, neglect of duty, clear abuses of discretion, arbitrary actions, and gross errors of judgement

must be brought to the attention of the legislature for proper review and investigation.

The Role of the Legislative Auditor

The Auditor General is, in reality, the legislature's arm for on-the-spot reviews of administrative performance. His role is one of reviewing administrative activity and of reporting his findings to the legislature. The purpose of his review is to assist the legislature by providing competent and timely reports to the legislature containing information relevant to its decisions and responsibilities. Thus, areas of state activity properly subject to his review include all areas on which the legislature needs information to more knowledgeably perform its duties, and which fall within the competence of the auditor to review.

Admittedly this role is much broader than the traditional financial audit, but it cannot logically be viewed any other way. To argue that the audit should be confined to financial transactions is to deny that the legislature is in need of information other than that of a financial nature or to assert that the auditor is incompetent to perform an examination and render an opinion on performance in non-financial areas. Neither of these positions can logically be supported. The function of the legislature includes a review of all administrative activity. The role of the auditor is to help the legislature perform such a review, and this he cannot do without extending his review beyond the financial area to include an examination of factors as outlined below. As stated by the Auditor General of Illinois, "The audit of a State agency has multiple objectives, only one of which is the opinion on the financial

statements."¹ By calling attention to strengths and weaknesses, and by identifying problem areas, even though he may not always be able to competently recommend solutions, the auditor performs an invaluable service to the legislature whom he is constitutionally required to serve.

The Functions of an Auditor

Before looking at the scope of the post audit, it will be helpful to note the specific functions of an auditor and to point out some functions which are not those of an auditor. A clear understanding of these functions will greatly facilitate the determination of the extent or scope of the audit effort.

Basically the functions of the auditor are to examine and to evaluate the records and controls of an organization for the purpose of rendering a report on the condition and the performance of the organization, and to make recommendations for improvements where they are found to be needed. The function of the auditor is not to impose the will of anyone on the organization or to enforce any rule or policy. Neither is it the function of an auditor to establish and maintain systems of accounting or control or to interfere in any other way with the decisions and prerogatives of management except as such decisions are influenced by the recommendations made by the auditor.

The purpose of the examination is to discover sufficient competent and relevant evidence upon which to base an objective evaluation and render a fair opinion. The purpose of the examination is not to see how many errors can be found or to discover every evidence of fraud. Rather, the examination is made to render a judgement on the control system, the

¹Illinois, Office of the Auditor General, Instructions to Independent Certified Public Accountants Performing Audits of State Agencies, April 30, 1965, p. 7.

financial statements, or the operation as a whole. The finding of a substantial number of irregularities does of course influence the decision, and may in some cases require a more substantial inquiry into the possibility of fraud or deliberate dishonesty. However, since the examination is performed in the nature of a test of the system, it is entirely possible that some errors or irregularities may escape detection, and readers of the auditor's reports must recognize this fact. Particularly in government activity, audits are too frequently looked upon as a means of assuring that no defalcations occur undetected and that public officials are kept dollar honest. The more important role of the auditor is to provide a review of the control system as a whole to determine that even honest mistakes are minimized and that operations and activities are oriented toward the desired objectives.

Once the examination has been made and an evaluation of the evidence has been completed, the responsibility of the auditor is to communicate such information in the form of formal reports to the legislature. A copy of the report should also be given to the Governor and other officials responsible for the agency or department audited to inform them of the findings and recommendations of the auditors, but the primary purpose of the report is to inform the legislature. Once the report has been filed with the legislature, the auditor's responsibility is completed. His authority is confined to examining and reporting, and it should carry no administrative power except to conduct the affairs of his own office.

Recommendations may take several forms, but they should always be confined within the limits of the auditor's area of competence. As a result of his examination, for example, he may feel that a different type of study is needed, one requiring expertise in areas that he does not possess, and he may properly recommend that such studies be made. But

he should not attempt to render opinions or make recommendations in those areas. To do so would not only open him up for severe criticism in the event that his recommendations were inappropriate or ill conceived, but it would also cost him the confidence of those whom he audits. And without their cooperation and confidence, his work is much less effective and far more difficult if not impossible to perform.

Scope of Audit Inquiry

The scope of the audit inquiry is difficult to define, since in any given situation the extent of the auditing which should or can be performed is a function of (1) the will of the legislature, (2) the extent and nature of the internal audit work done, (3) the competence or qualifications of the auditor, (4) the relevance of the inquiry to the legislative process, and (5) the existence of certain pre-requisites in some areas. In no case is the scope of the audit conditioned by the will of the Governor or of agency officials unless the expression of such will results in corresponding instructions to the auditor from the legislature. In this respect the state auditor general is different from the independent commercial auditor who is engaged by the organization which he audits. Since the auditor general is responsible only to the legislature, a third party, and is therefore not engaged by the agencies he audits, he is, in the words of Ellsworth Morse, "completely independent of them in establishing the scope of his examination."¹

Being responsible to the legislature, the scope of the auditor's work is subject to the will of the legislature. This is not to imply that the legislature should determine what items are to be examined and

¹Ellsworth H. Morse, Jr., "GAO Audits of Management Performance," The Journal of Accountancy (October, 1961), p. 44.

what items are not. In conducting the audit, the auditor must be as free from legislative influence as from executive influence. He must be permitted to carry out his professional responsibility in accordance with accepted professional auditing standards and in all ways to conduct his investigation within the framework of the ethics of the profession. No legislator or group of legislators has a right to interfere in any way with the procedures used, the evaluation of evidence on which the opinion is based, or in the formation of the opinion itself. Independence on the part of the auditor must be complete in these matters.

However, the legislature does have the clear right to request that the auditor undertake special investigations which may be substantially different in nature from that of the normal audit. Such investigations may be requested for the purpose of looking into specific activities of selected agencies or officials or to examine alleged irregularities, misappropriations, defalcations, and misrepresentations in financial or performance statements. It may also consist of special studies to determine the financial implications of proposed legislation. But in any case, the investigation, to be properly assigned to the auditor general, must fall within his area of competence. He is not a highway engineer, for example, and an investigation to determine how long it would take to build a highway of given size and quality is undoubtedly beyond his area of competence. However, an investigation into the reasons why it took two years to build a highway that was to have been built in one is an inquiry which he could properly be expected to conduct. Likewise it is beyond his competence to determine what it should cost to operate an English Department at a state university, but he certainly could be expected to determine why one such department spends twice as much as another.

The Competence of the Auditor

Basically, state auditors are trained and experienced primarily as accountants. And that is as it should be, although it is helpful if such auditors also have some training and/or experience in management, organization theory, systems analysis, statistical sampling, and public administration. The specific qualifications of auditors will be discussed more fully under staffing problems in Chapter V. For now, however, the fact is admitted that auditors are and will in all likelihood continue to be primarily accountants, and the question that must be answered is: What is their area of competence?

In answering this question, the term accountants will be used in a broad sense. It will be assumed that the auditor general is able to surround himself with a well-trained and experienced staff of capable individuals. Thus the quality of his staff will not be a major consideration at this point. It will, however, be discussed later in this study.

There is no question concerning the auditor's ability to review financial statements and accounting records. If he does nothing else, he at least does this in every state where such an officer exists. However, even here the matter of what constitutes the financial area is not entirely clear. Certainly it includes an examination of cash transactions to determine that such transactions are properly authorized and recorded, but it includes much more. As defined by the General Accounting Office, an agency's financial responsibility includes "the administration of funds and the utilization of property and personnel for only authorized programs, activities, or purposes, and the conduct of programs or activities in an effective, efficient, and economical manner."¹

¹U.S., General Accounting Office, Functions of the General Accounting Office, A report prepared at the request of the Committee on Government Operations, United States Senate. May 29, 1962, pp. 11-12.

Thus even a financial audit becomes a comprehensive review of administration.

The auditor is also a specialist in control. Even before he conducts an audit of financial matters, he must satisfy himself as to the adequacy or inadequacy of the management control system. Yet control is a very comprehensive matter too. As professor McFarland explains, "Control is the process by which an executive gets the performance of his subordinates to correspond as closely as possible to chosen plans, orders, objectives, or policies," and it includes, "the process of evaluating results, comparing them to established standards, and taking steps to correct discrepancies which appear."¹ Thus, to review control, it is necessary to review organization structure, operating procedures, policy statements, accounting and reporting systems, and the internal audit or review program. All of these items are within the competence of the auditor to review and evaluate.

The extent to which the auditor can review compliance with legislative intent or policy is directly related to the degree to which the legislature makes its intent and policy formally known. The auditor cannot take it upon himself to assume legislative will; neither can he judge administrative performance by what seems to him to be reasonable guidelines and standards. Yet, there is no question but what the review of legislative intent, both for compliance and for adequacy, is an important function of the auditor. This theme has been well developed in this chapter. A review of the faithfulness of the implementation of legislative will can be effectively and objectively achieved only when such will is expressed and the commitments of executive officials are explicitly

¹Dalton E. McFarland, Management Principles and Practices (New York: The MacMillan Company, 1959), p. 229.

set out.

One of the purposes of legislative review, as previously defined, is to determine whether or not programs are achieving their desired objectives. And the question of whether or not this matter is a proper subject for inclusion in the auditor's review is one which must be answered conditionally. To the extent that programs have been developed and related to specific objectives, and to the extent that useful performance standards have been established, the auditor can competently perform an examination of program achievements. However, it must be clearly understood that the auditor can only judge performance in relationship to some established standard. In the absence of specific standards for a given situation, it may be possible for him to use standards developed and used in similar situations by other states or groups. It may also be possible to use prior years' results or historical trends as standards. And in the absence of any other generally accepted standard, the auditor can often compare the performance of one organization, such as a hospital, with another similar organization. But when it comes to rendering an opinion on the question of whether or not such performance or achievement is in fact that which was intended by the legislature when the program was authorized and funds were appropriated, the auditor must decline such an expression of opinion unless adequate standards exist.

Audit of Efficiency and Economy

Throughout the review of the literature as well as in the interviews connected with this study, the frequency with which the terms efficiency and economy were used is striking. Almost as if they had been joined in marriage, these two terms are seldom separated and almost never distinguished. Yet, in spite of the frequency of their use and their apparent wide popularity as co-equal ideals, they are not equally

desirable objectives of an audit, and for this reason they have not been used together in this study to define the functions or objectives of either the legislative control system as a whole or of the performance audit in particular.

The problem arises primarily with the term "economy" or "economical." Whenever "economy" in government has been defined by those contacted in this study as being different from efficiency, it has been used synonymously with a "reduction in expenditures." Used in this sense, the term implies that if the auditor were to test for economy, he would merely be looking for ways to cut expenditures, and this cannot be supported as a desirable objective. Certainly the citizens of the state would be happy to see expenditures cut so that taxes could be lowered, but are they willing to accept a corresponding cut in the services rendered by the state? That is the question of real substance, and that question involves a matter of efficiency.

Efficiency, as used here and as used by most authorities contacted in this study, implies something about an input-output relationship. Whenever a greater output can be achieved with a given stock of resources, efficiency can be improved. Similarly, whenever the same output can be achieved or the same level of services rendered while lowering the cost, the operation becomes more efficient. Thus, the auditor can and should become involved in testing for efficiency in both senses. He certainly should watch for opportunities to cut state expenditures, but he must always relate the cut to its impact on output. To recommend a cut merely to reduce total expenditures is completely illogical, for it carries the clear implication that such reductions are desirable regardless of their consequences. Yet some audit groups, including the General Accounting Office, profess to adhere to this policy quite closely.

Another sense in which the term economical may be used is to describe whether or not a given output of goods or services is worth the cost of inputs. Here again, however, is a question beyond the competence of the auditor to judge. "Worth" implies a set of values against which the input-output relationship can be measured or compared. If such values are stated as standards and are generally accepted as valid, the auditor can use them and make the analysis. However, here he is once again relating performance to standards, which is his proper function. In the absence of such standards, the auditor can make comparisons between two similar operations, pointing out which seems to be most efficient. But he cannot state that one or the other is "economical" in this sense. That judgement must be left to the legislature whose responsibility it is to make such judgements and decisions.

The same is true of any other value judgement of this nature. For example, the auditor does not judge whether or not the accounting and reporting system is "good" or "proper;" rather he examines the system to determine whether or not it is carried out according to generally accepted standards and principles and whether or not it is meeting the objectives for which it was established. Similarly the auditor reviews the system of internal control to determine its adequacy and reliability in meeting the objectives for which such a system is set up, not to judge whether or not it is "good" or "proper" as such.

Likewise there are areas of cost analysis which are beyond the area of competence of the auditor. For example, not being an engineer it is beyond his competence to determine how much a bridge of given length and quality should cost. However, it is not beyond his competence to conduct an examination to determine why the construction of such a bridge actually cost more than it was originally intended to cost. Similarly, it is

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beyond his area of competency to determine what it "should" cost to treat mental patients or to rehabilitate prisoners, but it is not beyond his competence to determine why costs differ between similar mental hospitals or correctional institutions or to make recommendations based upon such comparative studies.

A final way in which the term "economical" is sometimes used is to describe the impact of certain expenditures on the economy of the state or local area. Once again, however, such a determination is clearly beyond the competence of the auditor and is not a proper subject for his investigation. Thus in all three senses in which the term is used, economy is not a desirable objective of the auditor.

Efficiency, on the other hand, is always subject to audit review. However, even here there are some problems. The output of government occurs primarily as services to society--services which are difficult if not impossible to quantify in any meaningful fashion. Thus efficiency in government does not lend itself to measurement as readily as does efficiency in an industrial plant. And the problems here for the auditor are many.

First, unlike a commercial enterprise which measures efficiency in terms of profit or contribution to profit, a government agency such as the conservation department must relate cost inputs to trees planted, to wildlife preserved, or to parks maintained. Thus efficiency cannot be measured in financial terms. As one writer points out, however, "This does not mean necessarily that figures cannot be developed which will indicate a measure of efficiency. It means only that figures developed according to the conventional pattern are simply not valid for this purpose."¹

¹W. Lynn Fluckiger, "A Philosophy of Fund Accounting," The Journal of Accountancy (August, 1963), p. 70.

Some writers have suggested that unit costs be developed, such as cost per patient day, cost per credit hour, cost per full-time equivalent student, or cost per mile of highway services. Obviously these measures have serious deficiencies too, but they do represent what seems to be the most promising approach yet suggested for developing standards of judging efficiency in government. Much progress has been made in some areas, such as hospitals, but much more needs to be done before such unit measurements will be fully effective. And even if such unit costs are developed on a wide basis, the auditor will still need to be extremely careful in applying them to a given agency or institution since there exists a wide variety both in size and type of activity among agencies of different states and locations.

Using dollar costs as inputs and dollar sales as output, a commercial enterprise can meaningfully ask the question, would the resources of this branch of the company be more efficiently used if gadgets were made instead of gizmos. But in government the same is not true. There is no way of determining whether or not funds could be more efficiently used if transferred from education to mental health or from conservation to public safety. Nor is there any way to determine whether or not funds would be used more efficiently if used to hire teachers rather than build school buildings. All of these questions depend on a complex set of community and social values and on the judgement of which output is to be maximized. Furthermore, the analysis of whether an agency is more or less efficient this year than last has the same value problem in most cases, and even if such problems could be eliminated, there is still the fact that when one compares total input to total output, the efficiency ratio will be lower the larger the operation becomes, simply because of what the economist calls the law of diminishing returns.

Beyond some point, every additional increment of input results in a proportionately smaller increase in output, and thus the total ratio falls. This fact is unavoidable in any organization.

Nevertheless, in spite of the difficulties, the test of efficiency is one with which the auditor must be concerned. It is a far different and more desirable objective than the test for economy under any of the described circumstances.

Relationship to Management Responsibility

Since the performance audit is a review of management performance, it is desirable to clearly set forth the functions and responsibilities of management which are proper subjects for review. Certainly the auditor should not assume the role of the omniscient judge and pretend to be qualified to review and challenge everything that management does. Yet, in some ways, virtually every decision and action of any administrator eventually comes under audit review. To understand and illustrate how this occurs, it is first necessary to clearly understand what management is expected to do.

Basically, the management function can be broken down into three components: planning, executing, and reviewing. The planning phase consists of selecting desirable objectives, developing programs to achieve the objectives, identifying standards with which to evaluate performance against the objectives, and the establishment of a control system to insure that all individuals and activities are oriented toward the effective accomplishment of the objectives in an efficient manner. Such a control system includes the formulation and enunciation of executive policy, the development of methods and procedures of operation consistent with such policy, the establishment of an organizational structure and the assignment of administrative responsibility to carry

out the programs, and the implementation of an effective accounting and information system to record performance and to provide effective communication within the organization. This whole planning function will be described and analyzed in Chapter 4.

The execution phase includes all of the direct and indirect effort expended by members of the organization to execute the plans and carry out the programs. It includes all decisions made, both at the management and at the operating level, which affect the results of operations.

The review function includes the preparation and receipt of reports, the internal audit, and the follow-up by management to take corrective action where necessary. Information received in this phase becomes prime material for the next round of planning. Thus the management function consists of a three-phased cycle, no part of which is complete without the other.

Now, if the auditor is to review administrative performance, it is clear that his review cannot be confined just to the execution phase, although that will undoubtedly constitute a major portion of his examination. He must also review both the planning and the review processes. He must examine not only what happened but also what was expected to happen, and he must question the adequacy of the plan as well as the propriety of the execution. This does not require that he attempt to second-guess management either in terms of the objectives sought or the programs developed. But he must ask the questions: Is the control system adequate to insure that the objectives will be met? Are the standards relevant and useful? Are the programs internally consistent? Is responsibility and authority clearly defined? Have alternatives been fully explored? Do old programs continue to serve their intended purposes? Are the budgeting and accounting systems consistent with the patterns

of responsibility and the programs developed? These and other similar questions are within the competence of the auditor to judge.

In the area of management review the auditor clearly must concern himself with the nature and the extent of the internal audit program, as discussed below. He must also review the adequacy and timeliness of reporting procedures and the use to which management puts such reports. Finally, he must review the extent and the effectiveness of management follow-up to insure that proper corrections are being made. To the extent that an effective management review function exists along with an adequate control system, the work of the legislative post auditor will be substantially reduced.

Thus, the auditor's role goes far beyond an inquiry to determine the financial results of operations for a given period, and includes an examination in one way or another of virtually every management function. Because of this fact, it is understandable why management people in state government are somewhat apprehensive about such a comprehensive audit program.

Again the tremendous responsibility of the auditor to make the audit a constructive and positive program becomes abundantly clear. In his instructions to Certified Public Accountants who are engaged in conducting audits within the state, the Auditor General of Illinois had this timely advice:

. . . Each individual auditor . . . has an obligation to conduct himself . . . in such a manner that he promotes the over-all constructive objectives of the post-audit program. The surest way . . . to hurt the program is to give agency personnel the impression that the auditor is part of a "Gestapo" or spy organization or that he will try to pillory them for every small error in judgement or departure from the statutes and regulations. While the audit reports must include disclosure of any instances of wasteful procedures, improvident expenditures, ineffectual controls, and unbusiness like methods in carrying out programs, each auditor should not forget that agency personnel are the individuals that will in most cases

have to take the necessary action to correct deficiencies and . . . to place recommendations for improved procedures into effect. An antagonistic attitude on the part of agency personnel, even with an honest purpose behind such antagonism, may negate the best of suggestions. If it can at all be avoided, agency personnel should not be put into a defensive position where they feel so compelled to justify past actions that they are blinded to the positive aspects of an auditor's recommendations.¹

Relationship to the Internal Audit

Implicit in the above discussion is the fact that the achievement of faithful, effective, and efficient operations is a basic management responsibility. The system of organization and control within each agency should be designed to achieve this end, and it is the responsibility of agency management to see that such is the case. Furthermore, it is the responsibility of executive officials to provide a system of control and to establish a framework of executive policy to insure proper coordination of programs and utilization of resources within the executive branch. Such a system of control, whether within the agency or encompassing the entire executive branch, requires proper accounting for delegated responsibility and complete reporting of the results of operations. To be fully effective, such a control system must include a competent and effective internal audit program.

Thus, the audit conducted by the auditor general is fundamentally an audit of management control systems. To the extent that the findings of the independent auditor reveal effective and competent internal audit staffs functioning within well-designed control systems, the scope and depth of the independent audit can be substantially reduced. On the other hand, if a weak and ineffective control system is found with insignificant or no internal audit review being performed, the scope and depth

¹Illinois, Office of the Auditor General, op. cit., p. 6.

of the independent audit must be broadened to include many of the tests otherwise not needed. Thus the extent of the auditing properly performed by the auditor general is to a great extent a function of the nature and scope of other audit work within the state. The work of the auditor general will not only be reduced but will also be considerably more effective if a good system of internal audit and review is operative throughout the state.

Ideally, internal audit work should be carried out at two levels of state government. The first and primary responsibility for such work lies with the agency or department. This fact is expressed in an excellent study on the subject of internal auditing prepared by the Office of the Auditor General of California which concluded that "internal auditing is essential to the proper fulfillment of the agency concept, and the preponderance of such auditing within the executive branch should be done at this level."¹ The purpose of such an internal audit function is to provide agency management or department heads with timely and relevant reports regarding the status and operations of their respective organizations so that proper control can be exercised and corrective action can be taken. Thus in a real sense, the internal auditor is the administrator's arm for effective review in the same way that the auditor general functions in this capacity for the legislature.

Much discussion has centered around the scope of the internal audit, and while it is not the purpose of this paper to develop that subject, it does have important implications for the auditor general which should be noted.

¹California, Office of the Auditor General, Report on a Review of Internal Auditing within the Executive Branch of the California State Government, 1962, p. 10.

Basically, the scope of the internal audit is as broad as the scope of management responsibility, and it is limited only by the competence of the auditor and the will of management. In recent years the scope of internal auditing has broadened considerably from the traditional review of financial controls and statements, and now many internal audit staffs are performing what are known as "operational audits."¹ Such audits are literally performance audits conducted at the agency level, and as such, are concerned with everything that such a designation implies. It is proper to include within the scope of the internal audit a review of every activity or function of the agency which falls under the responsibility of the administrator and which is not outside the area of the competence of the auditor. His function is to audit agency performance, financial and otherwise, and to report his findings and recommendations to management.

The second level of internal auditors should be responsible to the Governor and other top-level executive officials. Their duties should include the oversight of administrative performance throughout all of the departments and agencies of the executive branch of the state. This group of auditors need not be large if effective internal audit work is carried out at the agency level, since the work of this group would include a review but not a duplication of the work of the agency internal auditors. This senior audit group would also be responsible to see that financial and performance reports are timely and properly prepared in accordance with executive policy and accepted reporting standards. In addition, this small, well-trained and experienced staff would be available for special studies and investigations as requested by the Governor

¹See, for example, Bradford Cadmus, Operational Auditing Handbook (New York: The Institute of Internal Auditors, 1964).

in the same way that the legislature would use the auditor general for its special studies and investigations. Thus, what has come to be known as the management survey or management audit,¹ if conducted by personnel within the state, could well be performed by or under the direction of these top-level internal auditors. Certainly the scope of their audit authority would be as broad as the responsibility of the executives they serve, limited once again to the competence of the auditor and the will of the chief executive.

