

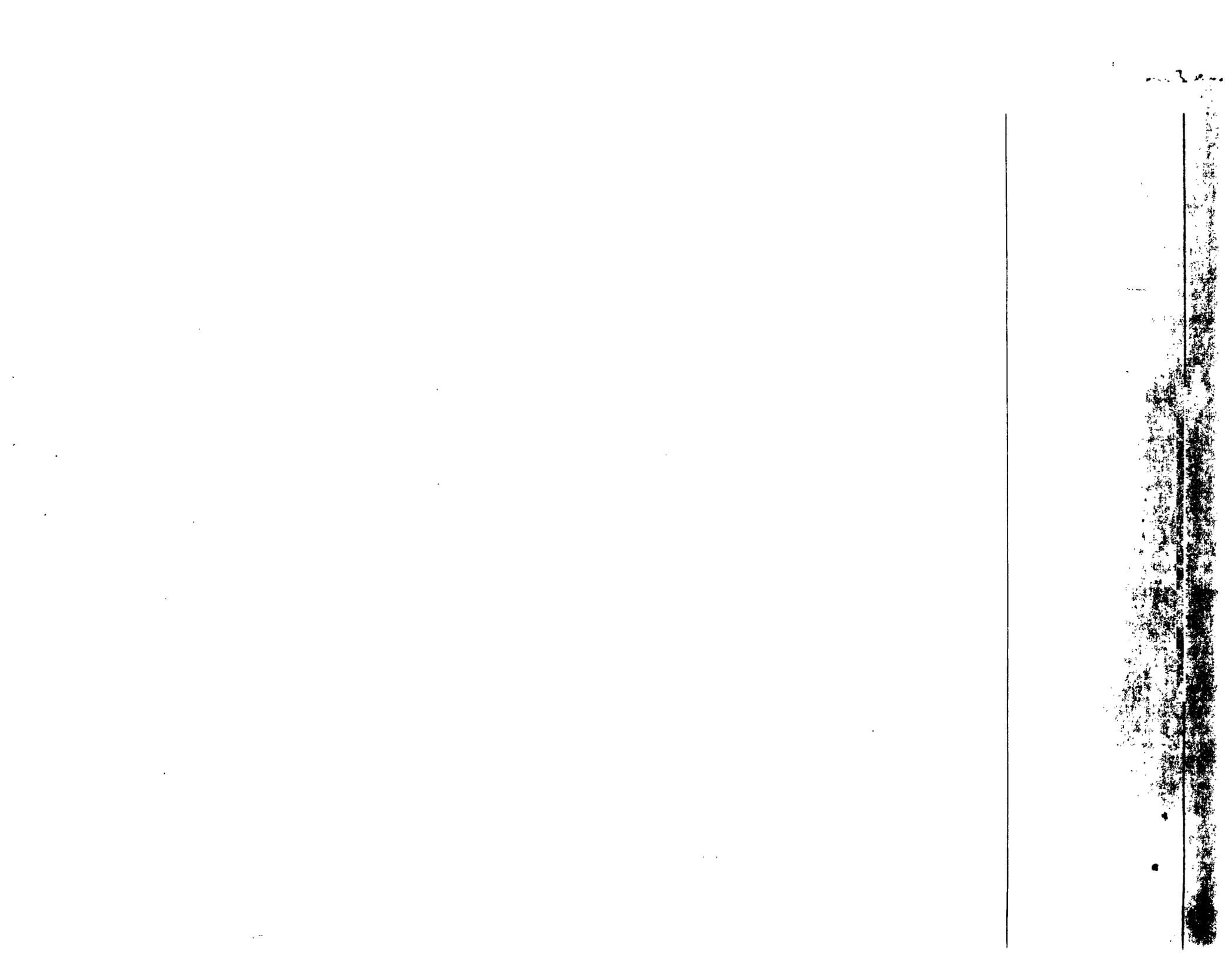
May 1988

CPA AUDIT QUALITY

Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs



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United States
General Accounting Office
Washington, D.C. 20548

**Accounting and Financial
Management Division**

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The Honorable Richard E. Lyng
The Secretary of Agriculture