The implications of such an audit program are obvious. To the extent that competent internal auditing is performed at both levels of management control, management reports will be timely, complete, and accurate. And matters such as organization, operating procedures, policy, and performance will be reviewed for adequacy and efficiency by an internal staff close to and familiar with the problems involved. Once the auditor general can assure himself of the quality of the management control system and of the internal audit program, he can proceed to evaluate the other matters on which he is expected to render an opinion with considerably less work and detailed analysis. While the scope of his audit inquiry would remain just as broad as ever, the depth and detail of his examination of evidence would be substantially reduced.

The corollary of this fact is that it becomes the first concern of the auditor general to examine the systems of management control and audit review and to make sufficient recommendations to improve their quality to the point where they effectively provide the type of control

¹See William P. Leonard, The Management Audit: An Appraisal of Management Methods and Performance (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1962); and Stephen R. Michael, Appraising Management Practices and Performance (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1963).

described.¹ In the absence of such internal controls and internal audit programs, the field of performance auditing is too broad and the demands are too great for the auditor general to even hope to do more than spot-check performance and review those aspects suspected or thought to require correction or improvement.²

Finally, the best assurance that legislative policy will be carried out by executive officials is to have a well-established and effectively operating system of management control, where responsibility is defined and accountability is secured. If internal auditors are checking performance against executive policies and legislative intent, it becomes much easier for the auditor general and his staff to identify deviations and to pin point responsibility for them. Moreover, the internal audit function should not be thought of as something in addition to the auditor general's audit, but rather as a vital element of management control that is needed in state government regardless of its relationship to the work of the auditor general.

Certainly there is nothing which is more clearly within the area of the competence of the auditor general than a review of the adequacy and effectiveness of the internal audit program. The only difference between the performance audit conducted by the auditor general and that conducted by the internal auditors arises from the nature and scope of their respective responsibilities. They all must go beyond

¹Consistent with this idea, the first general audit program undertaken by the Auditor General of California after the creation of his office and his appointment to fill it was an over-all study of internal control in state agencies to determine how much reliance could be placed on the reports of these agencies. See California, Joint Legislative Audit Committee, First Report of the Joint Legislative Audit Committee, December 31, 1958, pp. 18-23.

²This is basically the approach of the GAO. See U.S. General Accounting Office, Purpose and Objectives of Independent Audits, 1961, p.3.

financial areas if they are truly to function as broad review elements in their respective control systems. Furthermore, before the performance post-audit review, as conducted by the auditor general can become fully effective, it must be accompanied by a similar extension of the scope of internal auditing at both agency and top-executive levels.

Legislative Support of the Auditor

If the legislative post audit is to become an effective control element in state government, it must have the full support of the legislature whom it is intended to serve. Such support must come in four important areas.

First, the legislature must make every effort to provide the auditor general with the necessary authority to carry out his work. He should have the power to examine all records and documents which he deems necessary to examine in order to render a competent opinion on the financial position and results of operations of state agencies. He should have the power, as does the Michigan Auditor General, to obtain independent legal counsel, and to employ independent accounting firms to make investigations pertinent to such audits. He must also be permitted to employ competent and experienced personnel for his staff.

Second, the auditor general must be given adequate funds to perform the job he is expected to do. Occasionally state legislatures have looked upon their own auditors with suspicious eyes and have cut their budgets as a means of punishment for having disclosed information in an audit report which proved to be embarrassing to some public officials, even though such disclosures were proper and resulted in substantial savings to the state and the correction or elimination of improper and/or illegal practices. In other cases, legislatures have actually expressed a

willingness to receive "skimpier" audits rather than provide funds sufficient to enable the auditor general to perform the work constitutionally or legally required of him.

Third, the legislature must make a conscientious effort to provide the auditor general with a clear expression of its will, concerning both the audit policy which he is expected to follow as well as the instructions and policies prescribed for agencies and departments subject to audit.

Finally, the legislature must assume the responsibility for reviewing audit reports and enforcing audit recommendations. It does little good for the auditor to conduct an audit and file a report if that report is never used and the auditor's recommendations are ignored. Too often the only reports that receive the attention they need are those which report illegal conduct, material defalcations, or some other sensational finding. The legislature must realize that following through on a recommendation to improve a control system is far more valuable to the welfare of the state than calling for an investigation into alleged defalcations after the fact, for it is by strengthening the control system that such defalcations are prevented or at least minimized.

Yet it is presumptuous to expect that every member of the legislature will have time, or will take the time, to read every report that is prepared by the auditor general and his staff, or that if they did so they would all understand fully the significance of the statistics and information given. Because of this fact, it seems desirable for the legislature to establish from its members a joint, bi-partisan, audit committee or commission to receive and review the reports of the auditor general and to make recommendations to the legislature as a whole on the appropriate response to be taken in each case. A few states presently have

such groups established and functioning, and perhaps a brief description of one of them will illustrate the nature and value of their work.

The Case of the Illinois Legislative Audit Commission

The Illinois Legislative Audit Commission was created by statute in 1957 as part of the reformation of the state audit program following the Orville E. Hodge scandal and subsequent investigation.¹ The commission is composed of five members of the Senate, appointed by the President Pro Tem of the Senate, and five members of the House, appointed by the Speaker of the House. In both the Senate and the House, at least two of the appointees must be of the minority party, and appointments are made for a two-year term of office. The commission is required by statute to "ascertain facts, review reports and take action thereon, and make recommendations and reports to the General Assembly and to the houses thereof concerning the audit . . . and such related matters as may be directed by the General Assembly."²

The Commission is required to receive the reports of the Auditor General and other financial statements and to determine what remedial measures, if any, are needed. If the Commission feels that special studies or investigations are necessary, it is authorized to direct the Auditor General to undertake them.

The Commission has the power to summon and compel the attendance before it of any person directly or indirectly connected with any

¹See Lloyd Morey, Albert E. Jenner, Jr., and John S. Rendleman, Report and Recommendations to Illinois Budgetary Commission, with respect to investigation on behalf of the Commission as to operations of the Office of Public Accounts of Illinois under Orville E. Hodge; December 4, 1956.

²Illinois, Legislative Audit Commission, Ninth Annual Report of the Legislative Audit Commission, submitted to members of the 74th General Assembly of the State of Illinois; February 28, 1966, pp. 57-59.

transaction involving state agencies, or any other persons having information concerning the conditions and affairs of the management or administration of fiscal matters, and to examine such persons under oath. It may also secure the possession of any records or documents pertinent to such matters or transactions. Failure of any person to obey such a summons or to surrender such records, without reasonable cause, may be brought by the Commission before the court for prosecution.

In this manner, the commission is fully able to investigate and review audit findings and to satisfy itself as to the reasonableness of audit recommendations. When a disagreement arises between an agency responsible to the Governor and the Audit Commission concerning a report or recommendation made by the auditor, the Commission is required to promptly advise the Governor of such area of disagreement. The Governor is then required to render a report within sixty days expressing his views on the area of disagreement and indicating what corrective action, if any, has been taken by his office or setting forth the reasons why no action was taken if that is the case. The same sixty day rule applies to all other state officials if the agency in question is under their jurisdiction, whether Executive, Legislative or Judicial.

The Commission is required to report its activities to the General Assembly (state legislature) including a report of all remedial measures which it deems necessary based upon the audit reports, its own hearings and investigations, and the replies from the Governor and other state officials should they be necessary in the event of disputed matters. A copy of the report of the Commission is to be given to each member of the General Assembly at least annually.

Such a system certainly provides the machinery to make the audit report a very effective and instrumental control device. When agency

officials know that they are going to be called before the Audit Commission to report on their progress in implementing the recommendations of the auditor or to explain why they disagree with such recommendations, they are not prone to ignore such recommendations and leave problems uncorrected year after year. Most recommendations are readily implemented directly by the agency, and only when administrators feel they can build a strong case in their own defense do they allow items to go unchecked until brought before the Audit Commission for review. Knowing that the Governor will become involved if they fail to comply with the Audit Commission's decision, agency administrators usually work out some compromise with the Commission or ultimately comply with the initial recommendation.

One of the distinguishing features of the Illinois system is the sixty-day rule, and it certainly has considerable merit. By bringing audit recommendations up for quick review, this provision insures that such changes in procedures, organization, operations or policy as are felt needed will be timely and effectively implemented throughout the state. It also provides for a thorough review of each problem by every responsible official so that every argument both for and against the recommendation can be heard, and through this process, those recommendations which have little or no justification or merit may be eliminated.

Generally the Legislative Audit Commission has been very effective in Illinois. In a brief report on the work of the Commission, Dr. Lloyd Morey, who perhaps more than anyone else was responsible for its creation, stated in 1960 that the Commission "has clearly substantiated its usefulness and importance and has given an impressive record of performance

and high interest."¹ From the beginning, the Auditor General has attended all of the meetings of the Commission, and thus has been available to assist in interpreting the audit reports. Also, the Commission has employed an executive director who receives all audit reports and, together with comments submitted by the agencies, prepares a review of the problems for the commission. This review has greatly facilitated the effectiveness of the commission in being able to focus attention directly on the problems requiring its attention and decision. Furthermore, agency personnel are invited to attend the Commission meetings when reports of their agencies are involved, and every effort has been made to look at both sides of disputed issues. The result, according to Dr. Morey, "has been almost without exception a favorable reaction among the agencies to the policies of the Commission, as well as to the entire post audit program."²

Finally, the recommendations of this commission to the legislature have resulted in new laws and statutory revisions to improve the operations and controls within the state.

In at least one area, however, the success of the commission has been grossly overstated, and that is the area of dollar savings to the state. In its annual report of 1966, the commission lists all of its alleged savings to the state over its nine-year history and compares that total to the total expenses of the commission to date. It says, ". . . the Audit Commission to date has caused to be collected or recovered for the State a total of more than \$1,800,000. In sharp contrast

¹Lloyd Morey, A Review of the Post Audit Programs of the State of Illinois, a report prepared for Frank H. Whitney, Auditor General, State of Illinois; November, 1960, Part III, p. 6.

²Ibid., p. 3.

the Commission's operating expenses have totaled only \$250,000 in this same nine-year period."¹ A careful analysis of the list of "funds caused to be recovered," however, shows that of the \$1,805,919 listed, \$1,609,183 represents (1) the transfer of special funds to the general fund in the amount of \$823,863, (2) an advance from the Road Fund to the Illinois State Toll Highway Commission of \$321,059, and (3) cancelled outstanding warrants totaling \$464,261. The net effect of these actions was to transfer funds from one hand to another, which in every case allowed them to be spent more quickly and in no way resulted in a "recovery" for the state. Thus over 90 percent of the alleged saving involved only book entries on the accounts of the states, and of the remainder, \$62,400 represents increased revenues resulting from rate changes and fee adjustments which had future application and in no way constituted a recovery of past losses.

This example points up one of the major problems in trying to quantify in dollars the savings resulting from an audit or review activity. The real saving, and it may well have exceeded the \$1,800,000 listed by the commission, are the funds either collected or retained by the State that otherwise would have been lost due to weak controls, inefficient procedures, or lack of proper information had the audit or review not occurred. Such savings can never be measured or even estimated, but assuredly it is substantial.

In spite of this problem, the Illinois system has much to commend itself to other states. Such a legislative audit commission is needed in every state to complement the legislative post auditor in making the audit function viable and effective in state government.

¹Illinois, Legislative Audit Commission, op. cit., pp. 4-5.

The Audit Advisory Board

A few states have also established audit advisory boards designed to provide a professional review and explanation of the Auditor General's reports. One state which has such a board is Illinois, so again it will serve as an example of what might be done.

As is the Legislative Audit Commission, the Advisory Board in Illinois is authorized by statute as part of the post-audit function in the state.¹ The board is composed of five members, no less than three of whom must be Certified Public Accountants and no more than three of whom may be of the same political party. Each member is appointed by the Governor for a term of six years, and no member of the board receives compensation beyond necessary expenses.

The duties of the board consist of (1) examining and establishing standards of audits performed by or for the Auditor General, (2) advising the Governor, the Auditor General, the Legislative Audit Commission, and the Illinois Budgetary Commission on problems relative to audits of state agencies, (3) working in cooperation with professional accountants and accounting organizations for the improvement of state audits, and (4) assisting the Governor and members of the General Assembly in understanding and interpreting audit reports submitted to them by the Auditor General or other professional auditors. Thus, several important functions are served by this board.

First, it provides a competent and professional body to assist the Auditor General in developing and using professional audit standards in government audits. Furthermore it insures a broad range of acceptance and understanding of such audit standards both in and out of state

¹Morey, loc. cit., part II, p. 1-5.

government. It also provides for a continual review or examination of such standards and for their modification and improvement through the years. The value of such a service is tremendous.

Another function of such a board is to provide the Governor and members of the General Assembly, including members of the Legislative Audit Commission, with a consulting body to whom they may go for interpretation and explanation of technical matters of a financial or accounting nature which they otherwise would not understand. It is always possible for these officials to call in the Auditor General, but it is equally important for them to be able to confirm the opinions and interpretations of the Auditor General with an outside professional group also familiar with the problems. Such a check provides an additional benefit to the Auditor General because it removes all doubt concerning the professional nature of his opinion or interpretations, and, in effect, preserves the integrity and effectiveness of his department.

Third, such a group provides a badly needed liason between government auditors and professional accounting groups. This is particularly important in a state such as Illinois where the bulk of the state audit work is actually conducted by independent public accounting firms, but it is also important in states where such firms are not greatly involved in state audit work. Unfortunately the Illinois Advisory Board has not been able to be very effective in providing this liason, and efforts are being made to improve the situation. Both the state and the accounting profession stand to gain from a mutual exchange of ideas and information.

While this example of the Illinois situation is an excellent one in theory, in actual practice there seem to be some problems which require additional attention. One of these is the fact that since all members

of the committee are active professional men, they have insufficient time to devote to the numerous problems that require their review. Furthermore, the fact that they receive no financial compensation other than a reimbursement of necessary expenses makes their work a voluntary contribution, and the attention given sometimes reflects this fact. Finally, while the size of the board (five members) is adequate for the review and analysis work that is required, it has not been adequate to conduct the investigations or penetrating examinations into the problems of standards and practices that are needed to make the function most effective. Neither has it permitted effective working relationships with professional groups or with governmental groups as was originally intended.

The solution to these problems may not come easily. Nevertheless, the Advisory Board and its function represent another important element in an effective post audit program which merits the careful consideration of every state. Some such organization is needed, whether it be organized similar to the one in Illinois or in some other way. Its potential contribution to the audit program certainly seems significant.

Summary and Conclusions

A few years ago a television documentary on state legislatures asked whether or not the legislature still serves the purposes for which it was intended, and Duane Lockard, in attempting to answer the question, pointed out that the answer depends upon what the legislature was intended to do. He adds, "If it was 'meant' to be a well-spring of public policy, a primary initiator of rules, a master of the public purse, then it is not unreasonable to say that it no longer serves its intended purposes fully."¹

¹Lockard, op. cit., p. 274.

Certainly state legislatures, like other political institutions, are to a great extent the product of evolutionary processes. Their history is filled with trial and error, with contest and compromise, and with change over time. Perhaps the intent of the originators of the system has little meaning for modern society which is well over a century removed from that early beginning. In any event, as Lockard continued, "it is obvious when one examines the duties of and the powerful role played by the state legislatures of the 19th Century that the legislature of today represents a striking contrast."¹

In this chapter an attempt has been made to describe a theoretical system of control which is consistent with the original purpose of the legislature, yet which reflects the realities of modern state government. Certainly no state has such a system fully developed, but almost without exception, every state is moving in this direction on at least one or more of the issues. Legislatures are both a part and a reflection of the political, social, and economic changes and circumstances which surround them, and they therefore move in the same direction as do other institutions in society. The use of sophisticated and scientific management techniques within the framework of government will come just as surely as in business, and the strengthening of the control systems in government will likewise parallel that which is being developed in commercial enterprises.

Many factors have conspired to produce the current status of the state legislature, and this chapter by no means discusses or proposes remedies for even a small portion of them. However, one of the responsibilities of the legislature which has lost much of its effectiveness

¹Ibid., p. 275.

over time is its ability to control and review administrative performance. In this area the material in this chapter offers considerable hope for improvement.

The legislative process has been briefly analyzed, including the expression of legislative policy, intent, or will. It was noted that in most cases there is great need for improvement. The system of legislative oversight or review was discussed including not only the use of performance post auditors but also the need for a legislative audit committee and an audit review board, and the dependence of independent auditing upon the system of management control and internal audit was emphasized.

The role of the auditor general and the scope of his audit were discussed and related to the system of legislative control. It was found that the traditional financial audit is by no means adequate to permit the auditor's review to be of great value to the legislature. Viewed in the context of the legislative control system as a whole, the performance post audit becomes more than a possibility; it becomes a necessity. Furthermore, it is within the competence of the auditor to conduct such an audit, providing he is not required to go beyond the point where he can make valid comparisons or use accepted standards in rendering his opinion on performance. Faithful fulfillment of executive commitments and compliance with legislative policy, effective administration and control of programs and activities, and efficient use of all resources in operations are all proper subjects for audit review. However, "economy" was found to be inappropriate as an objective of the audit.

In Chapter IV which follows, the management function and the areas of executive and administrative responsibility properly subject to audit review by the auditor general will be more fully developed and analyzed.

CHAPTER IV

THE MANAGEMENT FUNCTION AND THE PERFORMANCE AUDIT

Introduction

If the Auditor General is to audit the area of executive performance, it is essential that he understand the function and responsibility of executive officials. Basically, that function is similar to what one would expect to find in industry. As noted in the previous chapter, it consists of planning, executing, and reviewing the activities of the state. In this chapter, these broad areas will be further subdivided and analyzed, and the implications for the auditor will be noted.

It is important to state at the outset that this chapter does not treat in depth any of the numerous responsibilities and activities of administrators. It is not the purpose of this study to tell management how to perform its functions. Neither is it the purpose of this study to propose changes in the management system. However, numerous changes have been suggested, many of which seem inevitable given the progress and evolution of state government. Thus, this study takes a forward look and attempts to describe these functions not so much in terms of what actually has been done but what theoretically is done and ultimately will be done if the proposed reforms and improvements are fully adopted.

In this respect this description of management responsibilities will seem to some as being too idealistic and perhaps too optimistic. Yet it is no more idealistic to talk in terms of program budgets, for example,

than in terms of performance audits. The purpose of this study is to identify the direction of change and to expose the picture that lies on the horizon of expectation and possibility and progress, not to lament the current situation.

Although the expression may be made in this chapter that certain things are needed before the auditor can fully perform his function in a meaningful manner, it should never be understood that such reforms are being proposed because they will facilitate the audit. In almost every case, and the exceptions will be duly noted, reforms or changes are needed because they permit or help management to better perform its own functions and carry out its own responsibilities. And the position of this study is that the better informed management is in its decisions and the better the control is that management exercises over operations, the easier and more useful the audit becomes. Thus, improvement in management methods leads to better auditing, and the fact that something is needed before a meaningful audit can be performed usually implies that it is needed by management to fully be able to conduct its affairs effectively and efficiently.

The Management Function in Brief

The essence of management is decision-making and control, and the functions of management are planning, executing, and reviewing.

Every organization is presumably ordained to fill a mission, which mission is conceived in terms of long-range goals. Such goals are broken down into immediate objectives which seem reasonably attainable by the organization. In a government where organization structures already exist, the first function of management is to identify the objectives and to define them in workable terms. Once these objectives have been

defined, planning can occur, for planning is the process of charting the most efficient and effective course for achieving the objectives within a specified period of time. Planning, if rational, involves a weighing of alternatives and the selection of the most appropriate alternative in light of the objectives sought.

Programs are the means by which objectives are achieved. Thus a program is characterized by the organization of activity and resources toward the achievement of an objective. Several alternative possible programs may exist each of which could achieve the objective, and the management function is to rationally choose from among them that program which will produce the most efficient and effective result. Several programs may exist within an organization, but ideally no single program involves more than one organization.

In developing programs to achieve specific objectives, management must also detail the performance standards by which it will know when such objectives have been achieved or by how far such objectives were missed. Such standards are needed for each program. These standards, to be most useful, should be objective, measureable, and consistent. They should detail the conditions that will exist when the objective has been achieved.

Once programs have been formulated, specific assignments of responsibility can be made. It is the responsibility of management to deploy all personnel and equipment and to establish the internal pattern of responsibility. It is further the duty of management to dictate policies for the purpose of giving direction to and controlling activity within the organization so that all effort and decisions combine to produce the desired results. Consistent with this policy and with the assigned patterns of responsibility, performance standards need to be set for each job or

activity so that management can determine and appraise the quality of individual performance at every level of the organization.

Budgeting is the process by which scarce resources, usually expressed as funds, are allocated among competing demands. Budgeting, to be most meaningful, must follow program patterns and lines of responsibility. In fact, since the selection of any one program from among several alternatives includes the consideration of input-output or cost-benefit relationships, the allocation of resources occurs among programs at the time each program decision is made. Within a given program, budgeting is the process by which funds are assigned to the acquisition of specific resources, both human and non-human, and both capital and operating. The responsibility of management includes the budgeting function at both levels.

It is also the responsibility of management to provide a system of accounting and reporting to record actual expenditures and obligations incurred. Such a system should provide for program accounting consistent with program budgeting and with the patterns of responsibility as assigned within the organization. Reports should be made in terms of areas of responsibility and program achievements, and should permit comparisons with the designated performance standards. Internal reports should facilitate rational management, and external reports should provide relevant performance statistics in terms of program achievements. It is not sufficient to provide only statements of source and use of funds. Such funds statements, to be meaningful, must be related to performance criteria.

Finally, it is the responsibility of management to review actual performance and to take corrective action when needed to preserve the integrity and effectiveness of the organization in achieving its objectives. Such a review is accomplished in a variety of ways, including the post

audit by an internal auditor. Such reviews permit competent and accurate representations by management on the performance of the organization in terms of programs and objectives, both financially and otherwise.

In every agency or department of the state, however great or small, management responsibility follows this pattern, including the responsibility of the Governor to the whole executive branch. However, in state affairs, executive officials have additional responsibilities to the legislature which tie into the functions above but which in no way inhibit or detract from such functions.

First, it is the responsibility of management to present to the legislature an estimate of the financial needs of the state over the next fiscal period. Such an estimate usually is made in the form of the executive budget, which details state expenditures in terms of organizations and programs. As support or justification for the budget presented, the programs must be identified with specific objectives and must offer the most efficient and effective alternatives available to achieve such objectives. Furthermore, executive officials must demonstrate an ability to carry out the programs in the manner prescribed. Thus it is necessary to identify each program with a specific organization and to designate the responsible official. It is further necessary to demonstrate that the necessary talents and resources are presently or potentially available and that an adequate system of management control exists within the organization to insure that effort and decisions are oriented toward the proper objectives.

It is also the responsibility of executive officials to report to the legislature the results of operations. Thus, when plans are proposed to the legislature in support of budgetary requests, it is important that executive officials identify appropriate standards by which performance can

be measured and reported, and it is important that reported performance correspond with and relate to such objectives and standards.

Thus, in theory, the legislature is able to review executive planning and approve proposed programs as well as to check actual performance against such plans and proposed programs. In this respect, the legislature serves as the guardian of the public interest to insure that every responsible administrative official of the state is held accountable for his use of public resources.

Unfortunately, no state today operates entirely in the manner prescribed above, although some are much closer than others. There are, however, encouraging indications that most states are moving in this direction. In the sections which follow, the major items of this system will be noted. But first, this theoretical system will be related to the work of the auditor general.

Implications for the Auditor

It is important that the auditor be familiar with the whole management function, not just with a few segments of it, if he is to render an informed and competent opinion on performance. There are several reasons why this is so.

First, actual program performance is a product of the planning function. Poor performance results either from poor planning or from deviations from plans. Thus, while it is helpful to know actual performance for a given period, it is perhaps equally important or more so to know whether or not such performance agreed with or deviated from planned performance. Only then can corrective action be taken, for only then can the source of difficulties be determined.

Second, legislative policy is a reflection of the legislatures's

reaction to proposed plans and programs as presented by the executive branch. Thus to fully understand legislative intent and to test to see if legislative policy has been effectively and faithfully followed in the execution of programs, it is necessary to know on what basis such policy was formed and intended. Furthermore, executive commitments to the legislature are, or at least should be, based upon planned activity and planned programs, and thus it is necessary for the auditor to be familiar with the planning function to understand such commitments and to determine that they have been faithfully kept.

Third, it is in the planning process that performance standards are identified by which management is able to determine if programs are achieving their desired objectives. It is likewise by means of these same standards that the legislature and the auditor general are able to determine whether or not performance has met expectations. Thus it is important not only to know what standards are being used or how they are being used but also whether or not they effectively serve the function for which they are established. Without adequate standards an objective evaluation of performance may be impossible, both for internal management and its internal auditors as well as for the auditor general and the legislature.

Fourth, it is one thing to report that performance did or did not conform to accepted plans and quite another to pinpoint the problems and take responsible corrective action. Thus, the auditor general must examine the internal review function to determine that responsibility for performance is established by management and that proper corrective measures are taken to improve it in the future. Such a review includes not only a test of the adequacy and effectiveness of the internal auditors but also of management's reaction and follow-up to internal audit recommendations. It also includes an examination to determine that each responsible

official effectively reviews the area of his own jurisdiction, including the performance of all persons directly responsible to him. The corrolary of this requirement is that the auditor must determine if authority has been properly defined and responsibility properly assigned consistent with the proposed organizational plan to carry out and implement the programs.

The same is true for the whole system of executive control, from the initial plan to the final action taken. In addition to the areas mentioned above, the adequacy and effectiveness of policy must be examined. The accounting system must be tested in terms of adequacy and appropriateness to insure that information is recorded and reported in terms of programs and areas of responsibility. And an effective review of operating procedures is essential to insure continued efficiency in the use of funds and other resources available to management.

A final purpose for these reviews is to provide the legislature with information relative to its responsibility and to implement legislative control through the auditor's review. Legislative control is affected in part by the degree of executive control, and the more effectively management reviews and strengthens its own control system, the less need there is for a penetrating and detailed legislative audit review of operations. Thus, ideally the auditor general need not be so much interested in testing for efficiency as to see that management does it, for efficient operations come not so much from recoveries and corrections after errors have been found as in the careful control of such matters in the planning and reviewing processes as performed by management. And the same is true for most of the other tests of performance. Truly the more effective the auditor general is in recommending and securing improved management controls and reviews, the more he reduces

the extent of the need for his own audit work. Thus it is essential that he fully understand the management function from beginning to end so that he can appropriately test the whole executive control system and make appropriate recommendations for improvements and adjustments.

Planning

Planning is the most basic characteristic of executive action. As Dimock says, "The executive may not consciously use the term, but all his work, whether he knows it or not, is in some way concerned with the unfolding of a plan."¹ The essence of planning is making decisions.

Planning is the means by which rational choice is brought out of chaos and purpose is given to action. Yet planning itself can be chaotic and confusing if it is not undertaken systematically or if it is not based on sufficient or reliable information.

Before a decision can be made, two or more mutually exclusive alternatives must be available. And if the decision is to be rational, full information must be available regarding the consequences of choosing either alternative. Thus the biggest difficulty in planning is obtaining sufficient competent information on which to base the decision.

Planning is always concerned with action that will occur in the future, and since the future is always uncertain, planning is always subject to uncertainties. Thus, no plan can guarantee success, although the safest formula for achieving success is still the admonition familiar to most executives: Plan your work and work your plan. Through planning, an organization becomes better prepared to face the uncertainties as they become realities and to respond or react appropriately. Changing conditions

¹Marshall Edward Dimock, The Executive in Action (New York: Harper and Brothers Publishers, 1945), p. 124.

are inevitable, but through planning, management seeks to influence and control the nature and direction of change and to determine how desired change can be brought about. Thus, as McFarland declares, "The ability to plan successfully sets the adept executive apart from those who are merely average."¹

Planning in the state involves every level of state organization and administration. It is not just an activity for top-level executives. This fact is illustrated in the following instructions in Illinois:

Since each Agency is required . . . to present its plans, programs, and requirements for approval, there should be established in each Agency, a planning function, directly supervised by the Agency head and charged with the duty of developing future plans and requirements of the Agency. This function . . . should be clearly assigned and staffed . . . in order that the programs developed are the most effective and economical for achieving Agency objectives.²

In reviewing the planning function, the auditor is not charged with the responsibility of questioning the decisions themselves. What he is charged with is determining whether or not the planning function is explicitly recognized, staffed, and performed. He may also review the adequacy or completeness and the reliability of the information upon which plans are based, and most importantly, he can certainly determine whether or not alternatives are being considered and evaluated or whether tradition and habit dictate the choice. In no way does the auditor become a consultant in the planning process. Such professional help is available within the executive branch or can be secured independently by management, but the auditor general should in no way become involved in making decisions or dictating policy that is the responsibility of

¹McFarland, op. cit., p. 70.

²Illinois, Department of Finance, Requirements for Internal Control and Recordkeeping in State Agencies (State of Illinois: December 27, 1963), p. 2.

management.

The elements of planning include selecting objectives, setting standards, formulating programs, allocating resources, determining policies, and assigning responsibility. Each of these elements of planning will be considered below as separate items, although it is obvious that they correlate with each other very closely and in fact are almost identical problems in many cases.

Objectives

The first step in planning is the clear determination of objectives, for as Dimock explains, "you cannot make valid detailed plans for either your program or your strategy until you know just where you are going."¹ This fact is supported by Schultze who said, "The first and most difficult of these tasks is defining program objectives in specific terms capable of being analyzed."² (emphasis in the original)

Not only is it important that objectives be specific, they must also be associated with definite time periods within which the objectives are expected to be achieved. For unlike long-range goals or missions, objectives represent achievable results within a specified time period. Stated in another way, objectives are the immediate contributions which the organization expects to be able to make toward its long-range goals or mission.

Presumably the objectives result from the desires and needs of society as reflected in the demands on the state. Thus, broad objectives for each organization must be determined or defined by top management, and for state organizations which have had a long history of activity, such objectives are to a great extent influenced by custom, tradition, and

¹Dimock, op. cit., p. 54.

²Charles L. Schultze, "Needed: New Approach to Expenditure Evaluation," Tax Review (August, 1965), p. 32.

law. Once organizational objectives have been defined, they must be broken down into program objectives. That is, each program of the state should contribute in some way toward the achievement of one or more objectives.

Objectives may be viewed in a hierarchical pattern. The achievement of several small objectives with limited programs may be necessary before a higher order of objectives may be sought, and the achievement of several higher-order objectives may be necessary to achieve the overall objectives of the organization. For example, an objective of the Conservation Department may be to improve fishing conditions in the state. Before this can be done, however, fish must be raised in fish hatcheries in sufficient quantities to provide for planting of additional fish in the lakes and streams of the state to improve the fishing conditions. But even before the fish can be raised, trout farms must be secured and hatcheries built, so this becomes the objective of the first order. Its achievement permits the second objective to be tackled, and its achievement in turn permits the final objective to be undertaken. The important thing to recognize is that at every level, programs and activities are oriented toward the achievement of an objective which is specific and identifiable.

It is the function of management not only to define and identify such objectives but also to communicate them effectively to responsible members of their organization, and even to involve the members of the organization in defining and refining the objectives. Each member of the organization should be able to answer the question: What are we trying to accomplish? As the planning function is basic to each agency, so also is the identification and clarification of objectives.

For any agency, there are numerous objectives which could be sought.

Rational planning requires that they each be considered and carefully analyzed and that from among them those objectives be selected which are most urgent, are in the greatest public demand, and are within the immediate capability of the organization to achieve. This selection of specific objectives is subject to certain restraints as represented by the limited resources which are available to carry out such objectives.

As Arthur Smithies explains:

Governments, like private individuals or organizations, are constrained by the scarcity of economic resources at their disposal. Not only the extent to which they pursue particular objectives, but the character of the objectives themselves, will be influenced by the resources available. On the other hand, the extent to which the government desires to pursue its objectives will influence the resources it makes available to itself by taxation and other means.¹

Thus, from the very beginning, planning involves compromise and choice, and nowhere is this more evident than in selecting and defining appropriate objectives. No state, whatever its resources, can prevent all crime, maintain perfect public or mental health, or fully educate all of its citizens. Each state takes certain risks in public safety in order to provide better public education. It is impossible to avoid compromises of this nature. Likewise, it is necessary to compromise between the present and the future. Maximizing public education today may mean putting off until tomorrow the improvement of the state's highways, thus perhaps delaying the state's economic growth.

As a result of the limitations and compromises inherent in the selection of objectives, it is important that those objectives be designated in terms of priorities. There will always be a surplus of needs and demands beyond that which can be accommodated within the current means

¹Arthur Smithies, "Conceptual Framework for the Program Budget," Program Budgeting, ed. David Novick (Washington: U.S. Government Printing Office, 1965), p. 2.

of the state, but as Maurice Stans said, "This does not mean that such unmet needs have been dealt a fatal blow. In time, if they have genuine merit and the support of public opinion, they will have their day."¹

It is not the responsibility of the auditor to question objectives chosen by administrators. This is the responsibility of the legislature. Once approved by the legislature, the auditor has the right to determine that such objectives are being pursued. In the event the auditor finds that the legislature has not fully understood the implications of pursuing a given objective, he may suggest to the legislature that it inquire further into the matter. But it is not the auditor's duty to interfere in any way with management's right to choose from among the alternative objectives that are possible.

In the event the auditor discovers that objectives have not been clearly identified in an agency, he can make recommendations and suggestions concerning their establishment. And under certain circumstances as discussed below, determine whether or not the objectives are being achieved.

Programming

Programs are the means by which objectives are achieved. Programming therefore, is the process of determining the means of achieving objectives, and it involves two important steps.

The first step is to determine every possible way to achieve the objective sought. It requires that new programs be analyzed for all of their implications and that old programs be evaluated to determine whether or not they continue to serve their original purpose, or if there is now

¹Maurice H. Stans, "The Federal Budget: The Deeper Issues," The Journal of Accountancy (May, 1959), p. 36.

a better way of doing the job. As one writer noted, "it should be recognized that identification of programs must change from time to time as services change."¹ The formulation and evaluation of programs at this point is done strictly in terms of effectiveness. It requires an analysis in terms of results only. In this step alternative programs are formulated and ranked in priority according to their effectiveness in achieving the objective.

Programs, like objectives, vary widely both in size and type. And there is nothing inevitable or characteristic about a program except that it must represent coordinated and organized effort oriented toward the achievement of an objective. This leaves a lot of latitude for variation. For example, the major programs of a hospital may be developed in terms of the age of the patient, such as child care, old-age care, etc. These major programs may be divided into smaller programs, or what some prefer to call sub-programs, based on the type of treatment required for each of the selected age groups. On the other hand, the major programs may be designed in terms of type of treatment required with the minor programs determined by the age of the patient receiving the treatment. Or some other breakdown may be possible. The important thing is that the programs be consistent with the objectives specified and be designed in such a way that they can be identified with and evaluated in terms of the objectives.

Ideally, each program is conducted within only one organization; however, more than one program may be conducted by a single organization. In the latter case, one individual would probably be charged with the

¹Citizens Research Council of Michigan, "Proposal for a Grant in Support of the Design and Installation of Program Budgeting for the State of Michigan," 1964. (processed)

specific responsibility for each program. Thus programming has direct implications for organization structure and for the assignment of responsibility within the organization structure.

The second step in programming is to compare alternative possible programs with the available resources of the state. The state, like any other organization or institution, has limited resources available to it. This is true of both human and non-human resources.

Human resources are limited both as to quantity and skill. Not only is it difficult and sometimes impossible to hire enough doctors or teachers to fill the needs of the state hospitals and public schools respectively, it is also difficult and often impossible to find needed skills or leadership ability even among those individuals who are available. And in formulating and evaluating state programs, it is important that such programs be developed within the limits imposed by the degree of competence and skill of present and potential state personnel.

Non-human resources are likewise scarce, and thus in evaluating alternative program proposals, efficiency becomes vitally important. In fact, in the long run all matters of efficiency eventually come down to program decisions. Thus it is first necessary to determine the minimum cost of conducting each proposed program. The relevant cost in this case is incremental or differential cost. That is, the planner must determine what additional costs will be incurred if the program is undertaken that can be avoided if it is not undertaken. These added costs must then be compared to the added benefits expected from the program. This is cost-benefit analysis.¹ At this point it is possible

¹For a more detailed analysis of this process, see Gene H. Fisher, "The Role of Cost-Utility Analysis in Program Budgeting," Program Budgeting, ed. David Novick (Washington: U.S. Government Printing Office, 1965), pp. 33-48. See also Ruth Lowens Mace, Municipal Cost-Revenue Research in the United States (Chapel Hill, North Carolina: The University of North Carolina, 1961).

to compare alternative programs to determine which one is able to achieve the objective most efficiently. This process does not automatically provide the answer to the question of which program should be selected, but it does provide a rational basis for that choice by showing the implications of the available alternatives.

In theory, this process of analysis is simple to describe. Programming seems to offer no major conceptual difficulties in either of the above two steps. However, in practice, programming has proven to be far more difficult to accomplish than is suggested here. In fact, after several years of study and hard work on the part of many individuals, there is still no system in existence in any state that is programmed on this basis.

Since programs are designed to achieve specific objectives, it becomes the responsibility of the performance auditor, internal or independent, to conduct an examination to determine if in fact the programs are accomplishing the objectives designated. This test requires the use of performance standards, as discussed below. It is also the responsibility of the auditor to determine that relevant cost figures and other such information is used in the programming process and to compare the actual costs incurred to the estimated costs. Any testing that the auditor does for efficiency and effectiveness of operations ultimately ties back to the programming process, for it is in this planning step that operating procedures are determined.

One fact should not be overlooked, however. The ultimate decision to conduct program A rather than program B includes a number of factors other than considerations for efficiency and effectiveness as described above. Right or wrong, political considerations also are given considerable weight in the selection of one program over another; and tradition,

custom, personal opinions or preferences of executive officials, and many other such elements influence any final program decision. However, the point of this discussion is that the state can determine its basic policies and programs most effectively if it chooses among alternative courses of action with a knowledge of the implications of the alternatives involved, and even political choices can be improved if politicians are aided by comparative information and technical analysis of the probable consequences of each alternative choice available to them. Frequently such information and analysis is lacking at both the state and the federal level of government. As Schultze explains:

At present, problems often come up for decision at the highest political levels in a form which prevents the making of sensible choices. The objectives may be unclear, the contribution of particular programs to these objectives obscure, the costs highly uncertain, and most commonly the relevant alternatives missing.¹

Thus, in his examination, the auditor can render a valuable service by testing the planning-programming system to determine if it provides the needed information and analysis on which to make a rational and informed choice.

Program Budgeting

Of all the subjects relating to the fiscal affairs of state government, none has been more debated or discussed in recent years than has the subject of program budgeting. The term is familiar to virtually every employee of every governmental agency in the United States; yet few if any of them understand its meaning and significance. For this reason, the term has not been used in the development of this study up to this point.

¹Schultze, op. cit., p. 33.

Program budgeting means a variety of things to a variety of people.

As Mosher explains:

To a student of politics and of legislative bodies, it means perhaps a reduction of appropriation items, a rationalization of the appropriation structure in terms of programs, a presentation and review of budget requests in such a manner as to emphasize issues and make possible more effective choices. To a top administrator, it means these things and also greater flexibility and discretion in his operations, plus better control and accountability with regard to subordinates. Down the line of an agency, it may mean a single source of funds, an enlargement of authority, flexibility, and responsibility in the use of the funds, and a mechanism for relating program planning with financial planning. To the accountant, it means accrual accounting, cost accounting, segregation of capital from operating accounts, working capital funds, and many other techniques.¹

Yet even this explanation fails to fully identify the multifarious connotations of the term. Thousands of pages of print have been devoted to a discussion of various budget concepts, including program budgeting, performance budgeting, cost-based budgeting, line-item budgeting, and many others, and to lengthy discussions of the relative merits or weaknesses of each of these systems. A representative sample of this literature is included in the bibliography of this study. For purposes of this discussion, "program budgeting" will be used simply to define the process of allocating available state funds (revenues) to state agencies on the basis of programs and expected program achievements, not on the basis of objects to be purchased. Thus, budgeting is an integral part of the planning process and is consistent with the other phases of planning. Indeed, as noted above, programming cannot occur without considering the cost implications, and neither can budgeting be rationally accomplished without considering program implications and objectives. A program budget is literally the dollar expression of the program plan.

¹Fredrick C. Mosher, Program Budgeting: Theory and Practice (New York: Public Administration Service, 1954), pp. 80-81.

The term program budgeting has frequently been used to describe the whole planning process from the setting of objectives to the establishment of program accounting systems. Its use in this study, however, is not so broadly conceived. The purpose for this restriction is to avoid the common misconception that the inadequacy of the budget is at the heart of the state's financial and control problems. Certainly improvement in budget formulation and preparation is needed, but the budget is merely a reflection of the planning process. And the basic problems of the state lie in planning and programming, not in budgeting. If objectives were defined and programs were properly developed, the budgeting would reflect these changes. To mask these planning problems under the name of program budgeting seems somewhat inappropriate and misleading. In recent months a better expression--"planning-programming-budgeting"--has begun to be used which expresses the problem more as it exists.

Programming and budgeting need to be distinguished in another respect. Programming involves planning over a longer period of time than does budgeting. Programs can seldom be started and completed in one fiscal period. Usually programs must be projected several years in advance, and while long-range program projections certainly have budget implications, the budget is prepared and authorized anew each fiscal period, which is one or two years depending upon the state. Thus the budget document itself only reflects current program needs.

In spite of the theoretical arguments favoring a program budget, no state in the United States has yet developed such a budget. Several states have made some progress in this direction, as noted below, but none have yet succeeded. Most state budgets are still prepared on the basis of objects of expenditure. Consequently budget authorizations

detail the funds to be spent for tires or uniforms or light bulbs, and the financial reports give detailed descriptions of where the money went. Such a system, as Burkhead explains, "shows what government purchases but not why; accordingly, it does not show the nature of governmental programs, or accomplishments under those programs."¹ As a result, agency administrators are held accountable for the supplies they buy and the people they hire but not for the achievement of program objectives.

Charged only with spending the funds allotted for acquiring supplies and personnel, administrators have little incentive to economize on the use of funds. Funds found to be in excess of current needs are often spent for additional supplies or other items such as sidewalks and landscaping. The measure of successful administration is frequently based on how much can be spent rather than on how much can be achieved. Furthermore, few major attempts are made to review continuing programs to determine whether they continue to need the sum of funds normally allotted. Only new programs and incremental changes in old programs are given careful scrutiny. In brief, efficient and effective use of the state's resources is not fostered by a line-item appropriation budget.

Program budgeting, on the other hand, offers such incentives. Under program budgeting, administrators are granted specific funds to achieve specific results. Budgetary control results not from determining that only authorized items have been purchased, but whether funds granted have been used efficiently and effectively in achieving the program objectives. Thus, management is motivated to improve operating procedures and methods, to economize in the purchase of supplies and in the hiring of personnel, and to combine the resources at its disposal in such a way that the output

¹Burkhead, op. cit., p. 133.

of the organization is optimized.

Another advantage of program budgeting is that it provides a control over the kinds of things government does. As one writer noted:

Line-item budgeting without other planning or program stipulations can also favor extensive administration leeway. Diminution of one program may free manpower and supplies for another. When this goes unstated and unaccompanied by budgetary reductions, the . . . officer working within administrative rules and a statutory framework that he well understands may undertake major new programs, or even traditional ones that had been most scrupulously vetoed previously.¹

Many other advantages and disadvantages of each method could be noted, and a discussion of the obstacles to the development of program budgets might well constitute a subject for dissertation research in itself. But the point of this discussion is that rational planning and effective control require that fund allocations be based upon programs designed to achieve specific objectives. Budgeting must be oriented toward output, not supply. Only then can costs be effectively identified and compared with program achievements and responsibility for waste and inefficiency secured.

Responsibility for developing such budgets falls at two levels of the state. Since planning and programming are agency responsibilities, it is also the responsibility of each agency to determine the estimated cost of the resources needed to carry out the programs. The agency also has the responsibility to see that there is a consistent relationship between budget preparation and budget execution, for the planning which is done in the preparation of the budget request provides the basis for the management of the programs that are authorized. Thus if program execution is to be efficient and effective, programming and budgeting

¹Henrik L. Blum and Alvin R. Leonard, Public Administration--A Public Health Viewpoint (New York: The MacMillan Company, 1963), p. 185.

must be planned with these objectives in mind by the agency who will carry them out.

At a higher level, the central budget office of the state has two responsibilities, according to Burkhead. They are "program review and management improvement."¹ Program review is concerned with evaluating not only the operations and programs of individual departments and agencies, but also with the comparison and coordination of programs of all agencies relative to each other. It must review the benefits to be derived with one program as compared to another. It must further insure that program planning and budgeting follow the broad objectives of the state. And finally, it must determine that funds are available or will become available to support the proposed programs.

The second responsibility of the central budget office is management improvement. "Management improvement," says Burkhead, "consists in the optimization of a given program--the effective allocation of resources for the achievement of objectives."² This requires that the central budget office be concerned with program efficiency, the appropriateness of the methods by which the program objectives are to be accomplished, and with the effectiveness of organizational structure and executive policies to control and give direction to the performance of the program. Both program review and management improvement, as a practical matter, are accomplished simultaneously, and both are important in effective management planning and control.

Progress in Program Budget Development

As noted above, no state at the present time has a program budget that is operative, although several states have made some progress in

¹Burkhead, op. cit., p. 278.

²Ibid.

that direction. The following discussion of this progress is intended to provide a brief position report and does not constitute either a critical evaluation of such progress or a full coverage of all states who have experienced such development. It is, however, sufficient to indicate that progress to date is small compared to the vast amount of work still to be done.

A careful review of the literature in the early stages of this study seemed to indicate that substantial progress had been made in a number of states and cities in developing program or performance budgets. As each of the claims was checked out, however, it was found that in most cases the actual progress made was substantially less than that claimed in the article or other publication reviewed.