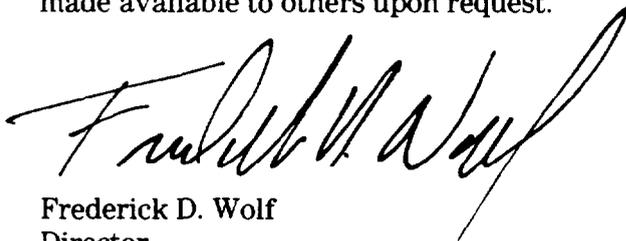
The Honorable Samuel R. Pierce, Jr.
The Secretary of Housing and
Urban Development

The Honorable James Abdnor
Administrator
Small Business Administration

This report summarizes the results of our review of agency controls needed to ensure quality audits of participants in federal loan programs. We found that CPA audits of federal loan programs did not always satisfactorily comply with auditing standards. Federal agencies need to improve their controls for receiving and reviewing these audits.

This report contains recommendations to you in chapter 4. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. Each of you should submit your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Operations within 60 days of the date of the report and to the House and Senate Committees on Appropriations with your first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director of the Office of Management and Budget and to interested congressional committees and members of the Congress. Copies will also be made available to others upon request.



Frederick D. Wolf
Director

Executive Summary

Purpose

The federal government relies to a large extent on certified public accountants (CPAs) to audit several hundred billion dollars in federal funds provided to participants in guaranteed and insured loan programs. The audits are part of an oversight process designed to ensure that the programs are achieving their intended purposes and that federal funds are properly managed.

Recently, GAO issued three reports which discussed problems in the quality of CPA audits of federal grant programs. Because of those problems, GAO also reviewed the quality of CPA audits of participants in federal guaranteed and insured loan programs. Specifically, GAO determined whether

- CPAs were experiencing problems in their audits of participants in federal guaranteed and insured loan programs similar to those GAO noted in its prior reports on federal grant programs, and
- federal agencies had established effective controls for ensuring that they received quality audits of participants in federal guaranteed and insured loan programs.

Background

The federal government administers a number of programs involving guaranteed and insured loans. The Congress and federal officials have a common interest in ensuring accountability over these programs. They want and need to know if the programs are being administered properly and if they are conducted consistent with applicable laws and regulations.

To ensure accountability, the federal government relies to a large extent on CPAs to audit participants in these programs. These audits can help provide reliable reports on the financial activities of program participants and, in certain instances, on the adequacy of internal controls and compliance with laws and regulations.

Audit Quality

In the context of GAO's work, compliance with applicable auditing standards and contractual terms is used as the primary basis for determining audit quality. Compliance with standards helps assure users of audit reports that the CPA has adequately performed the audit and that the audit report can be relied upon in determining that federal funds were used for authorized purposes. Violations of auditing standards cast doubt on the credibility of the audit and can significantly reduce the usefulness of the audit report.

Auditing standards require CPAs to properly plan their work and to obtain sufficient and competent evidence to support their conclusions and opinions. A written record of CPAs' evidence must be retained in the form of working papers, and should show that

- audit work has been adequately planned and supervised;
- accounting transactions, balances, financial items, and any related evidence have been examined;
- internal controls have been evaluated; and
- compliance with laws and regulations has been tested.

Results in Brief

CPA audits of participants in federal guaranteed and insured loan programs were not always performed in a quality manner. The public accounting profession has recently taken action which GAO believes should improve the quality of governmental audits. However, GAO believes federal agencies need to improve their controls for receiving and reviewing those audits to ensure that the federal government receives quality audits.

Principal Findings

Audit Quality

In a random sample of audits of participants in guaranteed and insured loan programs performed by CPAs, GAO found audit quality problems similar to those GAO noted in its three prior reviews of CPA audit quality. GAO found that 7 of 28 loan program audits did not satisfactorily comply with auditing standards. The problems included working papers that did not adequately show that the CPA appropriately tested financial transactions, evaluated internal controls, or tested compliance with laws and regulations. (See chapter 2.)

In a sample skewed more towards problem audits, the Department of Housing and Urban Development (HUD) found that 123 of 182 CPA audits of participants in federal loan programs had problems similar to those found by GAO. (See chapter 2.)