For example, several articles indicated that the State of Maryland had effected a substantial revision of their budget procedures and had fully developed a performance or program budget, which was reported to offer substantial improvements not only for managerial decisions and control but for legislative review as well.¹ George A. Bell, for example, states in his monograph that "among the states, Maryland is a pioneer in program budgeting. . . . The Maryland system is significant because of its comprehensiveness."² He also listed some other states that he claimed had utilized this concept, among them Illinois and Michigan. These statements were made in 1957, yet in 1966 Michigan is just presenting its first sample of program budgeting (see below), Illinois denies having used a

¹See John A. Donaho, "Performance Budgeting in Maryland," Municipal Finance (November, 1955), pp. 69-77; and John Wood Logan and John A. Donaho, "The Performance Budget and Legislative Review," State Government (July, 1953), pp. 185-187.

²George A. Bell, State Budget Administration in Maryland (College Park, Maryland: Bureau of Governmental Research, University of Maryland, 1957), p. 14.

program budget, and an examination of the Maryland budget document for fiscal 1966 reveals no program breakdown, no identification of program objectives, no program justification in terms of services rendered or products produced, and no evidence that any of these items are contained in any other documents.¹ What is found is a budget prepared in terms of broad functional activities, which is certainly an improvement over line-item expenditures. But it can hardly be termed a completed and operative program budget.

Likewise, one budget officer of New York indicated in 1960 that New York State had conducted a vast study to program all of the activities of the state.² This study followed an earlier one at Homer Folks Hospital which supposedly served as a pilot study. However, a visit to New York in the spring of 1966 failed to locate any broad development of programs of the type and scale indicated. It was found, however, that in the last couple of years a great effort has been made to program the activities and budget of one department--the Department of Taxation and Finance, and work is currently being started in others. Correlated with the program budget development, a Joint Statewide Accounting Improvement Committee was set up which developed a program accounting system consistent with the activities and budget of the department.³ As a result of the progress in the Department of Taxation and Finance, its budget for

¹See Maryland, Fiscal Digest of the State of Maryland, for the fiscal year 1966, including Revenues and Appropriations with Explanatory and Supplemental Statements.

²See Daniel Klepak, "Efficiency and Economy through Program Evaluation," Municipal Finance (August, 1960), pp. 59-63.

³See New York, Joint Statewide Accounting Improvement Committee, Accounting Improvement Program of the State of New York, Third Progress Report of the Joint Statewide Accounting Improvement Committee, September 1, 1965.

fiscal year 1966-67 is presented on a program basis in the executive budget submitted by the Governor to the legislature.¹

Based upon the experience gained with the programming of this first department, the state prepared and issued to the remaining departments of the state an instruction booklet on planning-programming-budgeting which outlines the basic policy and approach to be used by other departments in the development of their own program budget systems.² Also, the accounting systems in the State Education Department and in the State University of New York are being converted to a program basis. Certainly the work of the state is commendable and is perhaps as far advanced as any state in the nation. Yet as New York State officials themselves are quick to admit, they are just getting off the launching pad.

In Michigan, all agencies and departments of the state were recently reorganized into 19 major departments as required by the new Constitution. Recent budget emphasis, as a result, has been placed primarily upon the problems associated with the reorganization. However, two departments were selected for initial programming, and their budgets were prepared and submitted to the legislature in 1966 on a program basis.³ The two departments involved are the State Department and the Conservation Department. An analysis of the budgets prepared indicates

¹New York, The Executive Budget, for the fiscal year April 1, 1966, to March 31, 1967, submitted by Nelson A. Rockefeller, Governor, to the New York State Legislature, 1966 Regular Session.

²See New York, Executive Department, Division of the Budget, and Executive Chamber, Office for Regional Development, Guidelines for Integrated Planning, Programming, Budgeting. 1966.

³See Michigan, The Executive Budget, for the fiscal year 1966-67, including the Supplement to Department of State 1966-67 Recommended Budget, and Supplement to Department of Conservation Recommended Budget; prepared by the Budget Division, Bureau of the Budget, 1966.

that substantial progress has been made in identifying the major activities and functional areas of these two departments. However, considerable work still needs to be done in program planning before the full objectives of program budgeting can be met. Nevertheless, the progress to date is certainly encouraging.

In 1964, an article in State Government which was co-authored by the Governor of Wisconsin¹ reported that programming in Wisconsin would be completed so that the budget for the fiscal biennium of 1965-1967 could be put entirely on a program basis. Once again, however, the actual budget prepared seems to have fallen short of the expected development. In California, the Governor submitted to the legislature in 1965 a report entitled Sample Program Budgets.² It contains examples of such sample budgets for twenty one state agencies and authorities. While these budgets are by no means fully developed and refined, they do represent a start in breaking down some of the complex activities of the state into reasonably well defined components. Much more work will be required before the sample budgets are able to fill fully the needs of the state in this area, but again the progress is encouraging.

Undoubtedly the most notable progress in programming has occurred in the Defense Department of the United States.³ Yet for all its noteriety, very little has been written to describe the details of the system used, perhaps because of the classified nature of the

¹John W. Reynolds and Walter G. Hollander, "Program Budgeting in Wisconsin," State Government (Autumn, 1964), pp. 210-215.

²California, Sample Program Budgets, for the fiscal year July 1, 1965 to June 30, 1966; submitted by Edmund G. Brown, Governor, to the California Legislature, 1965 General Session.

³See Robert J. Massey, "Program Package and the Program Budget in the Department of Defense," Public Administration Review (March, 1963), pp. 30-34; and Charles J. Hitch, "Management of the Defense Dollar," Federal Accountant (June, 1962), pp. 33-44.

information involved. But it seems that substantial help could be rendered to other governmental bodies if more detail were known both of the achievements and the limitations of that system. The satisfaction on the part of leading Washington officials with the Defense Department system is indicated in its endorsement by President Johnson who issued a memorandum dated August 25, 1965, to the heads of all Federal Government departments and agencies, stating in part:

At the Cabinet meeting today, I announced that we would begin to introduce a new planning-programming-budgeting system in the Government. This will be a large and important job. I want all of you to devote personal attention to it. . . . You should begin at once to develop plans for the creation of your program planning staffs. I want you to get the best people possible for these staffs both from within your organizations and from outside of Government.¹

To assist the departments and agencies in complying with that order from the President, the RAND Corporation, which has been working on a comprehensive study of program budgeting, prepared an "abridged version" of that study and made it available to the departments and agencies of the Federal Government.² This report constitutes undoubtedly the most advanced and penetrating study yet available on the subject. But even here, the problems identified are far more numerous than the solutions suggested. In fact, the point is made time and time again in the study that it is designed to provide thought-provoking discussion and analysis and to stimulate ideas in the further development of the subject, not to present answers and solutions.

Certainly program budgeting is no easy task. And those who have tried and fallen short are not to be criticized for their failure to

¹Quoted in David Novick (ed.), Program Budgeting, A RAND Corporation Study (Washington: U.S. Government Printing Office, 1965), preface.

²David Novick (ed.), Program Budgeting, op. cit.

complete the process. Every inch of progress requires weeks and months of dedicated hard work by many individuals. And over the years as the states, along with the Federal Government, work together in attacking the problems that remain, effective systems will undoubtedly be developed. Such systems will make major contributions to increased efficiency in the allocation of resources, thus improving and expanding the benefits society derives from the state's many activities. And equally important, such systems will provide the necessary information and analysis to improve the ability of executive officials to make rational choices among the alternatives offered.

Organization Planning

Program planning and budgeting are not sufficient by themselves to insure effective and efficient operations or the achievement of state objectives. It is necessary in addition for management to provide for an organization structure within which the programs can be effectively and efficiently carried out. Since state governments, and the agencies of which they are composed, have existed for many years, it is not possible to start anew in developing a state organization based on current plans and programs. Within the existing organizations, however, the need to clearly assign responsibility and to define the limits of individual authority clearly exists, and this is part of the management function.

Organization planning is not a separate or isolated responsibility of management; rather, it is inseparably connected with the other basic elements of planning. Organizational considerations permeate the planning process from the selection of state objectives to the allocation of the last dollar in the state budget. Its main purpose, according to Lukens,

is simply "to fix responsibility and accountability."¹ Thus it includes the process of identifying the various activities of the state which are necessary to accomplish specific program objectives, and of combining these activities into jobs which may be performed and assigned to specific individuals. In the words of Zimmerman, organization structure "is really nothing more than a managerial device to assure that the unit achieves its desired goals."²

Organization planning certainly has implications for program planning. As noted previously, each program is ideally conducted within only one organization. Thus organizational limits become program limits, and if planning is to be effectively achieved, the organization structure must be flexible enough and sufficiently dynamic to permit it to change with changing objectives and to adjust to program needs. Furthermore, only if program planning and organization planning are effectively coordinated is program budgeting possible. Program responsibility and organizational responsibility are then identical, and budgeting as well as accounting and reporting are more easily accomplished on a program basis.

Finally, organizational planning is the chief way in which management establishes its control system in the agency. Its importance to the control system is no better indicated than by its prominence in the definition of internal control given by the American Institute of Certified Public Accountants, which says:

Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the

¹Matthias E. Lukens, "Organizing to Achieve Program Objectives," in Guidelines for Administrative Action, ed. Frederick C. Irion and Eleanor Rosenthal (Albuquerque, New Mexico: Division of Government Research, The University of New Mexico, 1961), p. 10.

²Robert R. Zimmerman, "Auditing the Organization Structure," The Internal Auditor (Fall, 1965), p. 59.

accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.¹ (emphasis added)

Certainly organizational planning is a vital and basic responsibility of management for which management must account. Management performance cannot be fully evaluated without considering how well this responsibility has been met. And in addition, an understanding of the organization structure and how it works will enable the evaluator to better understand the programs and activities that are carried on within the department or agency, for it is in organizational planning that the basic patterns of responsibility and accountability are defined.

Performance Standards

Throughout the preceeding discussion, reference was frequently made to performance standards. It was noted that performance standards are necessary to determine whether or not objectives have been achieved or by how far they were missed. Performance standards were also found to be essential to determine whether each activity is contributing to the program and each program to its proper objective. Thus, the evaluation of program output requires performance standards. In fact, performance standards are used in every evaluation of performance or achievement made by every person in or out of the organization, whether that evaluation relates to a single person or a group of people or to an activity or program carried out by such persons. No measurement can occur in the absence of standards, and measurement of "performance" requires "performance standards."

¹Committee on Auditing Procedure, American Institute of Certified Public Accountants, Internal Control (New York: American Institute of Certified Public Accountants, 1949), p. 5. Also see Maurice B. T. Davies, "Organization as a Basis for Control," The Internal Auditor (Winter, 1963), pp. 40-53.

These facts are very basic. Before one can measure distance he must have acceptable standards of distance, such as yards or miles. Before weight can be determined, weight standards such as pounds or tons must be specified. Without such units, measurement is impossible and communication is vague and imprecise. Even to express distance as "a long way" or weight as "quite heavy" is meaningless unless related to some norm or standard. The same is true if performance is expressed in terms such as "reasonably well" or "not too good." These expressions, however vague, connote the idea that intuitively or inherently the reader will be able in his own mind to relate such concepts to some standard or norm. This fact is even more true for expressions such as "better than average" or "below expectation," for this type of expression clearly implies that an average can be determined and that some level of expectation can be specified, each of which then serve as a standard for evaluating the performance or achievement described.

Standards can be specified in a variety of terms and can relate to an infinite number of different situations. This discussion, however, will be limited only to those which relate to the evaluation of performance in state government. The development of such standards is a management responsibility. Standards of performance should be set by top administrators and executive officials including the Governor in cooperation with the members of the agency or department involved. It is not a responsibility that can be delegated to the accountant or budget officer, although both may render valuable service in assisting in the development of the standards. In short, performance standards are the responsibility of the same people who are responsible for planning programs and setting objectives.

Two kinds of standards are particularly relevant: standards of

effectiveness and standards of efficiency. Standards of effectiveness are those which permit judgement concerning the achievement of objectives, whereas standards of efficiency relate to the manner in which men and resources are used to pursue objectives. In the first case the relevant statistics concern program output; in the latter the relevant statistics concern program composition. In both cases, the specification of standards is an integral part of the planning process and should be specified at the time objectives are chosen and programs are designed.

Performance standards always relate to people, and thus such standards have important implications for organizational planning. Virgil Rowland, in his excellent book on standards, explains this fact: "Every management person needs to know how well he is expected to perform the various segments of his job." He adds that "regardless of his level in the organization, each management person needs to know what standards his immediate superior is using and what that superior looks for in the performance of his subordinates."¹ Whenever an assignment is made to an individual, that individual has a right to know how well he is expected to perform. And the "how well," for that individual, is his standard.

Thus, performance standards can be defined as a statement of the conditions that will exist when a job is well done. At the program level, the "job" is achieving the objective. Thus program standards are statements of conditions that will exist when the objective is achieved. And for every activity or job assignment within the composition of the program, equally appropriate standards are applicable. Fixing responsibility for each individual for efficient performance according to established plans is a fundamental concept of management control. If such individuals are

¹Virgil K. Rowland, Managerial Performance Standards (New York: American Management Association, 1960), pp. 31-32.

to be held accountable for performance, they must know precisely for what and to whom they are accountable. And their performance must be reviewed by management and evaluated in terms of the standards set. This is the essence of effective and efficient performance.

The purpose of standards is to improve performance. This improvement results from two things. First, the standards give the person responsible an objective criterion by which he can measure his own performance and make adjustments where he feels they would help. This is the most important benefit to be derived from standards. Standards should be incentives not clubs, and they can only become incentives when they are established primarily to serve the person or group to whom they relate. Furthermore, to the extent that such standards are effective in motivating the individual to better performance, they will also serve their second purpose, that of providing a means of performance review by that person's superior. Thus performance standards are the key to effective organizational control and management review.

It would be extremely naive to suggest that it is possible to set simple standards to measure how well the state does in providing education or health or public safety, for the objectives in these fields are complex. And the standards will likewise be complex. Yet as Schultze says, such standards are "essential if we are to understand how our programs contribute to our objectives."¹ In discussing the same point, Jerome argues that the difficulty in developing satisfactory performance criteria "results mainly from neglecting to define rigorously what we mean in a given circumstance by successful or effective performance."²

¹Schultze, op. cit., p. 33.

²William Travers Jerome, III, Executive Control--The Catalyst (New York: John Wiley & Sons, Inc., 1961), p. 55.

He contends that it is hard to define success because most people are more failure oriented than success oriented. That is, it is much easier to determine when something fails or goes wrong than to determine the extent of success. Yet the standards that are needed to measure effectiveness in government are precisely those that can give an indication of the degree of success. They must answer the question: How successful was the program in achieving the objective sought?

Two methods of selecting performance standards are often suggested as appropriate for government. The first is based on the end products produced, and the second is based on activity or work performed.

There are a number of government programs where the end products are identifiable, measurable, and significant. Tax returns processed, gallons of water provided, and number of trees planted are examples. Others include miles of highway constructed and number of students graduated. In each case, however, problems of homogeneity appear. Were the trees planted on hills or level ground? Were the highways built in the city limits, in mountainous canyons, or across arid wasteland? A single statistic is not always enough to tell the whole story. Other factors must also be considered.

Another weakness in output statistics is the inability in most cases to include quality statistics that can be objectively evaluated. It is sometimes possible to include size statistics or weight in addition to the quantity, but most quality measurements cannot be expressed in size and weight. Judgements of quality usually require the skill of an expert, and even then they must often be based upon a set of values which may or may not conform to those of other persons. Quality of education cannot be measured by the number of graduates. It is true that it may be determined in part by a combination of statistics derived from test scores

and student performance. But even these statistics must be evaluated by one who knows and understands the education process and can bring to bear on the evaluation problem the expertise which he possesses. The same is true of the quality of medical treatment, the quality of public safety, and the quality of criminal rehabilitation, to name only a few examples. In each case, however, it must be recognized that someone can make the quality judgement if he has the right combination of statistics. And the job of management is to establish performance standards in light of this fact and require that actual performance be related to the standards by one competent to render such an opinion. Then not only the question "How much are we doing?" but also "How well are we doing?" can be answered.

It is important to note at this point that end-product statistics can in no way determine the value judgements regarding what government "should" do. The facts of performance are not judgements about the value of a program and should not be regarded as such. Judgements of this type are made in the minds of men and are related to their social, political, religious, economic and moral values in a way which makes it impossible to determine them by means of such statistics. The unit of output is meaningful only as it relates to predetermined standards of what that unit was expected to be. Its actual qualities can be compared to its expected qualities. But this does not specify whether or not its actual qualities or its expected qualities are those qualities which it "should" possess, nor does it determine that the unit "should" have been produced in the first place.

The second type of performance standard is that which is based upon activity or work performed. And even though this method is theoretically inferior to the end-product method, it is nevertheless the one most likely

to be used in most agencies of the state for the simple reason that meaningful output statistics are simply not available in very many cases. Thus, instead of trying to measure education by the number of graduates or some other such statistic, education is evaluated in terms of equivalent full-time students taught, number of credit hours taught, or number of classes held. Thus the relevant standards in this case are based on what is done, not on what is accomplished. And the difference is significant. As Burkhead explains, "Measuring accomplishment and measuring work performed are not the same thing. Work performed is the process or the activity; accomplishment is the end product. . . ." ¹

Even under the general category of work-load statistics, there are at least two different types of standards. One type can best be described as unit standards, the other as activity standards. Examples of the first are unit costs and man-hour per unit ratios. Cost per student fed in a school lunch program (or cost per meal) is this type of standard. So also is cost per student educated or man-hours per insurance claim processed. Situations which are not adaptable to such unit-cost statistics or other unit standards must be classified under activity standards. Rehabilitation programs, personnel training and recruitment, and civil defense and preparedness programs are of this variety. There are no meaningful unit statistics in these cases. Thus, standards relating to the activities or programs must be related to the whole activity or program, whichever the case may be. Yet even in this case it is possible to state the conditions that will exist when the objectives have been met, and this statement of conditions, however brief or involved it may become, constitutes a statement of standards which is useful in evaluating performance.

¹Burkhead, op. cit., p. 142.

Each of these types of standards are relevant in some cases. And some situations may require standards developed in several ways. Education is one such area. Yet it should be obvious at this point that true measurements of performance in terms of effectiveness and efficiency can only be made when some output or achievement statistics are available, for only then is it possible to accurately determine whether or not the program is accomplishing the ultimate objective of the state and is doing so in an efficient and effective manner.

The conclusion of this discussion is simple. If management is going to intelligently direct an organization, it must know (1) what it is expected to accomplish, (2) what it does accomplish, and (3) what the cause and significance of the variance between the two is. Only by setting up adequate performance standards can any of these items be known with exactness. Furthermore, while performance standards are useful for outside review of managerial performance, their greatest utility is their ability to assist management personnel in the performance and control of the operations for which they are responsible.

In spite of the obvious advantages of such standards, very few of them formally exist in state government. As a matter of good management practice, most managers formulate in their own minds certain standards by which they judge the performance of their organizations. What is now needed is a more precise and penetrating analysis of all programs and objectives and the formulation of formal performance standards on a broader and more objective basis. In a few cases, special studies of this nature have been undertaken. One notable study concerns standards of prison operations,¹ and another involves the operations and services

¹Roland W. Wood, "Standards for Correctional Agencies," State Government (Winter, 1960), pp. 48-52.

of state libraries.¹ Certainly much more needs to be done. And until it is, program budgeting and most of the other popularly proposed fiscal reforms will continue to remain undone.

As will be discussed below, the development of such standards is not only vital to management and its responsibilities, but also in justifying proposed programs and budgets before the legislature as well as in conducting the performance post audit, both internally and by the auditor general.

Executive Policy

Pervading the whole planning process from the setting of objectives through programming, budgeting, organizational planning, and setting standards, is executive policy. This policy is the expression of the will of the executive official who is ultimately responsible for the plan or program. The purpose of this policy is to give direction to the planning of activities as well as to the execution of the plans or programs. It is therefore the responsibility of executive officials from the Governor on down to clearly establish policy guidelines within the executive branch of government and to take all necessary steps to insure that such policy is followed both in planning and in executing state programs.

Executive policy sets the boundaries within which administrators and other responsible personnel are expected to act. It is therefore similar to legislative policy as outlined in the previous chapter. And just as legislative policy is effective as a guideline to executive action only when it is developed within an effective system of legislative control, so also executive policy is only effective when formulated and

¹Phyllis I. Dalton, "Standards for Library Services in State Government," State Government (Spring, 1964), pp. 129-131.

implemented as a part of a system of executive control. Consistent with the pattern of responsibility in the executive branch, such a system of executive control requires that the chief executive provide direction and establish policies for the guidance of administrative officials, and that the administrators in turn be responsible to the chief executive and account to him for all activities and programs in terms of the policies established. An important consideration in this pattern of responsibility is the fact that while the chief executive may delegate responsibility for program administration to other administrative officials within the state, he can never escape the ultimate responsibility which is his to see that programs are prepared and implemented in accordance with the policies set by the legislature.

Accounting and Reporting Systems

If management control is to be effective, executive officials and agency administrators must be able to compare actual performance to planned performance. This requires that actual performance be recorded and reported in the same terms as planned performance. As one writer said:

When one desires evaluation, the things that connote success or failure must be indicated on the record; the numbers, intervals, and kinds of efforts made must also be a planned part of the record. Records good enough for these purposes must have been part of the initial program planning.¹

Therefore, the designing and installation of the accounting system is part of the planning process, and should be consistent with the other elements of planning. Program planning requires program accounting just as much as program budgeting, and this fact has important implications for the design of such accounting systems.

First, accrual accounting is a must. The purpose of accrual

¹Blum, op. cit., p. 294.

accounting is to match the cost of operations with the results of operations. In industry, this means recording expenses in the same period as their resulting revenues. In government, since expenses are not incurred to produce revenues, the relevant items in the matching process are the expenses of operations and the resulting benefits to society. Such benefits, since they are often impossible to measure and quantify, are sometimes expressed in terms of work performed or activities conducted. But the important fact remains that if any input-output comparison or evaluation is to be made, accrual accounting is a necessity.

Second, program accounting is necessary. As Homer explains, "The success of a program budget will depend upon the sufficiency, accuracy, and relevancy of a supporting system of program accounting and reporting. Without such a system any . . . program budget is a hollow shell."¹ Based upon the earlier sections of this chapter, this fact should be fairly obvious. Unless accounts are kept and reports are prepared on a program basis, it is impossible to relate program activity to program objectives, and the efficiency and effectiveness of program performance cannot be determined.

Third, responsibility accounting is imperative. Responsibility accounting requires that costs and results of operations be related to the organization structure in such a way that each responsible official can determine the efficiency and effectiveness of the operations under his direction. As Cohrs explains, "Management must be in a position to evaluate the performance of the personnel with whom they have placed responsibility. Accounting, therefore, must help to establish measurements

¹Porter W. Homer, "Program Accounting and Reporting," Municipal Finance (November, 1955), p. 83.

of performance and report the results obtained at various levels of the organization."¹ Thus the development of the accounting system is an integral part of organization planning. Responsibility for its development and its effectiveness belongs to the same level of management responsible for the assignment of responsibility within the organization.

Fourth, cost accounting or some comparable system is needed. Much has been written about both the merits and the limitations of cost accounting systems in government. For the most part the arguments on both sides of the issue have tended to be narrowly conceived and inadequately related to the other elements of the accounting and reporting process. Certainly an extreme position either for or against such a system on an over-all state basis is subject to serious question. Yet there does seem to be considerably stronger arguments in favor of such a system than against it. For example, how can one measure efficiency without knowing the cost of inputs relative to specific outputs? Unless costs are accumulated and classified in terms of units of production or service, it is impossible to analyze or compare efficiency. Furthermore, one of the most useful standards by which performance can be measured in many agencies and institutions is standard cost per unit of production. In these cases, certainly cost accounting is indispensable. In those areas where standard costs do not serve as effective performance indicators, the man-hour approach to work measurement has gained considerable attention. In this case, input is recorded in terms of man-hours rather than dollar cost, but the principle is still the same. Here, man-hours must be accumulated and classified in terms of units of

¹James C. Cohrs, "The Accountant's Responsibility for Effective Management Control," The Texas Certified Public Accountant (July, 1965), p. 46.

production or service rendered in order to check performance against the pre-determined standard and there-by make any type of performance evaluation. The key to the development of an adequate accounting system lies in the ability of those who design the system to define performance units or measures that can be recorded and reported. Most accounting in state government is done in terms of funds spent and funds received. Funds spent, however, is not a measure of performance. As Homer declares, "It must be remembered that the expenditure of funds is only a means to an end. The end is performance, not expenditure. Therefore, to account for only the means and to ignore the end is incomplete and meaningless accounting."¹ The key to program accounting and performance statistics lies in the development of useful performance standards as described above. If standards are measureable, objective, and significant, performance measurement is possible. And to the extent that performance measurement is possible, records can be kept in one way or another to record and report performance on both a program and a responsibility basis.

Thus the type of accounting system needed in the state is one which serves several purposes. It not only measures program accomplishment and matches such accomplishment with program cost, but it also records and reports the costs and achievements based upon areas of responsibility. It differs from traditional accounting in that program accounting records and reports on the basis of cost effectiveness, whereas traditional accounting uses only revenues and expenditures. Program accounting in the state is much closer to cost accounting as used in industry, where costs are related to units of production. The difference here, however, is that in the state, productive units are

¹Homer, op. cit., p. 84

frequently not available and thus output or accomplishment must often be measured by statistics based on work performed or activities conducted.

The responsibility for seeing that such accounting improvements are made belongs to top management, but it should now be apparent that a uniform accounting system throughout the state is not the answer. Since each agency or department is engaged in a different type of service or activity, each department must have an accounting system based upon its own organization structure, its own program plans, its own performance standards or indicators, and its own particular management needs. Undoubtedly there will be great similarity in the systems used throughout the state, but failure to decentralize the accounting function and to specialize the system in terms of individual agency needs will leave the state with only half a loaf.

A performance reporting system cannot be separated from a program or performance accounting system. To discuss them as though they were separate is inconsistent. However, there are some important reporting standards which must be observed if the reports are to serve their intended objectives. And in the establishment of the accounting system, these standards are very important considerations.

First, the information that is contained in reports must be relevant to the decisions and responsibilities of management and facilitate rational management. This requires that the reports be timely prepared, that they be based upon accepted standards and principles, that they be consistent with management needs and expectations, and that they be competently prepared and factually reliable. They must fully disclose every material fact relevant to the decisions and responsibilities of the person for whom the report is prepared and issued. And they must clearly indicate deviations from planned performance.

A very important concept is responsibility reporting. This concept has been mentioned above in connection with responsibility accounting, but a closer look at the specifics is helpful. Basically, responsibility reporting requires that each responsible official be able to determine the results of operations for which he is responsible. Such a reporting system, as one writer notes, "should meet the requirements of all levels of supervision and provide for the integration of reports at the lower levels into reports for top management control."¹ It requires that each person receiving a report be able to determine the results which occurred as a result of decisions he made, or failed to make, and that he be able to identify those areas requiring corrective action.

Another important concept is reporting by exception. For effective management control to exist and for management personnel to be able to determine what corrective action is needed in the case of poor performance, the reporting system must show those specific areas where variances from planned performance occur, as well as the magnitude of the variance. This is a common feature of a standard cost system as used in industry, and when performance standards are effectively formulated in the state, such reports of variances and variance analysis are equally possible and effective in the state. Until and unless such reports are provided for state officials, timely and appropriate corrective action on irregularities will continue to be difficult, and executive control will be weak in this important area.

Existing accounting and reporting systems in the states do not conform to all of the above specifications. For example, while several states use accrual accounting to some extent, most states continue to

¹Joseph Pelej, "Budgeting and the Corresponding Modernization of Accounting," The Journal of Accountancy (June, 1958), p. 67.

use a modified cash basis for most accounting and reporting. The biggest difference, however, between the systems currently used and the one described here stems from the lack of performance standards and responsibility accounting. Almost without exception, the reporting systems used throughout the states are strictly financial systems which contain little or no elements of program accomplishment. Performance indicators are limited to those relating to the handling of funds or to the control and preservation of assets and other resources.

Undoubtedly one of the things that has impeded progress in this area as much as any other is the traditional concept of accounting as merely a control device over funds and expenditures. The accountant's primary function has frequently been seen as that of preventing fraud and the illegal use of state funds. Only in recent years has there been a significant departure from that thinking. Now, however, legislatures and executive officials alike are beginning to recognize that a greater potential contribution of accounting is its service to management, a service which can be accomplished effectively and efficiently without in any way sacrificing the control aspects of the system.

The Case of New York State

An excellent example of the recent shift in emphasis to managerial accounting systems is the work currently being done in the state of New York.¹ On December 22, 1960, Governor Nelson Rockefeller and Comptroller Arthur Levitt issued a joint statement establishing a Joint Statewide Accounting Improvement Committee, hereafter referred to as the Joint Committee. It was composed of two high-ranking state officials--a Deputy

¹The discussion which follows is based largely upon New York, Joint Statewide Accounting Improvement Committee, op. cit.

Comptroller and a Deputy Budget Director. Also a representative of the New York State Society of Certified Public Accountants was designated to serve as an advisor to the Joint Committee. Subsequently, a Departmental Advisory Committee, composed of a representative group of departmental officials with experience in financial affairs, was set up to work closely with the two members of the Joint Committee. In addition, working committees were established in the Division of the Budget and in the Department of Audit and Control, whose purpose was to actively assist the Joint Committee in its work and to help in the installation of new procedures in the departments and agencies of the state.

In the initial statement establishing the Joint Committee, it was charged with considering each of the following items:¹

1. The feasibility of delegating certain accounting functions to the departments and agencies within the Comptroller's legal responsibility for providing accounting systems and procedures.
2. The development of an accounting system which will provide cost data necessary for review and comparative analysis of programs and operations for purposes of improved budgeting and day-to-day management.
3. The proper uses of cash and accrual accounting.
4. The coordination of financial reporting with the budget process.
5. The provision for property accounting on a monetary basis as an integral part of the accounting system.
6. The further application of electronic data processing and related techniques to the state's fiscal operations.
7. The training needs of state personnel in the accounting field.

A full statement of the progress and achievements of this committee since its inception would run well beyond what is possible to discuss here. However, some significant items are worth noting.

First, it was recognized by the Joint Committee that accounting improvements could not be divorced from improvements in budgeting. As

¹Ibid., Exhibit B.

stated by the Committee, "one of the first decisions of the Committee was the establishment of the basic requirement that any system evolved must serve equally well for the purposes of budgeting, accounting, and reporting."¹ Furthermore, the program of the Committee "emphasizes the integration of budgeting, accounting, and reporting in a unified process for the State Government as a whole, with recognition of the need for flexibility in meeting the varying requirements of individual departments."²

After intensive study of the state's financial operations, the committee undertook a pilot study in the Department of Taxation and Finance.

The committee first studied in depth the existing budgeting, accounting, and reporting system for the department. In New York, as in most states, that system has been characterized by line-item appropriations for personnel and other objects of expenditure. Following this study, the committee formulated some basic principles to guide the development of a new or revised system and identified the purposes the new system was expected to serve.

First, it was agreed that the accounting and reporting system should facilitate informed decision-making at three levels of state government. First, it should serve as a basis of informed legislative appropriation. Second, it should facilitate executive budget preparation and control. And finally, it should assist internal departmental management in the decisions for which it is responsible. In addition, such a system was seen as an aid to the performance of the audit by the Department of Audit and Control. Since New York does not have a legislative auditor

¹Ibid., p. 3.

²Ibid.

general, no mention is made of the assistance such a program would be to the conduct of his audit, but such assistance is implied in the fact that the system would aid the internal post auditor in the fulfillment of his function.

Two significant features of this system are its emphasis on responsibility accounting and upon program achievement. In fact, one of the original statements of intent of the committee was that "the emphasis of the revised system was to be placed on the purposes to be accomplished rather than on the kinds of expense to be incurred."¹ Furthermore, the system was to be specifically designed in such a way as "to hold every supervisor responsible for projections and the results accomplished."²

Following the implementation of the pilot study in the Department of Taxation and Finance, the department's budget was prepared and submitted to the legislature on a program basis, and the legislature authorized it on that basis. This represents a significant mile-stone in the actual implementation of concepts that have long been discussed and considered desirable but seldom attempted successfully in practice.

Based upon its experience in the Department of Taxation and Finance, the Joint Committee issued a set of instructions and explanations to other departments and agencies outlining the system developed and explaining the significance of the various concepts and developments in terms of other agencies' needs.

It was pointed out, for example, that the Department of Taxation and Finance has no institutional accounting requirements or capital construction accounting needs. Thus, matters relating to these problems would have to be further developed in future studies. Currently such

¹Ibid., p. 6.

²Ibid., p. 7.

studies are nearing completion both in the Department of Education and in the State University of New York. The plan of the Joint Committee is to continue such studies on a case-method basis until all problem areas have been fully analyzed and revised. Once such an area is completed, general principles and methods are established which are then expected to be adapted and used by similar departments and agencies within the state. Such an approach has succeeded very well to date and promises to continue to meet the expectations of state officials in the future.

In conclusion, the system adopted by New York meets every major criterion outlined above for a state accounting system, so far as it has been developed. It is based upon responsibility accounting and reporting concepts, and the major emphasis is placed on the purpose or objective to be accomplished rather than on the nature of the goods or services acquired. In the words of the Joint Committee, "accounting by programs has been emphasized, while accounting for objects of expense has been given considerably less importance."¹ The remaining problems may take several years to resolve, and the system undoubtedly will yet need considerable refinement. This is expected, and it should be. The goal is not to have half a loaf today or tomorrow, but a fully revised and effective system developed as soon as possible. Certainly the state is to be commended for its progress to date.

Executive Proposals to the Legislature

As discussed in Chapter III, executive officials have no authority to spend state funds or to undertake programs involving state resources without the express or implied consent of the legislature. All decisions

¹Ibid., Exhibit C, p. 2.

that are made and actions that are taken are expected to conform to the will of the legislature as expressed in the appropriation acts and other statutes. Walker expresses this fact as follows:

While the executive and the judges make many decisions in the course of their daily work in rendering service to the public, all of these must be made within the framework of the basic decisions enacted as laws by the legislators. Without laws creating Executive departments, and assigning them the broad duties which they are to carry out, they could have no existence or function. Every expenditure is made within limits imposed by legislative appropriations. Truly, all administration and adjudication is dependent upon legislation.¹

Yet it is evident that legislative policy or intent is to a great extent a product of the legislature's reaction to executive proposals. As Burkhead declares, "Legislative review of the budget depends first and foremost on the way in which budget programs are presented by the executive. . . .Clarity in budget presentation carries over to clarity in appropriation structure."² The more explicit the intent of the executive is expressed in proposals made to the legislature, the more explicit will be the expression of legislative will in response to the proposal.

Most executive proposals, if based upon a rational and comprehensive planning process as outlined in this chapter, will be made in the form of complete programs or modifications of existing complete programs. Such program proposals should represent the final product of the executive planning process and should be related to specific objectives, be identified with specific standards, be conceived within a specific organizational framework, and be formulated in accordance with established executive policy. Each such program proposal should, in the opinion of administrative officials, represent the best possible alternative available for achieving the stated objectives. That is, it is a basic

¹Walker, op. cit., p. 97.

²Burkhead, op. cit., p. 311.

responsibility of executive officials to be able to fully justify to the legislature the selection and formulation of the specific program proposed.

Budget requests detailing necessary expenditures for the coming fiscal period can then be related to specific programs and can be justified on the basis of program needs. In this manner, both the legislature and the executive can more easily determine the consequences of all cuts or additions to budget requests, for such adjustments can then be rationally analyzed in terms of their program impact. Budget authorizations, based upon program justification, assist both the legislature and the executive in the fulfillment of their responsibility. The legislature is better able to control the types of programs conducted within the state, while the executive is free to use the funds and resources at his disposal in a variety of combinations to achieve efficiently and effectively the programmed objectives, depending upon the needs and the developments of the operations as they occur. He is not required to purchase specific items when in his judgement alternative resources would accomplish the objectives more effectively or efficiently. Rigid itemization, which stifles administrative initiative and creates mountains of work for legislative committees, is replaced in appropriations with program authorizations and standards, and control is exercised by both executive and legislative officials in terms of output or performance rather than on the basis of inputs or sources of supply.

When the legislature receives a proposal or request from the executive, it has not only the right but the duty to fully review the planning process underlying the proposed program. This includes approving the objectives sought, challenging the ability of the department or agency to competently administer the program proposed, and reviewing the standards by which both the executive and the legislature may know when the

objectives have been achieved. The legislature may question the accounting system, the reporting process, the organization structure, and all other elements of executive control. In the event that the legislature desires to change the proposed program, it has the full right to do so and to require such change by law. Thus, virtually every action or program decision of executive officials in some way depends upon legislative will either as expressed in policy statements or by law.

In the absence of legislative exceptions to executive proposals, it can be reasonably assumed that the legislature in effect concords with executive intent. In most cases, even though the legislature may whittle at the corners of program proposals, programs are usually approved and budgets are generally authorized substantially as they are presented and requested. And this is particularly true when both the legislature and the Governor are of the same political party or where inter-party differences are small.

Program Execution

Once programs have been approved by the legislature and funds have been appropriated, it is the responsibility of management to carry out the programs in accordance with its representations to the legislature, and to do so in an efficient and effective manner. All program execution is a product of program planning or deviations from such plans. Good performance results from good planning and effective control of operations, whereas poor performance results either from poor planning or poor control of operations or both.

The implications are clear. It is not only the responsibility of management to effectively plan, but also to effectively control. Moreover, the first step in evaluating the quality of executive performance

is to test the adequacy and effectiveness of management control. Such control is the product of the organization structure, of executive policy statements and the enforcement of such policies, of the system of accounting and reporting, and of internal audit and review. In fact, the whole planning and review processes are designed to give direction and control to the execution of programs and to promote efficient, effective, and faithful performance.

Efficient execution of programs requires that management constantly keep an eye on costs. When prices change, when equipment becomes worn and obsolete, if operating procedures or methods are cumbersome or overlapping, if employees are frequently absent from work or generally inefficient, or when supplies and inventories become excessive, management is responsible to see that prompt and appropriate action is taken to correct the problem and reduce the costs.

Effective execution requires that management always be conscious of the output of the agency or the service performed. It requires that constant attention be given to the quality of teaching, to the results of rehabilitation programs, to improvements in mental-health patients, and to the training and preparedness of national guard troops. Effectiveness is a measure of management's ability to maximize the achievement of planned objectives and to control the quality of performance throughout the organization.

Faithful execution of programs means two things. First, it means that legislative intent is effectively implemented in the operations of the state. Second, it means that agency personnel effectively follow the policies set down by top administrative officials. In both cases it is a matter of responsible obedience to higher authority and it follows the basic patterns of responsibility that characterize the system

of government based upon the concept of separation and balance of powers.

In all of these matters relating to execution of programs, each administrative official is expected to bring to bear on all of his decisions and actions the expertise which he along possesses relative to the operations with which he is charged. It is also his responsibility to hire and train competent personnel with which to staff his organization, and to insure that each individual is capable of the level of performance his job requires. Finally it is the responsibility of executive officials to account to the legislature for the use of state resources and to report on the progress made in achieving the goals and objectives of the state. Such reports can be readily prepared if a program accounting and reporting system is operative as described above.

Management Review and Report

Effective, efficient, and faithful performance of authorized programs is a basic management responsibility. To insure that such performance actually occurs and to enable management to render reliable performance reports to the legislature concerning its stewardship, it is important that an effective system of management review be operative in the state. Such a system consists basically of three parts: personal review, internal audit, and corrective action.

The personal review is an individual management responsibility. It requires that each person charged with supervising the activity or work of other persons evaluate the work performed. It involves the comparison of individual performance to individual performance standards. Such reviews result from good organizational planning and must be performed at every level of management.

The second step is the internal or management audit. This respon-

sibility was described in some detail in Chapter III, but it deserves special mention again here, not only as a vital element of the review function, but also because of its significance in light of the above discussion of the entire management function. The scope of the internal audit is as broad as management wishes to make it. It need not be limited to an audit of financial records. Indeed, the internal audit can become just as much an audit of performance as can the audit of the auditor general. The scope of the audit comprehends an examination of actual performance as compared to planned performance and includes tests to determine the effectiveness of the control system in all its parts, including the efficient and effective administration of programs. The specifics of such an audit will be discussed in detail in the next chapter.

The third phase of management review is the follow-up or corrective action taken in light of revealed deviations and variances from standards. It does no good to develop an elaborate system to plan, control, and audit program performance if no use is made of the reports prepared and no action is taken on the disclosures made. Just as it is essential that the legislature take action to insure the effectiveness of the auditor general's reports, so also it is the responsibility of internal management to take all necessary steps to insure that proper corrective action is taken in light of disclosures arising from the internal audit report or other review activities. Such corrective action must be timely as well as appropriate if it is to be truly effective as a control function.

Relationship to the Auditor General

A detailed analysis of the audit as required of the auditor general will be made in Chapter V. However, some important implications from the above discussion should be noted at this point.

First, an audit of management performance comprehends the whole management function and is not restricted to the financial accounts or any other such narrowly defined area. It includes a review of planning, execution, and review, for all of these are included in the definition of management performance.

Second, the auditor is in no way a member of the management team. This independence precludes his participation in any part of the management function. It is not his responsibility to participate in selecting objectives, setting standards, formulating programs, preparing budgets, specifying organization structure, or developing accounting and reporting systems. All of these items are management responsibilities which are subject to audit review. Based upon such audit review or examination, the auditor may make recommendations both to the legislature and to management concerning any one of these areas, but he does not participate in either the decision or the control process of management.

Third, it is not the responsibility of the auditor to enforce his recommendations. His duty is to examine and report the results of his findings and to make recommendations both to management and the legislature. It is then the responsibility of management to consider and implement the recommended changes, and it is the responsibility of the legislature to enforce such recommendations unless they are found to be inappropriate, in which case the legislature may excuse management from the responsibility of adopting them. But the moment that the auditor begins to enforce his own recommendations, he assumes unto himself the role of a manager, and he violates his independence.

Fourth, the basic responsibility for reviewing and reporting administrative and program performance is management's. The role of the auditor is to determine that such review and report is made

consistent with accepted standards and principles. His duty is to insure that the legislature is made fully aware of the implications of management performance and of deviations from planned performance. Thus, his responsibility includes the rendering of an opinion on the fairness of the financial and performance reports as prepared and filed by management, and an investigation and report of the adequacy of management controls throughout the executive branch of government. In the event his examination discloses apparent weaknesses and inefficiencies, he is charged with investigating those areas. But to the extent that his examination reveals adequate control and effective internal review of operations, the need for in-depth investigations is removed. Thus, the auditor general literally is charged with the responsibility of auditing by exception.

Finally, the more explicit the legislature is in its examination of executive proposals and in its expression of intent concerning such proposals, the better the auditor can determine whether or not performance complies with legislative policy. In this respect, the auditor is charged with bringing to the attention of the legislature anything of significance which the auditor feels would influence the policy or intent of the legislature.

Summary and Conclusion

The purpose of this chapter is to discuss the functions and responsibilities of executive management officials in order to determine the areas in which management performance can be identified and evaluated. The system described here is not based upon an empirical analysis of the things that are actually done in any state. Neither is it a description of how planning, executing, or reviewing actually works out in practice among the states today. Rather, it is a description of a theoretical

system based upon ideal conditions and is consistent with the thinking and philosophy of noted officials who are now and who have long been studying these problems in government.

There is neither empirical proof nor refutation of the principles enunciated here. Yet virtually every state in the nation is moving in this direction, some faster than others. As program budgeting becomes increasingly popular, as program accounting systems are developed, and as legislative and internal audits become more sophisticated, this outline of the management function will increasingly become a better description of reality rather than of theoretical concepts.

From the standpoint of the auditor, it is imperative that he understand the model system, for only then can his recommendations and reports provide relevant motivation to move the state system closer to that ideal. Only by comparing present management practices to a model system which in effect serves as a standard, can the auditor, the legislator, or the executive official determine the direction of change needed and the magnitude of the change required. The purpose of this chapter has been to describe in rough outline such a model system.

In the chapter which follows, the conduct of the audit itself will be examined in light of the findings of this and preceding chapters.

CHAPTER V

THE CONDUCT OF THE PERFORMANCE POST AUDIT

Introduction

The approach to performance auditing that is developed in this chapter is based upon the theoretical discussions and empirical findings noted in the preceding chapters. It is impossible here to describe a "correct" or "best" method of conducting a performance audit. It is only possible to identify the major elements of such an audit and to suggest a reasonable or logical approach based upon the discussion thus far. In the development of the chapter, as in those which precede it, considerable assistance has been received from many state and national authorities¹ who have contributed ideas and insights. This is a vast new area which will require years of attention by numerous individuals before the audit approach is refined to the point where it serves its maximum benefit. However, any future development is likely to take the form of a further breakdown of the components of this system into finer parts and thereby prescribe in more detail the appropriate actions and inquiries to be made.

The performance audit can conveniently be divided into five parts: (1) preliminary planning, (2) initial survey, (3) evaluation of management controls, (4) analysis of exceptional areas, and (5)

¹A list of the persons interviewed in the process of this study is contained at the end of the bibliography to this study.

report and recommendations. The relative weight to be given to each of these parts is a function of the circumstances and conditions of the audit, including whether or not it is the first such performance audit conducted in the agency, the sophistication of the management control system, the wishes of the legislature, the competence of the auditor, and the nature of the agency's operations. The one over-riding consideration in determining the extent of audit effort to be allocated to each phase is the potential contribution to the improvement of administrative and legislative performance.

Preliminary Planning

The effective and efficient performance of an audit requires appropriate advanced planning in the same manner that effective administration of programs within the executive branch requires such planning. The audit plan should define the work to be done, identify the specific objectives sought, outline workable programs to accomplish the objectives, and assign responsibility for each phase of the work so that audit performance can be evaluated and controlled.

The purpose and the objectives of performance audits have already been defined in the preceding chapters of this study. Briefly summarized, the purpose of the audit is to provide the legislature with an independent and competent evaluation of the manner in which executive officials are discharging their responsibilities to faithfully, efficiently, and effectively carry out the programs of the state. For each audit engagement it is important that specific objectives be set and that the audit be planned to achieve those objectives. To facilitate and make possible such planning, the

following information should be obtained by the auditor.