Action by the Public Accounting Profession

Recognizing the problems CPAs have had in performing governmental audits, a task force appointed by the American Institute of Certified Public Accountants (AICPA)—the national professional association of

CPAs and the most important private group affecting governmental auditing—recently made 25 recommendations for improving the quality of governmental audits. The recommendations include, for example, improving CPAs' training in governmental accounting and auditing and strengthening the disciplinary process for poor quality CPA audits. (See chapter 2.)

Ineffective Federal Controls

GAO believes that the agencies covered in this review—the Departments of Agriculture (USDA) and Housing and Urban Development (HUD) and the Small Business Administration (SBA)—could do more to ensure that they receive quality CPA audits. Agency controls could be strengthened to ensure that (1) audit reports are received on time and agency officials follow up on reports that are not submitted on time, (2) audit quality is reviewed when reports are received, and (3) CPAs are given adequate written guidance on how the audits should be performed. (See chapter 3.)

In addition, USDA and SBA do not require CPAs to follow generally accepted government auditing standards (GAGAS), which are more specifically tailored to the needs of the government. Requiring CPAs to follow GAGAS would improve the usefulness of the audits to the federal government. (See chapter 3.)

Recommendations

GAO believes that, if properly implemented, the recommendations made by the AICPA governmental auditing task force should strengthen CPA audit quality.

GAO recommends that the agencies administering guaranteed and insured loan programs improve controls for relying on CPAs. Specifically, GAO recommends that agencies ensure that they have controls for

- receiving CPA audit reports on time and for following up on reports that are not submitted on time,
- reviewing the reports for audit quality,
- providing adequate written guidance to CPAs for performing governmental audits, and
- requiring CPAs to follow GAGAS.

Agency Comments

GAO received comments on a draft of this report from USDA, HUD, and SBA. All three agencies generally agreed on the need for controls for receiving

and reviewing CPA audits of federal loan programs. USDA and SBA, however, believed that they already had adequate procedures for following up on late reports. GAO believes that these two agencies do not provide procedures for requiring loan program officials to follow up on late audit reports, nor do they specify the time frame in which they must follow up.

USDA and HUD agreed with GAO's recommendation to provide written guidance to CPAS. However, SBA said that the recommendation was inapplicable to audits of SBA program participants because they are commercial, not governmental, entities. GAO believes that SBA misapprehended the meaning of "governmental audits" in the recommendation. For purposes of this and other reports on audit quality, GAO has used "governmental audits" to include audits of participants in governmental grant, loan, and other programs where the audit is required as a condition of participation in the program. Therefore, since SBA program participants are required to be audited by, and are otherwise subject to, SBA laws and regulations, SBA should provide written guidance which will facilitate CPAS' understanding of its loan program requirements.

Only HUD agreed that CPA audits of federal loan programs should be done in accordance with GAGAS. While USDA and SBA offered several reasons for disagreeing with the recommendation, GAO believes their disagreement results from a misunderstanding of the nature of GAGAS audits performed by CPAS.

Contents

Executive Summary

Chapter 1 Introduction

What Is Audit Quality?
Objectives, Scope, and Methodology

Chapter 2 Problems in CPA Audit Quality

Results of GAO's Review 1
Results of HUD's Review 1
Action by the Public Accounting Profession 1

Chapter 3 Ineffective Federal Agency Controls

Untimely Receipt of Audit Reports 1
Insufficient Review of Audits 1
Inadequate Written Guidance 1
More Useful Audit Reports 1

Chapter 4 Conclusions and Recommendations

Audit Quality 1
Federal Controls 1
Recommendations 1
Agency Comments and Our Evaluation 2

Appendixes

Appendix I: Description of Guaranteed/Insured Loan Programs 2
Appendix II: System for Promoting Quality Audits 2
Appendix III: Recommendations of the AICPA Task Force on the Quality of Audits of Governmental Units 2
Appendix IV: Comments From the Department of Agriculture 3
Appendix V: Comments From the Department of Housing and Urban Development 3
Appendix VI: Comments From the Small Business Administration 4

Tables

Table 1.1: Federal Loan Programs Included in the Scope of the Review
Table 2.1: Receipt of Annual Audit Reports

Abbreviations

AICPA	American Institute of Certified Public Accountants
CDC	Certified Development Companies
CPA	certified public accountant
FHA	Federal Housing Administration
FmHA	Farmers Home Administration
GAAS	generally accepted auditing standards
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HUD	Department of Housing and Urban Development
IG	inspector general
OIG	office of inspector general
OMB	Office of Management and Budget
PCIE	President's Council on Integrity and Efficiency
QCR	quality control review
REA	Rural Electrification Administration
SBA	Small Business Administration
SBIC	Small Business Investment Companies
USDA	United States Department of Agriculture
VA	Veterans Administration

Introduction

The federal government administers a number of programs involving guaranteed and insured loans. The Congress and federal officials have a common interest in ensuring accountability over those programs. They want and need to know if the programs are being administered properly and if they are conducted consistent with applicable laws and regulations.