Legislative Intent

First, it is necessary to determine legislative intent. All laws and legislative history pertinent to the agency or department being audited should be examined to determine the original intent of the legislature in setting up the agency and authorizing its programs. To the extent possible, a complete history of every significant bill should be assembled, from its introduction and initial justification through the hearings and the debate up to the final vote. Particularly is this true for recent bills and budget authorizations which have direct impact on current operations. In some cases where legislative intent cannot be clearly defined, it may be necessary to ask the legislature to clarify its position by issuing a summary statement or declaration of intent.

In the absence of formal records of hearings and debate, it may be necessary for the auditor general to assign members of his own staff to attend the legislative hearings and floor debates and to record the instructions given and commitments made. This is currently being done, for example, by the Auditor General of Michigan, and it promises to provide invaluable data on the nature of executive commitments and the expression of legislative will.

The auditor must always be careful to distinguish legislative advice or individual intent from the official will or request of the legislature concerning the programs and activities of an agency. He must also be alert for areas which have an implied intent even though not formally expressed.

Finally, the auditor should give special consideration to those

areas in which the legislature expresses particular interest. Since the purpose of the audit is to provide the legislature with information to better enable it to perform its responsibilities, its needs and desires should be closely watched and noted.

Other Legal Factors

The auditor needs to assemble information in other areas, such as court decisions, constitutional provisions, legal opinions by the Attorney General or other comparable authority, and rulings by governing boards and commissions established for the purpose of giving direction and control to institutional activities. In most cases, these factors are as binding on administrative conduct as are the laws passed by the legislature.

Programs and Budgets

The auditor should know in advance the specific programs which the agency is required to administer and the amount of funds and other resources that have been placed at its disposal. In part, this information can be assembled as part of the review of legislative intent and other legal factors. However, it also requires that a brief history of agency activity be compiled so that traditional programs may be noted and the basis of budget requests can be understood. This is particularly true for "non-controllable" expenditures, which are those funds that are spent in current periods because obligations were incurred in prior periods. Conversely, the auditor needs to know the obligational authority that has been granted to the agency, for under such authority, considerable program activity can occur even without a great sum of current appropriations. Finally, all authority to borrow money, to enter into contracts, or in any other way to incur long-range commitments should be known in advance.

Again, however, these items will likely come to light in the review of legislative intent and other legal factors above.

Administrative Manuals

Still another important area for preliminary review is administrative policy and procedures manuals. Where written manuals exist, they should be reviewed to determine (1) what policies have been established to direct the activities and decisions of each administrator, and (2) what operating procedures have been prescribed by top officials. Policies that are relevant to the audit, of course, are those which have been set by officials at a higher level than those whose performance is being directly evaluated.

Prior Audits

When the auditor returns to an agency which he has previously audited, one of the greatest sources of information available to him is the audit working papers and reports from the previous audit. This is true even if the previous audit was only a brief inquiry into a special, restricted area or confined only to financial records. Of course, the more comprehensive the previous audit was, the better will be the information which is available for the current audit. This should be especially true for successive performance audits.

Permanent File

All of the pertinent information gathered in the planning process prior to the actual audit engagement should be summarized and filed in a "permanent file" where it can be referred to by the auditor at any time during or following the conduct of the audit. Such a file should contain a background history of all relevant facts which the auditor needs to

consider in setting up his initial plan of attack. The first time a performance audit is conducted in an agency or institution, the preparation of this file will take considerable time, but once compiled, it needs only to be up-dated on subsequent audits. And that should require only a fraction of the time taken in the original compilation.

Summary

Once this preparatory review is completed, the auditor can then define his specific audit objectives and determine the basic approach he feels would be most appropriate to accomplish those objectives. The most important decision which he must make at this point is what he must do once he has arrived on the job. The direction, intensity, and scope of his initial on-the-job review will all be determined by this advanced planning and preparation.

The Initial Survey

The initial survey, like the advanced planning, is critically important in the determination of the direction, the scope, and the extent of the audit effort. It is imperative in planning for the evaluation of management control. The purpose of the initial survey is to familiarize the auditor with the operations and programs of the agency and to identify the various elements of the management control system. Such a survey should be brief but comprehensive. Its purpose is only to identify the elements of control and the nature of operations, not to evaluate them. One step in the survey is to determine the location of physical assets and accounting records. Another is to obtain familiarity with the nature of the operations of the agency. The auditor should determine as part of this survey what programs are being administered by the agency, and he should obtain and review the financial statements and other relevant reports

which may be of value to him in gaining familiarity with the organization and its operations.

The most important part of the survey, however, is the review of the organizational structure and the planning function. The auditor should determine who is responsible for what phases of the operations. He should know to what extent planning has occurred, whether or not objectives have been identified formally in the planning process, and on what basis budgets are prepared and accounting records are kept. The audits should also ascertain whether or not performance standards have been established and used. He should obtain copies of all written policy statements of executive officials, and he should determine whether or not internal auditing and review is performed.

This initial inquiry is particularly important on the initial performance audit, in that it identifies the elements of control that actually exist and provides a basis upon which to prepare formal audit programs to evaluate the control system. All information gained in this survey which will have value in future audit engagements should be recorded in the "permanent file" along with the other vital information. Like advanced planning, this survey is likely to require much less time on subsequent audit assignments if proper records are kept on the findings of the first assignment.

The Audit Program

Based upon the advanced planning and the results of the initial survey of conditions in the agency, the auditor is prepared to formulate specific audit programs to accomplish the objectives of his audit. Only when such programs have been carefully and competently designed can the auditor hope to attack his problem in an orderly and professional manner.

The audit program for a performance audit differs from audit programs of traditional financial audits. First, the audit programs of financial audits are conditioned by the internal control analysis, whereas the audit programs of performance audits must be designed with particular emphasis on the evaluation of controls. Likewise the particular elements of control subject to audit review are different. The financial audit is concerned with financial controls, while the performance audit is concerned with all control elements which are designed to insure effective, efficient, and faithful operations. And as outlined in Chapter IV, this broader view of management control includes financial control, but it goes far beyond it.

Another difference between the audit programs of financial audits and those required for performance audits is that while financial audits deal with historical results--such as financial condition, statements of expenditures, etc.--performance audits are primarily oriented toward determining why the results and conditions are as they are, not just how they are. Performance auditing tests the underlying causes of performance results. Efficiency and effectiveness of administration and the faithful execution of program responsibilities are the basic criteria. Performance is analyzed, not just reported. And audit programs must be designed with that in mind.

Likewise, the control analysis in the financial audit emphasizes the preservation of the agency's assets by preventing abuse or misuse of delegated authority or responsibility, whereas in the performance audit the evaluation of control must also determine whether or not there are additional ways of operating or new opportunities available for using the resources of the agency which would increase the agency's contribution to society. Management control, in this sense, should seek to promote and improve, not merely to restrain and police. Lost opportunities

are equally as serious as wasteful practice.

Audit programs must be tailored for each assignment, for each audit will be different. The audit program should reflect the particular conditions that exist in each agency, and it must direct primary attention to those areas having the greatest apparent need for review and analysis.

Written programs should be prepared and used wherever practicable. Oral instructions or standard check-lists are not adequate for this important work. Neither are standard programs designed to cover all engagements. And even the written programs which are designed specifically for the audit being conducted must be used as general guides rather than specific and rigid requirements.

Good supervision and proper direction has always been essential to the audit regardless of the quality of the audit program, and this is particularly true of the performance audit. This type of audit requires a high degree of analytic skill and the ability to apply competent judgement throughout the course of the audit. Audit programs must be flexible enough to permit the application of such skill and judgement, yet be specific enough to provide effective direction in the application of appropriate tests so that informed judgement is possible.

Inadequately planned audits, like inadequately planned operations of any other kind, will fall far short of their desired objectives. Perhaps the greatest challenge of the performance auditor is the planning of his work.

The Evaluation of Management Control

Without doubt the single most important phase of performance evaluation is the evaluation of the management control system, for it is by means of the controls that are established that faithful, efficient, and

effective performance is secured and insured. Indeed, this step alone will likely consume a majority of the audit time on any engagement, particularly on the initial performance audit. Without a full and complete understanding of the control system and its effectiveness, evaluation of actual performance is difficult if not impossible. Thus, this portion of the audit needs to be carefully and thoroughly planned.

The procedures and sequence of steps to be used in evaluating management control will differ for each assignment. The discussion below is therefore not intended to provide a first-second-third order of steps to follow. Neither is it intended to represent by any means an exhaustive list of the things that can or should be done in such an evaluation. However, those items noted here are important in every audit of administrative performance, and each should receive the attention it merits in the particular situation.

The Extent of the Control Evaluation

As noted above, the purpose of a management control system is to insure faithful, effective, and efficient performance of program responsibility on the part of administrators and agency personnel. Faithful performance refers to whether or not actual performance conforms with established policies and commitments. Effective performance refers to whether or not the desired objectives are achieved. Efficient performance refers to whether or not resources are used in their least-cost combinations to accomplish the objectives, including the elimination of waste. Thus, audit tests of management control must cover each of these areas. The auditor's responsibility here is to test and evaluate each of the elements of control identified in the initial survey, and to determine what controls are needed which were not found to already

exist in the agency.

Planning. The starting point in evaluating the management control system is with the initial agency planning.¹ First the objectives of the agency must be determined, and the programs by which the objectives are to be achieved must be identified and defined. Presumably these are the programs that were presented to the legislature for approval, so theoretically it is not difficult to determine legislative intent concerning them. In reality, however, it seldom occurs that way. Planning is often fuzzy, and programs are at best nebulously defined. Historically, most programs have been reviewed by the legislature only on an incremental basis. Seldom, therefore, is an overall program policy stated by the legislature. Nevertheless, if objectives have not been defined, and if programs have not designed to achieve them, management has not performed one of its most basic functions. Without proper planning and orientation of programs and activities, management control has no direction or goal, and it is therefore ineffectual at the program level.

In the absence of defined programs and objectives, the auditor may still inquire of agency management: What are you trying to accomplish? And what are you doing to accomplish it? How do you know if your activities contribute to your goals?

Answers to questions such as these will at least give the auditor an idea of the underlying motivations of management, and they will help in the evaluation of the accomplishments of the organization.

Organization and Policy. The next step in the review of the management control system is the evaluation of the plan of organization and the

¹William Travers Jerome, III, "Management Control--Some Audit Implications," The Internal Auditor (September, 1957), pp. 41-43.

assignment of responsibility for each part of the work to be accomplished.

Equally important with delegating specific responsibility for the work that is to be done is the responsibility to secure qualified and competent people to perform the tasks assigned. Efficient and effective operations cannot be expected if those charged with responsibility are incompetent and unqualified for the technical direction and decisions that are required of their jobs. Thus, the auditor should review the methods by which employees are assigned to their jobs within the organization to determine, for example, the extent to which such assignment takes note of the particular skills of the employee. He should also review the recruitment and training programs, and particularly he should inquire into the turn-over rate of employees and determine the reasons why responsible and capable persons are leaving the agency, if in fact they are doing so.

Even further, the auditor should evaluate the policies that give direction to employee activity. The policies should not only be evaluated in terms of their relevance and significance to the conduct of assigned responsibilities, but also on the basis of whether or not they are consistent with the agency's objectives and plans and with legislative will. The auditor must also determine whether such policies are effectively followed and enforced throughout the organization.

Finally, the organization structure should be evaluated in terms of its relationship to programs and plans. It is impossible to evaluate program performance in terms of administrative responsibility unless the organizational plans and the program plans correspond. Programs are conducted by people, and objectives are achieved through human effort. The auditor should test to determine if in fact those who are engaged in program activity are motivated by the objectives. Such motivation is

essential for effective and efficient operations.

The evaluation of the organization, even though it is far more penetrating and purposive in the performance audit than in the financial audit, should not be difficult for the auditor to accomplish. The plan of organization has long been one of the traditional areas of audit inquiry, and the expanded scope of the inquiry required here should present no major new problems to the skilled auditor.

Performance Standards. It is impossible to evaluate performance either of individuals or of programs without performance standards. Thus, they too become a very important subject of audit review and analysis.

First, the auditor must determine if standards have been set in the agency. If so, he must evaluate them to determine if they are relevant, sufficient, and reliable. That is, the auditor must do more than identify the standards; he must evaluate them. He must next determine the extent to which they are used by internal management. Unless they are used, the most carefully prepared standards in the world are ineffective as control devices. Finally, the auditor must determine how effective the standards have been when used. Again he is testing the effectiveness of administrative performance in an important area.

Performance standards, while designed primarily as control devices for internal management, can also be used in many cases to evaluate performance after the fact. In fact, without some type of standard or performance indicator, it is impossible to render qualitative opinions on performance. Thus the auditor general must not only determine whether or not performance standards are effective for internal management, but also whether or not they are useful for his post-performance review.

Two kinds of performance standards were mentioned in Chapter IV:

personal standards and program standards. Personal standards are primarily used in the employee-employer type of relationship. They are used when one person reviews the performance of another person under his direction. Standards of this type are not likely to be of great value to the auditor who does not witness the actual performance of the employee involved. However, the auditor is under just as great of an obligation to determine that such standards exist and are used as he is for program standards. To effectively review such standards, the auditor should become very familiar with their nature and purpose.¹ Otherwise, he can identify their presence or absence but cannot evaluate them for relevancy, effectiveness and adequacy.

Program standards, on the other hand, are designed to indicate program progress toward the achievement of the objective sought. These too are difficult to define, as discussed in Chapter IV. They can also take a variety of forms, but only by using such standards is it possible to competently render an opinion on the achievement of program objectives or the appropriateness of policies and procedures designed to promote program success. It is important, however, that the auditor evaluate the standards before he uses them. Only if and when he feels that they represent reliable indicators of performance should they be used in the post-audit evaluation by the independent auditor, and only then with extreme care.

In spite of the obvious need for standards both to management and to the auditor, very few such standards formally exist in any state today.

¹Some excellent sources of information in this area are Carl Heyel, Appraising Executive Performance (New York: American Management Association, 1958); Virgil K. Rowland, Improving Managerial Performance (New York: Harper & Brothers, 1958); and Virgil K. Rowland, Managerial Performance Standards (New York: American Management Association, 1960).

It is true that in the minds of administrators, performance is evaluated in terms of some standard. But few of these standards have been written down and formalized as part of the control system. Thus the question that arises is: How can performance be evaluated when such standards do not exist? This will be answered in a later section of this paper.

For now, the important fact is that setting and using meaningful performance standards is a management responsibility. It is a vital part of the management control system, and the auditor is evaluating another part of administrative performance when he evaluated the quality of performance standards set and used in an agency. Perhaps no performance area is in greater need of the auditor's attention than this. And no one is better qualified to evaluate the quality of performance indicators than the auditor whose whole responsibility is to evaluate performance.

Accounting and Reporting. Accounting is the means by which the events that occur in the organization are recorded, and reporting is the means by which the results of such events are brought to the attention of administrative officials and others such as the legislature. Yet accounting is more than recording events. That is the function of a historian. Accounting connotes the idea of responsibility. Accounting is the means by which the results of decisions made by responsible officials (as reflected in the activities and programs of the organization) are recorded. It is a process of identifying cause and effect, input and output, responsibility and performance. Thus accounting too is a proper subject for performance audit review.

Here the auditor is concerned with the type of accounting system used. Does it articulate with the other elements of control and with the patterns of responsibility? Is it sufficient to provide timely,

relevant, and reliable information to those who are responsible for making decisions and appraising performance? Does it provide a record of the disposition and use of agency resources and relate the use of such resources to the programs and accomplishments of the agency? If the record of actual performance is incomplete, or if it does not permit relevant comparisons with plans and standards, evaluation of program performance is extremely difficult. And if the results of decisions and actions of administrative officials cannot be identified with those decisions or actions, it is impossible to determine the effectiveness of them.

Thus in the evaluation of the accounting and reporting system, the auditor is again rendering an opinion on an important element of administrative performance, for it is the responsibility of the administrator to secure proper accounting and render competent and reliable reports to the legislature and to top Executive officials.

Of all areas in the performance audit review, this one is perhaps closest to that of the financial audit review. Yet even here the objective is different. In the financial audit, the auditor has traditionally been concerned with the proper recording of transactions according to prescribed accounting rules. Now he must determine whether or not the accounting rules themselves are adequate and meaningful. Such an evaluation requires that the auditor determine whether accrual accounting and cost accounting procedures are being effectively used in those situations which require them. Program accounting systems should be fostered among the agencies, and the auditor should recommend them and evaluate them as they are developed and come into use. In many cases, progress in this area has been impeded by rigid and out-dated laws, and the auditor should be especially careful to point out to the legislature those areas where management cannot affect improvements until the legislature amends the law.

Finally, reports must not only be prepared in accordance with accepted accounting principles. They must also provide relevant information to the person receiving them. They of course need not be restricted to financial areas, but should include performance areas as well. Thus the auditor must go beyond the manner in which reports are prepared and evaluate them in terms of their use. No better example of inefficiency exists than where reports are prepared at substantial cost and effort but are never used. Accounting and reporting systems in state government have a long way to go before they will meet their potential objectives. And the auditor, perhaps more than anyone else in the state, can push this progress along with careful and competent recommendations and reports on the accounting systems in the agencies audited.

Internal Audit and Review. The only way that management can insure that its plans have been followed and that the results that have been achieved are those which were desired is by reviewing what actually happened and comparing it to what was expected to happen. This is accomplished by personal reviews and by internal post-audit reviews. Personal reviews were mentioned under personal performance standards. They are vitally important, and the auditor should determine whether they are conducted and how effective they seem to be in promoting more efficient and effective performance on the part of those reviewed.¹

However, the major internal review of operations and program performance will probably be made by the internal audit group. To some extent this type of review occurs in the annual budget preparation, but the bureau of the budget certainly has no means to affect a performance

¹See Richard E. Brown, A Review of Employee Evaluation Systems (Chicago: Public Personnel Association, 1963). This book also contains an excellent five page bibliography on the subject.

audit of every agency or department or institution of the state. This work is that of the internal auditor. And the work of the internal auditor is another important area for evaluation by the auditor general.

Internal auditing, like independent auditing in the state, has been traditionally associated with financial audits in the few departments and agencies where it has been done. In recent years, however, as noted in previous chapters, internal auditing has also expanded into performance areas. In fact, one can seldom find a discussion of internal auditing in the professional literature today which does not go to great lengths explaining the merits and means of expanding the scope of the internal audit review. And in its statement of responsibilities, the Institute of Internal Auditors includes "appraising the quality of performance in carrying out assigned responsibilities" as one of its duties.¹

This development has occurred not only among industrial internal auditors, but also in government. A recent study in California recommended a greatly expanded role for the internal auditor.² So did a 1958 study of internal auditing in the federal government which was made by the General Accounting Office.³ This expanded concept has been referred to as operational auditing or management audit. In either case, the auditor is expected to review the operations and programs of the organization

¹Statement of the Responsibilities of the Internal Auditor (New York: The Institute of Internal Auditors, 1957), p. 2.

²California, Office of the Auditor General, Report on a Review of Internal Auditing Within the Executive Branch of the California State Government (Sacramento: State of California, 1962).

³U.S. Government Accounting Office, Internal Auditing, August, 1957. See also Ellsworth H. Morse, Jr., "Some Considerations behind the General Accounting Office Statement on Internal Auditing," The Federal Accountant (December, 1957), pp. 30-49; and William A. Newman, Jr., "Evolutionary Changes in Auditing in the Federal Government," The Federal Accountant (December, 1958), pp. 41-55.

as though he were a management official, not just a financial expert. Such an internal audit function is truly needed in state government, and it is a management responsibility to see that it is established and competently performed.

Not every agency will be of sufficient size to warrant its own internal audit group, and in those cases departmental internal auditors should be assigned to periodically review the agency's operations. It is the responsibility of the auditor general to review the extent and quality of the internal audit under either situation. He may accept or reject the work of the internal auditors, but in any event he must do sufficient work to evaluate their work. His purpose is to appraise, not to duplicate. And to the extent that he accepts the internal audit work as competent and adequate, he will be able to reduce the detail of his own examination.

Method of Testing Management Controls

The purpose of the test of management control is to determine its effectiveness in promoting faithful, efficient, and effective performance. The proof of such control can only be tested by comparing accomplishment with plans, results with standards, practice with policy. As Ernest Miller has said:

To audit is to investigate in order to obtain information on practices and results accomplished, with careful attention to the reliability and validity of the information obtained. The objective is to arrive at a dispassionate and verifiable basis for comparing what is being done and how well it is being done with the plans, policies and standards of the organization, and to understand the reasons for positive and negative variances from these plans, policies and standards.¹

The starting point in evaluating such a system is to find out how

¹Ernest C. Miller, "The Case for a Management Audit Group," The Internal Auditor (Fall, 1961), p. 9.

the agency itself performs this evaluation. This can be done by selecting a few items as special case studies and by tracing them completely through the organization from start to finish. In a hospital, for example, it may be helpful to begin with the admittance procedure for a given patient and trace the patient's case through diagnosis, treatment, and ultimate release. The purpose of this inquiry would not be to evaluate the medical judgement or treatment, but the operating controls. Who is responsible? What procedures are followed? Is there unnecessary duplication of work or records? Is adequate information available at all points? These and many other similar questions can be asked.

Another example might be to test the use of foods and drugs. This can be done by again tracing a few examples through from start to finish--beginning with the determination of the need to place an order, then following through the placement of the order, the receipt of goods, payment, storage, distribution, preparation, and ultimate waste or garbage disposal. In this case the auditor is made aware of numerous operating policies and procedures, and these he can test against the stated objectives of the hospital. In each case he should inquire about the assignment of responsibility for each phase of the process, determine whether or not standards exist to evaluate the performance of those assigned, and find out what measures are taken to bring discrepancies to the attention of top management officials and what action is taken when irregularities are found.

At every turn, the auditor must be aware of possible inefficiencies. For example, are inventories excessive? Are reports used? Is waste controlled? Is there evidence of carelessness? Are there unnecessary duplications or work or records? Are purchasing procedures such that

goods are acquired at a minimum of cost? Are employees properly trained for the jobs they are required to do? Is equipment used and serviced properly? Are proper time and work records maintained for payroll purposes? In this connection, another test might be to trace what happens to an employee from the time he makes application for employment until his termination with the agency. This would include hiring, training, assigning, promoting, paying, demoting, firing, and retiring employees. And it would include security clearance and other such items if appropriate.

The auditor will always be faced with areas where he is incompetent to judge the effectiveness of a policy or procedure. For example, he cannot judge whether or not the method used to assign state police officers to their respective duties is the most effective way to secure public safety. However, the auditor can take the matter up with responsible administrators and make a reasonable judgement of the control system by asking the following types of questions and then testing the answers. How do you deploy your people? Do you have a plan? Why do you deploy your people as you do? What alternatives have you considered? What are the criteria you use to determine if this policy or procedure is effective? What measures do you take to assure that people are working at what they say they are? These questions are necessarily broad. Depending upon the answers received, the auditor can become more specific and detailed in his questioning until he fully understands what is done. Only then can he determine whether or not the procedures seem adequate.

The auditor must always be careful in judging the technical ability of an administrator. Such an ability should be evaluated only by the evidence found in the operations, not on the basis of personal impression. Technical or professional ability is inherent in the satisfactory

performance of the management function as required in the particular organization. As Charles Inman points out, ". . . by the examination of controls we should be able to satisfy ourselves as to the reasonableness of technical and professional abilities in the performance of a function, . . . we should not attempt directly to evaluate the exact degree of technical ability in an operation."¹

Finally, throughout all of this analysis, one theme must prevail. The cause is more important than the effect. The auditor has not performed his responsibility if he has only pointed out poor results or symptoms of weak control. These are the evidences of weaknesses in controls or in planning, but until the auditor has determined the cause of causes of each of the irregularities or inefficiencies, he has not completed his evaluation of the control system.

In some cases, due to lack of records or other objective information, it may be impossible for the auditor to fully explore the causes of the discrepancies noted. Certainly the existence of good accounting and reporting procedures facilitates the conduct of the audit. However, such records are not a condition precedent to carrying out performance audit work in an agency. The accounting and reporting function is a management responsibility which is subject to audit review itself. And the auditor should make every effort to ascertain and evaluate the other elements of control regardless of the adequacy of written records. In fact, the inadequacy of accounting records in vital performance areas should be an added reason for further investigation into those areas, not an excuse for stopping at that point.

The approach described here is broad and general, and for each audit

¹Charles N. Inman, "Managerial Auditing of Operations," The Internal Auditor (June, 1958), p. 49.

engagement the auditor will have to break down his examination into manageable portions and specify in his audit programs the methodology to be used in each instance.

Implications of the Management Control Evaluation

If planning has occurred and if control is effective, performance will agree with the plan. Thus the test of management control is the most important step in evaluating administrative performance. The findings of the audit of the control system will reveal areas of operations and decisions where controls are non-existent or weak, and these areas are, of course, subject to suspicion and should be further examined. Based upon the findings of the control evaluation, the auditor can prepare competent and effective audit programs to proceed with his audit into these exceptional areas. This is the policy of audit by exception.

In those areas where plans and program objectives are clearly outlined and where controls are effective so that performance corresponds with the plans and objectives, the auditor need make no further inquiry. This assumes, of course, that he has evaluated the plans, standards, programs, etc., to determine that they are reasonable, consistent, and appropriate for the objectives sought.

In actual practice, the auditor today is likely to find that this system of management control breaks down very fast. Thus, more often than not, the auditor will find that adequate controls do not exist and that planning has not occurred in the manner described.

The question that must be asked at this point is: What happens when the management control system is found to be lacking in many of its essential or vital elements? Does this mean the end of performance audits until and unless such planning, programming, etc., occurs? The

answer must be an emphatic "NO!" Performance auditing is certainly facilitated by these things, but it is by no means entirely dependent upon them. Executives still appear before the legislature to request funds to carry out activities or programs, budgets are prepared on the basis of some plan or objective, accounting systems are designed to report some elements of performance, and organizational structure, however inadequate or inappropriate, does exist. The purpose of the evaluation of management control is not only to determine where it is weak or strong and to make recommendations for its improvement, but also to enable the auditor to plan the conduct of the balance of the audit. Indeed, the very fact that such controls do not exist in an ideal condition underscores the fact that performance cannot be evaluated on a broad, over-all basis. Rather it must be attacked in pieces and chunks on a smaller basis at first. Later, perhaps, it can be expanded as the bits and pieces fall together and are included within a more comprehensive system of management planning and control.

In conclusion, then, a penetrating analysis of management control is essential; first, to determine where such controls are weak and to make recommendations for their improvement; and second, to determine those areas which require special attention from the auditor. Some alternative ways of approaching the audit assignment when the management control system is not up to standard are presented below. However, the most important recommendations which the auditor can make to promote efficiency and effectiveness in state operations are those designed to strengthen and improve the control system.

Financial Aspects of the Performance Audit

Both in this chapter and in those which preceded it, several

differences and similarities between financial and performance audits have been mentioned. It is appropriate at this point, however, that the exact relationship between these approaches be emphasized again.

First, under the general name of financial audit, several things have been done by state auditors which seem at first glance to be quite similar to what has here been described as the management control evaluation. For example, in a letter to one of the delegates of the Michigan Constitutional Convention, one member of the staff of the Michigan Auditor General stated the following:

The scope of our audits is much broader than would ordinarily be expected. In addition to merely verifying mathematical accuracy, test checking transactions, and counting cash our audits include (a) review of systems and procedures for propriety and adequacy, (b) review of practices for compliance with legal provisions, established procedures and proper governmental accounting standards, (c) review of the adequacy and effectiveness of internal controls, (d) verification of proper recording and handling of funds and property and (e) verification of legality and propriety of disbursements.¹

There is no question but what this type of audit includes many aspects of management performance and responsibility. Neither is there any question on the fact that performance audits must include these financial aspects of administration. Performance in financial areas is certainly an important part of total performance, and most of the audit procedures that have been used in financial audits are applicable and important in the conduct of a performance audit. Nothing in this discussion is intended to imply that the financial audit is not important. Indeed, the contrary is true. The financial audit takes on increased significance when financial statistics can be related to program output and the achievement

¹William J. Wood, letter addressed to Eugene G. Wanger, delegate to the Michigan Constitutional Convention, on the subject of the duties of the Auditor General, dated November 15, 1961.

of objectives. Thus, while the above audit procedures are essential to the conduct of some aspects of a performance audit, such an audit must involve much more, as outlined in this chapter.

For example, testing management compliance with legislative intent has always been recognized as an essential area of audit review. Yet, for the most part, such tests have been confined to issues such as whether or not state laws have been violated, whether statutory requirements have been met, and whether or not items for which money was appropriated were in fact purchased. The test of compliance with legislative intent has seldom if ever been designed to determine whether or not programs have been administered efficiently, effectively, and in the manner intended by the legislature and promised by the executive. Thus, the performance audit does not do away with the former practice; it adds to it and builds upon it so that the totality of compliance is tested.

The same is true in this matter of control evaluation. Internal control has always been a vital area of audit under financial audit procedures. Matters such as the division of responsibility, the proper authorization of warrants and requisitions, the pre-numbering of checks, invoices, and receipts, and a host of other items have long been examined in the internal control evaluation. The performance audit does not remove the need for this evaluation; rather, it adds to it by going far beyond this test to determine if in fact objectives have been set, programs have been planned, performance standards have been established and used, and responsibility and accountability secured--not only for the use of funds but also for the use of other resources and the control and execution of all program activities.

Thus it is true that state auditors have done some performance auditing in the past. But the type of performance auditing envisioned by the framers

of the Michigan Constitution and that developed in this study goes far beyond these traditional areas. This fact has been noted and explained throughout this study. In fact, the provision of the Michigan Constitution which requires performance audits also requires financial audits, as noted in Chapter II. And as noted in Chapter III, this type of audit is vitally important to the legislature as well as to administrative officials. But by itself, without being related to performance in terms of program achievement and objectives, the financial audit is inadequate to meet the needs of modern state government.

The Analysis of Exceptional Areas

The fourth phase of the performance audit is the analysis of those areas which lack effective control or which are found to require additional attention beyond that which is possible through the control evaluation. There are numerous possibilities both in terms of type and scope of such special investigations, and particularly in early performance audits where many of the control elements are found to be lacking, this type of investigation may be necessary in almost every phase of the operations of an agency.

The planning for this type of investigation must be based upon the findings in the management control review. It should also recognize the patterns of responsibility that do exist in the organization, for even if planning has not occurred in such a way that standards and other essential control features are available, certain individuals still bear the responsibility for the operations of the organizations.

In the absence of standards or other effective criteria with which to evaluate performance, three alternative approaches are available to the auditor. These are (1) a comparative analysis, (2) the use of

borrowed statistics, and (3) the test of reasonableness. It will be helpful in the discussion of these concepts to remember again that the basic criteria for evaluating performance are efficiency, effectiveness, and the faithful discharge of program responsibility. The approaches discussed below, however, can only test efficiency and effectiveness. Faithful performance depends upon the existence of instructions, promises, agreements, or established policies which, if non-existent, cannot be hypothetically formulated or tested by the auditor.

Finally, any one or all of the methods outlined in this chapter may be used on a given audit engagement. The important thing is for the auditor to do all that he reasonable can to obtain sufficient and competent evidence upon which to base his judgement and render his opinion.

Comparative Analysis

The first method of evaluating performance in the absence of specific standards is by comparison of similar situations. This can occur in two ways. First, current performance can be compared to past performance. Second, performance of one agency or institution can be compared to that of another.

Comparison of successive periods has the advantage of being able to reveal trends in performance. For example, if the cost per prisoner fed in a penal institution rises from year to year, attention is drawn to the fact that either prices have risen, inefficiencies in food preparation have increased, prisoners are being fed larger quantities, or a better quality of food is being used. The auditor can evaluate the situation further and determine precisely why the cost per inmate has in fact risen. In this case, the criteria by which actual performance is evaluated is not a pre-determined plan or a formal set of performance standards, but simply

that which was done in prior years. Such standards are not capable of permitting judgement as to whether or not the rise in price per inmate fed is good or bad. Neither can this method enable the auditor to determine whether or not costs are too high. But it does identify the causes so that administrators and legislators can make a judgement on performance as it occurred.

This type of comparison presents no problem in terms of the similarity of the units being compared. With few exceptions, the administrators, the programs, the organization structure, the size of the operations, or the personnel involved will all be very nearly the same for both periods of time. Likewise the geographical location and the public being served will be unchanged.

The biggest disadvantage of this type of comparison, however, also is a product of this same similarity in the units compared. While trends are possible to note and examine, meaningful comparisons of alternative methods or procedures cannot be accomplished. This is the great advantage of comparisons between two different but similar organizations, for nearly always such an analysis will provide an opportunity to evaluate different approaches to program administration. And having determined the results of different approaches to administration, the auditor can make helpful recommendations for improving efficiency and effectiveness in the operations of both organizations.

It was noted in a previous chapter, for example, that the auditor cannot determine what it should cost to operate an English Department at a state college. Neither can he judge whether or not the actual costs of operating such a department are excessive in the absence of some standard. He can, however, determine why it costs more to operate such a department at one college than at another college. And by pointing

out the "why" to the difference, he focuses attention on the variables which are relevant for the value judgements of administrators and legislators.

Again this is a problem of determining the cause of differences, not just determining what the differences are. As noted earlier, this is the essence of the performance examination. And all audit recommendations, to be truly effective, must get at the cause of the problem, not just the symptoms or the results.

There are some inherent dangers in comparing two separate organizations, however. One danger is that of failing to note factors which justify differences between the two. For example, the comparison of two hospitals is difficult since no two hospitals treat precisely the same type of patient, hire the same type of doctors, use the same type of equipment, or have the same proximity to supplies of food and other essentials. Thus any comparison must take these items into account. Two hospitals would, however, have many of the same types of problems regardless of their differences, and the similarity of the problems can at least lead the auditor to examine how each administrator handles these common problems and to describe what the consequences of such decisions and actions are. And in this way, alternative possibilities for improving the efficiency and effectiveness of operations are brought to the attention of the auditor for his analysis, and his recommendations can then reflect his judgement based upon the evidence of the utility of each of the alternatives used.

The Borrowed Standard

Several groups throughout the country have recommended that studies be made on a broad scale to provide uniform and comparable standards

for evaluating performance in various institutions and organizations. Some of these were mentioned in Chapter IV. However, here again there are some dangers.

First, national averages and broad-based statistics never relate to specific situations. Thus, while such statistics give some indication in general terms of the performance of the agency, they cannot be used for precise measurement or evaluation. Second, very few such national averages or uniform statistics actually exist. And in those cases where they do, such as hospitals, prisons, libraries, etc., they either relate to such a small portion of the areas subject to audit, or the statistics are so limited in their ability to indicate performance beyond very restricted areas, that they serve little use to the auditor.¹

A corollary of this problem also has important implications for the auditor. In testing the standards used by an agency or institution, it is important that the auditor determine whether or not such standards have been specifically developed to fit the programs and the needs of the agency or whether they have been "borrowed" from some other source. Unless they are tailor made for the specific agency, they are likely to be somewhat inappropriate. Consequently, they are probably ignored by most agency personnel.

Still, borrowed standards are often better than no standard at all, and as further studies are made both to broaden the types of statistics available and to enlarge the areas covered, this type of criterion may

¹For example, see The Feasibility of Inter-City Comparisons, A report of the Comparative Measurements Study, John L. Fava, Project Director (New York: Citizens Budget Commission, Inc., November, 1963). This is an excellent study of this problem at the municipal level. Also see Henrik L. Blum and Alvin R. Leonard, Public Administration--A Public Health Viewpoint (New York: The MacMillan Company, 1963), pp. 289-290, for a discussion of this problem in public health.

become an even greater aid to the auditor, particularly in the evaluation of the adequacy and appropriateness of standards established by the agency.

The important point for the auditor to remember when using borrowed standards is that he must be equally as critical of them and evaluate their appropriateness just as completely, and perhaps more so, than he would the performance standards established by the agency. Only when and if they are found to be relevant and appropriate should they be used by the auditor.

The Test of Reasonableness

Even when standards are non-existent, when comparisons are impossible, or when borrowed statistics are unavailable, it is still possible for the auditor to test performance on the basis of reasonableness. From his experience in auditing the many areas of the state, the auditor gains considerable familiarity with state operations and its many problems. Thus the auditor brings a broad perspective and wide experience to his job. Because of this, he can often spot irregularities and weaknesses that would escape a reviewer without such a background.

Furthermore, there are what may be termed "general standards of society" which have application to good management in any field, public or private. For example, work that is being carried out in a loose, unsatisfactory, and inefficient manner can often be cited even in the absence of specific standards. Obsolete inventory, excessive supplies, personnel who are continually absent from work, abuse in the use of state resources such as automobiles and expense accounts, or negligence in processing documents or in handling state funds, are all examples of items which can often be evaluated through the test of reasonableness.

Thus there are numerous examples of inefficient practices and

ineffective administration which the auditor can test simply because of his familiarity with state operations and his competence as a control expert. Most state auditors already evaluate some aspects of state administration on this basis. And as the auditor general and his staff gain familiarity and experience with performance auditing, their ability to test performance on the basis of reasonableness will greatly improve.

Finally, this test is always an appropriate tool for quick reviews of operating areas not subjected to detailed analysis. And even when a detailed analysis has occurred, the auditor should still examine his conclusions for reasonableness. This will insure that he has not become so engrossed in his statistics that he has overlooked important items or placed too much weight on items of a minor nature.

Audit Reports and Recommendations

The final phase of the performance audit is rendering a written report of the audit to the legislature outlining the scope of the audit, the nature of the tests conducted, the findings in terms of cause and effect, and recommendations for improvements which the auditor feels are needed. Such reports should also be made available to the Governor and/or other responsible administrative officials.

Most states require the filing of a summary audit report on an annual or biennial basis, but the auditor should also report findings of the specific audits as the audit is completed, or as matters warrant legislative attention.

Prior to the submission of the report to the legislature, the auditor should review the report in its entirety with the responsible administrative official of the agency audited. If proper rapport exists between the auditor and the agency administrator, such a review will prove to be

beneficial for both sides. The administrator will have a final opportunity to review audit recommendations and to discuss them with the auditor, thus insuring that he fully understands the basis for the report and the recommendations. On most recommendations, he will likely take immediate action to affect the necessary changes, and the auditor can report this action accordingly. On issues where he feels he has a legitimate reason for differing with the auditor's opinion, the administrator can at least express his feelings on the matter to the auditor and prepare his defense before the legislature and the Governor.

The advantage of this review to the auditor is that it helps him "clean up" his report. And this every auditor needs on virtually every audit. This is an opportunity to discuss proposed recommendations and to again review their soundness and importance. It is also the place to pick up additional loose ends and to discard frivolous and immaterial items. Certainly the auditor leaves himself open to severe criticism and takes an unnecessary risk when he fails to undertake this final review, regardless of the quality of his audit performance. Furthermore, his recommendations are much more likely to be followed if they are presented in a spirit of fairness and mutual cooperation and interest.

Each item included in audit reports must be significant and must be fully supported by facts obtained during the course of the audit. Findings must be based on reliable evidence, and they should be stated in a concise and objective manner. Particularly in the early stages of performance auditing, the manner in which the auditor approaches his engagement will be closely observed, and it is important that he proceed in a careful, constructive way. He must never give the impression that he intends to use his authority as a club to impose or force something on the administrator. Rather his spirit must be one of helpfulness. And in this regard

it is important that the auditor give proper recognition to favorable findings as well as to those areas found to be weak or in need of further attention. His obligation is to report administrative performance whether it be good, bad, or otherwise. And he must do so constructively and convincingly.

The recommendations should probably be divided into three groups for maximum effectiveness. First, those recommendations which were made and immediately implemented by the agency administrators should be noted. Second, those recommendations which require specific legislative action should be listed. These include items requiring changes in public laws or a clarification of legislative policy. Items such as a transfer of funds, changes in statutory authority, or the revision of laws affecting the use of public assets are examples of this type of recommendation.

The third group of recommendations includes those which come under management or executive responsibility but which were not implemented as of the date of the report. These items are thus brought to the attention of the legislature which may use whatever means it finds desirable to review them and enforce them according to its will. Among these recommendations may be some which will require substantial time to affect, such as recommendations involving programming or the establishment of performance standards. Others might include the establishment of program accounting or the formation of an internal audit group. Most of the recommendations in this group, however, will simply be those on which the auditor and the administrator have differences of opinions or where the administrator, although agreeing to the desirability of the change, has not had time to affect it in the manner recommended.

Particular attention should be given to those recommendations which have been made in previous audit reports and which the auditor now finds necessary to repeat again. If the legislature properly supports the auditor and follows through on the basis of his audit report to review and enforce the changes recommended, there should be no occasion for repeating recommendations unless the corrected practice or policy has again been allowed to fall short. And if this is the case, the auditor should note it. Furthermore, prior recommendations in which the legislature did not concur and which it did not therefore enforce may be brought to its attention again, properly noted as such, but only if there is some reason to believe that the legislature will decide differently this time or if the auditor feels that circumstances have changed which now make the recommendation more appropriate.

Finally, the audit report should provide information on anything affecting the agency which the auditor feels should be formally made known to the legislature. Some items do not require corrective action on the part of agency administrators but still need to be made known to the legislature. Such items are basically those which the legislature may find useful in conducting its investigation and inquiry into budget requests or proposed programs. These items are reported for the general education and enlightenment of the legislature to enable it to make a more informed judgement and render a more meaningful statement of policy.

In all of his report, the auditor must be careful not to disclose publically any information of a classified nature. And matters involving crimes, fraud, or other illegal acts should be made known immediately to proper legal and state authorities for prompt prosecution.

Implications for Staffing

It is important that the performance auditor be equally as well qualified to judge the performance of administrators as those whose judgement he may have reason to question. To insure that this degree of competence exists, several things are necessary.

First, the auditor general must secure for his staff persons with the necessary skill and ability to enable them to qualify, or to become qualified, for the job to be done. To the extent possible, they should be familiar with accounting systems, organization principles, and government operations.

Some persons have suggested that the auditor general should hire engineers, political scientists, and statisticians. There is no question but what much of the performance audit could be conducted by persons with these backgrounds, but the purpose for hiring them and assigning them to audits must not be to question the professional and expert judgement of management in these areas, but rather to render technical assistance to the audit. In this respect, it seems doubtful that such persons could add significantly to the skills that can be acquired by the use of top-level accountants whose training or experience includes these other areas. Accountants trained and experienced in management services and administrative science seem particularly well qualified to assume this responsibility.

Probably the single biggest handicap that state auditors face in the development of a competent and professional staff is the inability to hire good personnel. Most states are under some type of civil service classification which prevents the auditor general from hiring competent, experienced auditors at either an attractive position or a competitive salary. And starting salaries for college graduates are

usually so low that the auditor is unable to get the top students. Thus he has to be content with the average or below average student, and in some cases even to hire persons without a college degree. Among most state auditors with whom contact was made in this study, this problem was listed as the single biggest handicap to the development of a highly professional and competent audit staff.

Undoubtedly the most favorable situation revealed in this study is the one in California, where the auditor general has the power to set the salaries of his own employees, who by law are not under civil service classification. Thus the auditor general has been able to surround himself with a highly competent staff. Over half of the auditors on his staff are Certified Public Accountants, and others have completed the CPA examination and merely await the completion of the experience requirement. The supervisors and audit managers have all had broad experience with national CPA firms. Certainly this situation is an envious one compared to what most states have to contend with.

Michigan is one of the few states which has a fairly good situation in spite of the civil service classification of its employees. Recent adjustments in salary rates have made them more competitive, and also permission has been granted to the auditor general to hire experienced auditors at the upper levels of the classified ratings. Providing the Civil Service Commission continues to keep pace with the changing environment outside of state government, this situation may prove to be of no great disadvantage. But if it works out that way, it will truly be the exception rather than the rule.

Illinois has avoided this problem by contracting over ninety-eight percent of the state's post audit work out to CPA firms, and other states are being forced to follow this example in order to obtain competent

audit reports. Among the states which have recently moved more in that direction are New Mexico and Iowa, and many other states have shown considerable interest in the idea.

There is no reason, however, why the legislatures of these states could not provide by law, as was done in California, for the hiring and training of a competent audit staff responsible to the auditor general, and then the states would be able to benefit from the accumulated knowledge and experience of the audit staff as well as have in its possession the audit working papers for each assignment. Such a procedure seems preferable, particularly if these states intend to expand the scope of their audits to include an examination of administrative performance.

The second need in the development of a competent audit staff is a good training program. The auditors need not become experts in all fields, but they should have a thorough understanding of the procedures of planning, programming, budgeting, organization, accounting, reporting, and internal auditing. They should also understand the system of legislative control and the legislative process of which they are a part. Furthermore, inexperienced auditors need training in audit procedures, instruction in how to assemble and evaluate information and how to conduct tests of the efficiency and effectiveness of operations.

Much of this training can come on the job. But a good portion of it is better provided in formal training sessions, where concepts and policies can be discussed and developed, and where traditional procedures and old habits can be challenged in open and free debate.

Training alone, however, does not qualify the auditor for his job. He must bring to his work such characteristics as imagination, initiative, creativity, diligence, and self confidence. Likewise, a certain degree

of skepticism and curiosity is important. If these basic building blocks are inherent in the person conducting the audit, he will find performance auditing an exciting challenge. If he expects to depend upon a list of procedures or a set of rules to guide his every act and provide answers to his many questions, he will never succeed in this difficult assignment.

Perhaps more than anything else, the characteristic which is needed by the performance auditor is the ability to correlate complex information, critically analyze it, and effectively communicate to others the results of his analysis. And while this may in part be a native ability, it is primarily an ability that is based upon experience and training. An important element of this ability is the skill to determine the important things and not to worry little things to death. There is no better example of this problem than the auditor who meticulously audits petty cash while overlooking irregularities and lack of control in contracting procedures which involve thousands of times the amount of state funds or resources. Items such as this are certainly proper subjects for audit training sessions.

Statistical sampling is another area that can be studied in staff training sessions. This fact is explained by the Federal Government Accountants Association as follows:

There is a strong feeling among some auditors that the effective use of statistical sampling methods requires a long period of training involving highly technical mathematics. Actual experience indicates, that at least during the initial learning phase, this is not so. In many ways, it is similar to the problem of driving a car. One does not have to be an automotive engineer to learn the mechanics of driving a car; so it is with the auditor who does not have to be a mathematical statistician in order to apply the mechanics of statistical sampling effectively.¹

¹Audit Sampling in Action, Research Bulletin Number 1, (Washington, D.C.: Federal Government Accountants Association, 1961), p. 4.

Other areas such as computer programming, administrative and organization theory, and management science also need to be studied. Adequate familiarity with the problems and theories in these areas may require that members of the audit staff attend classes at a local college, or it may be necessary for the auditor general to hold week-long seminars in which these subjects may be properly treated. This he must decide.

The auditor should never attempt to become competent in all areas. If expert technical advice and assistance is needed, arrangements should be made to obtain them. In fact, one mark of a mature auditor is that he recognizes his weaknesses and inadequacies and is quick to acquire assistance if and when it is needed, recognizing that persistence in going into areas that are beyond his competence will cost him his audience elsewhere and will defeat his purpose. He should, however, at least be able to identify the problem areas and to determine the type of special assistance needed.

The Need for Independence

Throughout this study, the concept of independence has been stressed. One of the primary purposes of having the auditor general responsible to the legislature is to make him independent of the executive branch whose work he must audit and evaluate.

Not only is it important that the auditor general be independent of the executive branch in the matter of his responsibility, but also it is very important that he be independent from other outside influences, including the legislature, to pursue the objectives of his audit in a professional manner. As Sharaf explains, "If he has anything less than full freedom of investigation, the privilege to examine what and where

his professional judgement directs him, he lacks complete independence."¹ Independence in this sense means the avoidance of all situations which might tend to impair his objectivity or permit personal bias to influence his professional judgement.

Furthermore, it is important that the auditor maintain his independence not only in fact but in appearance. All of the auditor's work is conducted in a political area where the slightest appearance or indication of deviation from this standard is likely to explode into an open political issue. The auditor, regardless of party affiliation, must show absolute fairness, and he must maintain the highest standards of personal integrity to insure that facts of performance are judged impartially and objectively.

The auditor cannot, of course, attain absolute independence. As one writer observed, "No human being can free himself from all outside influences . . . No one except a hermit can avoid the influences of his family, friends, what he reads and hears, and the attitudes and standards of his community."² To contend that the auditor general should have no relations with members of the executive branch or that he should disavow any affiliation or activity with his political party for fear that the public might suspect a conflict of interest would lead to an absurd situation. The auditor would, in effect, be working in a vacuum. He would lose the benefit of free and frank discussions with officials of the state by which he is able to obtain a better understanding of the organization and activities of the state. He cannot isolate himself

¹Hussein A. Sharaf and R. K. Mautz, "An Operational Concept of Independence," The Journal of Accountancy (April, 1960), p. 51.

²John L. Carey and William O. Doherty, "The Concept of Independence-- Review and Restatement," The Journal of Accountancy (January, 1966), p. 42.

from the world he is responsible to audit.

What he can do is avoid becoming involved in the decisions that are made by other state officials, and he can critically evaluate and judge impartially the merits and weaknesses of each. Such conduct will bring to him and to his office the prestige and respect which is needed if the performance audit is to truly become an effective control element in state government.

Other Audit Policy Implications and Considerations

There are several other items which have important implications for audit policy and which deserve mention in this chapter.

Hindsight

First is the problem of hindsight. Since the auditor general will always be auditing performance some time after it occurs, he will always have the advantage of hindsight. This raises the possibility that decisions which seemed perfectly valid and reasonable when made will look foolish and unwise in light of information subsequently learned. As Mautz and Sharaf explain, "Judgements which appeared completely valid at the time they were made sometimes appear far less sound and reasonable when viewed, not so much 'in the light of the morning,' as with the benefit of knowledge of changed conditions and additional data."¹

The administrator will always have to swallow the fact that the auditor is going to have this advantage of subsequent information. He cannot avoid it. But the auditor too should realize in his evaluation and recognize in his report that the quality of a decision is unaffected

¹R. K. Mautz and Hussein A. Sharaf, The Philosophy of Auditing (Madison, Wisconsin: American Accounting Association, 1961), p. 32.

by subsequent information which was not available to the administrator at the time the decision was made. In light of the subsequent information, the auditor should feel free to make recommendations designed to avoid similar mistaken judgement in the future, but chances are that the administrator will have already recognized the problems and made the necessary adjustments. If this is the case, the auditor should recognize that fact in his report. Fairness, objectivity, and the ethics of his profession require that the auditor avoid evaluating performance of any kind simply on the basis of hindsight.

A Reasonable Attack

Another important policy consideration is the need to limit the scope of the audit examination to manageable proportions. The area of management responsibility is extremely broad and complex, and the auditor cannot hope to render an opinion on the overall operations of the agency. And even if he did so, it would likely be meaningless.

Performance can only be measured effectively by breaking down the areas of responsibility into their component elements and by attacking them individually. Some areas may produce positive results, others negative. And the report on performance evaluation will be far more meaningful if the findings in each of these areas are noted rather than attempting to report on the totality of performance.

This point has particular implications for initial performance audits. As outlined in this chapter, the most important aspect of performance evaluation is the appraisal of the management control system. Yet to evaluate every element of that system and then to investigate every area of weakness would likely consume so much time that only a few audits could possibly be performed in a year's time. Thus, a more

sensible approach would be to restrict the audit to those areas which seem to have the greatest possibility of making a significant contribution to efficiency and effectiveness of operations. Experience on a limited scale such as this is essential as the first step in refining the methods of audit examination in an area where extensive precedent is currently lacking. The area of interest must always remain broad and comprehensive, but the attack should be made in manageable portions.

Easy Areas

When the auditor begins to select the special areas for specific audit attention, he must be careful not to select only those areas which seem easy to accomplish. Certainly there is merit in starting with areas which present the fewest obstacles. The danger, however, is that the areas conducive to easy auditing may not be the areas most in need of auditing. And the audit effort should be concentrated in the areas of greatest need. Even a rough analysis of areas of substantial importance may be more meaningful than a detailed study of other items. An example might be the value of an analysis of construction costs as compared to a detailed study of the use of custodial supplies and services, although the latter would probably be far easier to accomplish.

Frequency of Audits

Not only is the amount of time to be devoted to each audit important, but also the frequency of the audit. And there is a wide variety of policies and practices among the states on this matter. Some states try to audit all agencies every four years, and others do it every two years. Still others try to conduct some audits annually while allowing longer periods of time to elapse between other audits. Each state will have to

make this decision for itself, but a few considerations are important to note.

First, audits should be conducted as often as they are needed by the legislature for proper legislative review and analysis. Second, if agencies are left too long between audits, the danger of minor irregularities becoming major problems is increased. Third, audits by the auditor general are probably needed more often where no effective internal audit is performed. And finally, since the auditor has limited resources and manpower with which to conduct his audits, he must find some reasonable compromise between the intensity of his audit and its frequency.

Evaluating Auditor Performance

A final consideration for audit policy and practice is the need for the auditor general and other top officials on his staff to review the performance of the audit staff after each assignment. The importance of this evaluation is expressed by Roberts who said, "To one whose duty involves appraisal and criticism of another's performance, self-appraisal may be even more useful to keep his perspective in proper focus."¹

To accomplish this review, it is necessary that performance requirements be clearly designated and that the objectives of the job be clearly defined. Performance standards should be used to provide an objective basis for measuring accomplishment and to promote a better understanding among members of the staff of what is expected of them. Campfield discusses this subject as follows:

A performance requirement is the understanding which exists between a staff member and a supervisor defining the necessary performance on a specific assignment considered

¹Ralph S. Roberts, "Internal Audit--Praise and Criticism," The Federal Accountant (June, 1960), p. 14.

acceptable by the supervisor. Since the practice of auditing . . . involves a large measure of judgement, performance requirements for auditors must necessarily be stated in sufficiently broad language to avoid constant alteration and change. . . . The requirements should include, in addition to the minimum printed criteria established . . . , written and oral instructions of supervisory audit personnel.¹

Certainly performance evaluation is as important in the area of the auditor's responsibility as it is for any other state official. And since he is the one primarily responsible for performance evaluation throughout the state, it is not unreasonable to expect that the auditor general himself should set the example in this regard.

Progress among the States

Progress among the states is extremely difficult to assess, but some indications of progress are evident and some states have conducted audits that come near to being the type of audit described herein.

Michigan has been working for over a year on the problem of developing performance auditing procedures, and a few audits have already been conducted in which the audit supervisors were specifically instructed to look for "performance areas." The most comprehensive such audit conducted to date was one involving the Ionia State Hospital, where the auditors looked into the quality of the supervision, personnel relations, communication, and other operating areas of the hospital.² Also the treatment program was analyzed, and recommendations were made to improve controls throughout the hospital. More recently, the auditors have been analyzing space utilization and other performance criteria at some state colleges

¹William L. Campfield, "A Blueprint for Appraising and Guiding Audit Staff," The Accounting Review (October, 1957), p. 626.

²Michigan, Office of the Auditor General, Audit Report of the Ionia State Hospital, Performance and Financial Audit, as of June 30, 1965.

and universities.

Basically, the Michigan approach has been one of letting individual audit supervisors determine for themselves which aspects of performance they wished to evaluate. Each audit supervisor is encouraged to use his own initiative in determining the area of evaluation, the extent of the evaluation, and the manner in which evidence is collected and performance is described. Recently, procedures have been initiated which call for closer supervision by top officials of the department in setting up the examination and evaluation procedures in the "performance areas." However, no standard or formalized approach to the conduct of the audit has yet been developed by the department.

California does not claim to adhere to a policy of performance evaluation in its audits, but the auditor general has followed a policy of conducting very penetrating examinations of the control systems in the departments and agencies of the state. Several such audit reports were examined in connection with this study, and from them it appears that the state does more evaluation of performance than it claims to be doing. Certainly the audit staff in the state of California is as well qualified to examine and evaluate the performance on a broad scale as is any audit staff in the nation.

Also, as noted in an earlier chapter, California is one state which currently has an active internal audit program in addition to the legislative auditor general. And much of the performance evaluation is seen by the auditor general to be the responsibility of this internal audit group, whose work is evaluated and supplemented by the auditor general in the course of his own examination.

Hawaii seems to have one of the most promising audit systems and

policies among the states. In a report of the programs and goals of the Office of the Auditor issued in 1965,¹ the Auditor clearly outlines an audit policy which includes an examination and evaluation of the management control system, including planning, programming, budgeting, and other such areas. And in a letter accompanying the report of the first "management audit" conducted in the state, the Auditor noted that it was "the first of a continuing series of management audits which will be conducted by this Office." He added, "In this examination, we have attempted to evaluate management's effectiveness in program planning and execution in light of the goals, policies, and resource commitments for the . . . program."²

In the report itself, the following significant comment is made:

The questions we have raised in our examination are characteristic of those which management is expected to ask of itself, in order that it may continuously subject itself to searching self-scrutiny to ensure that it is effectively serving an essential mission.³

The report itself seems to be everything it is represented to be, and it constitutes one of the finest examples of this type of audit examined in this study. Certainly Hawaii gives every indication of being one of the leaders among the states in the development and use of performance audit policies and procedures.

New York, although it does not have a legislative auditor general, has made considerable progress in developing a more comprehensive audit

¹Hawaii, Office of the Auditor, Report to the Legislature of the State of Hawaii, Long and Short Range Programs of the Office of the Auditor, December, 1965.

²Hawaii, Office of the Auditor, Report to the Governor and the Legislature of the State of Hawaii on the Examination of the Office of the Revisor of Statutes, Audit Report No. 66-1, January, 1966, p. i of transmittal letter.

³Ibid., p. 2.

program. As a branch of the Comptrollers office, the post audit function in the state is looked upon as a top-level internal audit program, and the expanded audit program is referred to as an "operational audit."¹

New York has by far the most comprehensive and advanced audit manual of any state contacted in this study, and in that audit manual the audit policy is clearly outlined to include operational and performance areas. For example, on the matter of relating the audit to the basic programs or missions of the agency or department, the following instructions are given:

To effectively serve the needs of modern Government, audit must look beyond the accounting records and into the basic programs or missions of the activity audited. Upon reaching the audit site, the auditor might well ask himself: "What are the basic programs of this organization, and what factors have a significant bearing on the effective and economical performance of these programs?" Upon approaching a specific activity or element of the organization, the auditor might first ask: "What is the objective of this activity and what would I expect to find if the activity were to be effectively (or ineffectively) performed?" . . . The audit program would then be tailored to prove the adequacy or inadequacy of program accomplishment.²

Later in the same section of the audit manual, this significant comment is made:

Costs result from decisions--management decisions--based upon alternate courses of action. . . . It may therefore be stated that costs and financial reports reflecting these costs represent quantified results of management decisions and controls. A meaningful audit, therefore, requires that the auditor examine into the management decisions and controls which underlie the incurrence of the costs.³

Three comprehensive operational audit reports were examined in the

¹Arthur Levitt, "Operational Auditing in New York State," The New York Certified Public Accountant (May, 1964), pp. 337-341.

²New York, Department of Audit and Control, Division of Audits and Accounts, Field Audit Manual, Vol. I, Sec. 1-2, p. 1.

³Ibid., p. 2.

process of this study. In each case, the audit clearly went beyond the traditional scope of financial audits and included an examination of a number of areas of management control and performance. These audits represent an excellent example of performance auditing done internally within the executive branch. And no one contacted in this study demonstrated a better grasp of the problems and concepts of this difficult area than did those in charge of the New York audit program.

Numerous other states have indicated an interest in expanding their audit efforts into performance areas, but none contacted in this study claimed to have done so thus far. And no audit reports examined in any other state revealed any evidence of such audit effort having been made.

Progress to date, therefore, is extremely limited but encouraging. As more states become familiar with the work of the states noted here, and as more of the newly appointed legislative auditors are able to build a competent and sufficient staff to conduct such audits, no doubt these concepts and policies will become better accepted and more widely used by other states. And those states which have to date experienced limited but significant progress in this area will undoubtedly move at a much faster pace now that some of the initial formative problems have been resolved and experience has been gained in the actual conduct of the audit in this critical area.

Summary and Conclusion

This chapter has been a discussion of the basic approach to the conduct of the performance post audit. The various phases of the audit were noted and discussed, and the need for effective audit planning was noted. Several implications for audit policy were noted throughout the chapter, and the qualifications and independence of the audit staff

were analyzed. Finally, progress to date among the states has been noted.

There is no magic formula or simple approach to performance auditing. Every audit will be different, and the key to success in this type of auditing lies as much in the ability and skill of the auditor assigned to the job as in any set of rules or audit guidelines.

Although the material developed in this chapter has been developed on a theoretical basis, the ideas and concepts have been discussed with numerous officials throughout the country. Based upon their opinions and upon the information presented in earlier chapters, the approach described here seems to be the most reasonable approach to the audit.

The test of this system will come in its use. Only after these concepts have been put to the test of actual practice will it be possible to evaluate them specifically. And only then will the problems be clearly identified which need further attention and development. As more and more states become familiar with these concepts and adopt these practices, additional examination and analysis of this approach will be needed. Until then, this suggested approach and any alternatives to it remain empirically unproven and untested.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

Burkhead reports that Sir Henry Higgs, a noted British financial authority, once accompanied a friend on a trip to Egypt for the purpose of trying to improve the fiscal administration in that country. When he arrived, he found that a sample audit system was being used. And upon examination he discovered that "items numbered 1, 5, 9, 13, etc., were regularly checked, so regularly, in fact, that this had become known throughout the service; obviously, no defalcations were ever discovered." This situation prompted the remark from Higgs, "There you had the Audit Office, with its officials going round like squirrels in a wheel, producing nothing of value, but rather creating a false sense of security in the minds of those who were relying upon it. . . ." ¹

Traditional state audits have likewise created a false sense of security in the minds of both the citizens of the state and the officials of the government. Limited as they are to an examination of the financial controls and accounting records, these audits are not capable of rendering a report on the manner in which officials of the state discharge their responsibilities to administer the programs of the state. This fact has been demonstrated in this study, and a bold new approach to state auditing has been outlined--one designed to evaluate administrative performance in

¹Burkhead, op. cit., p. 370.

all areas from the initial planning to the final review.

Contributions of the Study

The contributions of this study are many, and a few of the major ones will be summarized here.

First, the intent of the Michigan Constitutional Convention, which adopted the provision requiring performance post audits to be conducted in the state by the Auditor General, has been clearly determined and described. This contribution is significant not only because it clarifies the responsibility of the Auditor General, but also because it outlines to the legislature, the Governor, and all other state officials the implications of the performance audit with respect to their own responsibility. The performance post audit was related to the structure of state government which is characterized by the separation and balance of power concepts, and it was found to be a natural outgrowth of the resulting patterns of responsibility and of the growth trends and changing complexities of state operations.

Another contribution of this study is the development of the role of the auditor general as an element of the legislative control system. The legislative control system itself was described, and its function and purpose were noted. From this system, the auditor derives the purpose for his audit, and it was found that the performance post audit is not only in harmony with such a control system; it is essential to it. Steps were also outlined by which the legislature can make the audit meaningful and effective in the state. Both legislative and executive performance is improved when such an audit is effectively conducted, and thus the public is better served.

One of the most significant contributions of this study is the

development in Chapter IV of the areas of executive responsibility properly subject to performance post audit review and evaluation. The elements of planning and control were described, and their importance to the auditor were noted. Effective planning and programming are essential if true performance is to be measured in terms of the services rendered by state agencies to the citizens of the state. Performance standards are needed to indicate and measure progress. Organizational planning must be consistent with programs planned, and the accounting and budgeting systems must conform not only to organizational patterns of responsibility but also to program planning. And finally, effective internal audit and review is required if management is to complete its responsibility to faithfully administer the programs of the state in an effective and efficient manner.

Finally, an approach to the audit was developed. Five steps were outlined, which included advanced planning, initial survey, evaluation of the management control system, analysis of exceptional areas, and the audit report and recommendations. The most significant part of this audit is the evaluation of the management control system, for it is here that efficient and effective operations are insured and faithful compliance with legislative intent is secured. The audit approach described in this study is designed to serve in any situation in the state and will provide for the effective achievement of every objective of the performance post audit.

In addition, the bibliography to this study is itself a contribution--one that has value for both the researcher and for state audit officials. Although not intended as a comprehensive listing either of all materials available or of those reviewed in connection with this study, this bibliography does represent an extensive listing of relevant materials in the

published literature, of research studies and significant reports prepared by public organizations or private research groups, and of other unpublished but generally available materials which have proven helpful in the course of this study.

Challenges for the Future

This study is an attempt to provide a theoretical analysis and penetrating discussion of the relevant variables and fundamental considerations of performance post auditing, but it by no means is a final answer to the need for information and analysis of this important area. In fact, one of the contributions of this study is the identification of the major areas that badly need additional attention both from the researcher and from the auditor. And it is appropriate that some of these areas be noted again at this point.

One area needing attention is that of legislative intent. Much work needs to be done to modernize the means of formulating, enunciating, and determining legislative intent and policy. The Council of State Governments regularly devotes some attention to this problem in its annual conferences on state legislative services,¹ but this is not nearly enough. Each state legislature must recognize that it is inconsistent to call for executive officials or agency administrators to account for their lack of development of programs, objectives, standards, and other control elements if the legislature itself does not take steps

¹For example, see National Legislative Conference, The Committee on Rules, "Some Recommendations for Modernizing Legislative Rules," A Proposal of the Committee on Rules at the Fourteenth Annual Meeting of the National Legislative Conference, recorded in its Summary of Proceedings (Chicago: The Council of State Government, September 7, 1961); and "The Determination and Implementation of Legislative Intent," in Summary of Proceedings, Part II, Legislative Service Workshop Sessions (Chicago: The Council of State Government, September 20, 1962).

to put its own house in order. And there is no more appropriate place to start than in the matter of legislative policy expression. Unless such steps are taken, the auditor will continue to have difficulty determining faithful administrative performance.

Each of the areas of the management control system could well constitute a dissertation in itself. The selection of objectives for state programs is one area which must receive additional attention if planning is to be rationally accomplished. Programming methods are far from adequate, and organizational planning along program lines must be studied. Another area that has been almost totally ignored by accountants and financial authorities in their zeal to demand program budgets is the development of program accounting systems. With the exception of the State of New York, no evidence was found in this study of any state having done very much in this important area. This subject is a very timely and appropriate topic for dissertation study as well as for attention by the professional accounting groups and state fiscal authorities.

Another area needing attention is the problem of obtaining qualified auditors both for internal audit staffs as well as for the staff of the auditor general. One of the biggest factors contributing to the lack of development of internal audit staffs in the states is the inability to acquire competent auditors to do the work. And as noted earlier, the same is true of the staff of the auditor general in most states. And while some states have turned to the use of professional CPA firms for their post audit work, this cannot be done for internal audits. Probably this inability of the state to obtain competent internal or independent auditors is but one part of a much larger problem of effectively staffing state organizations, but certainly it needs attention.

Finally, each phase of the audit as outlined in Chapter V needs additional study. And these are areas in which the experiences of state auditors will become increasingly important. The approach described needs to be tested, expanded, and modified as new light is shed on the problems. It is also important that other individuals critically examine and challenge the theory here-in developed to insure that important considerations have not been overlooked in the research and development of this study. Such a challenge would be welcomed, because it is only in the competition of ideas that one's attention is drawn to the many alternatives and numerous complexities of a problem as comprehensive as that of the performance post audit.

Conclusions

The hypothesis of this study has been confirmed. Performance audits are not only meaningfully possible; they are essential to the continued vitality of state government as known in the United States today. Such audits are a natural and logical responsibility of the legislative auditor general, and they are essential to effective legislative control of administrative performance. Such audits are certainly facilitated by the existence of an effectively operating management control system, but such a system is not a condition precedent to the audit.

Both the administrator and the legislator stand to benefit from the development and increased use of performance post audits. More effective and more efficient administration of state programs is the product that can be expected when such audits are conducted in a spirit of mutual interest and understanding. Finally, the quality of the services rendered by the state to its citizens will be greatly improved, and in the final analysis, this is the end objective of all state activity.

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APPENDIX A

Article IV, Section 53 of the 1963 Michigan Constitution

The legislature by a majority vote of the members elected to and serving in each house shall appoint an auditor general who shall be a certified public accountant licensed to practice in this state, to serve for a term of eight years. He shall be ineligible for appointment or election to any other public office in this state from which compensation is derived while serving as auditor general and for two years following the termination of his service. He may be removed for cause at any time by a two-thirds vote of the members elected to and serving in each house. The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

The auditor general upon direction by the legislature may employ independent accounting firms or legal counsel and may make investigations pertinent to the conduct of audits. He shall report annually to the legislature and to the governor and at such other times as he deems necessary or as required by the legislature. He shall be assigned no duties other than those specified in this section.

Nothing in this section shall be construed in any way to infringe the responsibility and constitutional authority of the governing boards of the institutions of higher education to be solely responsible for the control and direction of all expenditures from the institution's funds.

The auditor general, his deputy and one other member of his staff shall be exempt from classified civil service. All other members of his staff shall have classified civil service status.

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