To ensure accountability, the federal government relies to a large extent on certified public accountants (CPAs) to audit participants in those programs. The audits can help provide reliable reports on the financial activities of program participants and, in some instances, on the adequacy of internal controls and compliance with laws and regulations.

Recently, GAO issued three reports on the quality of governmental audit conducted by CPAs.¹ Those reports discussed the need to improve the quality of audits of participants in federal grant programs and the steps the public accounting profession, the federal government, and others should take to better ensure the quality of those audits. This report discusses the quality of audits of participants in guaranteed and insured loan programs conducted by CPAs and the effectiveness of federal controls for ensuring that the government receives quality audits of those participants.

What Is Audit Quality?

The term “audit quality” has many connotations. In the context of our work, we define “audit quality” as compliance with applicable auditing standards and contractual terms. To help ensure consistency in the scope and quality of audit work and in the preparation of professional and meaningful reports, both the American Institute of Certified Public Accountants (AICPA) and GAO have issued auditing standards, known as “generally accepted auditing standards” (GAAS) and “generally accepted government auditing standards” (GAGAS), respectively. CPAs who audit participants in federal loan programs are required to follow one or the other sets of standards.

Auditing standards are generally accepted measures of audit quality. Compliance with standards helps assure users of audit reports that the CPA has adequately performed the audit and that the audit report can be

¹CPA Audit Quality: Inspectors General Find Significant Problems (GAO/AFMD-86-20, December 1985), CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standard (GAO/AFMD-86-33, March 19, 1986), and CPA Audit Quality: A Framework for Procuring Audit Services (GAO/AFMD-87-34, August 18, 1987).

relied upon in determining that federal funds have been used for authorized purposes. Violations of auditing standards cast doubt on the credibility of the audit and can significantly reduce the usefulness of the audit report.

Evaluating Compliance With Auditing Standards

Auditing standards are not absolute measures which must be rigidly applied in all instances. Rather, auditing standards are guiding principles to be applied with professional judgment in individual circumstances. They are the measures of quality of the procedures the CPA uses. In our review, we use the terminology "satisfactory compliance with standards" to mean a CPA's or CPA firm's general adherence to applicable auditing standards for an audit as a whole. In making that determination, we considered the nature and requirements of each audit and the degree of compliance with the standards.

In addition to auditing standards, audits are often subject to the provisions of program audit guides and other guidance provided to the CPA by the federal agencies or the entity under audit at the time a contract is signed. Audit guides typically set out the framework for conducting and reporting on an audit engagement and normally include detailed steps and suggested report language CPAs should follow. An agency's inspector general (IG) normally issues audit guides for specific programs.

Objectives, Scope, and Methodology

Our past reviews have shown that CPAs have had serious problems in the quality of their audits of participants in federal grant programs. The reviews documented those problems and resulted in several suggestions to the public accounting profession for improving the quality of the audits. In addition, the reviews resulted in several recommendations to federal IGs and participants in federal grant programs for strengthening their controls to ensure that they receive quality CPA audits.

Our objectives in this review were to determine whether

- CPAs were experiencing problems in their audits of participants in federal guaranteed and insured loan programs similar to those noted in GAO's prior reviews of federal grant programs, and
- federal agencies had established effective controls for ensuring that they received quality audits of participants in federal guaranteed and insured loan programs.

The scope of our work included seven loan programs administered by three federal agencies, as identified in the following table:

Table 1.1: Federal Loan Programs Included in the Scope of the Review

Federal agency	Loan program participants^a
Department of Agriculture (USDA)	Multifamily housing programs administered by the Farmers Home Administration (FmHA) Rural electric and telephone utility companies administered by the Rural Electrification Administration (REA)
Department of Housing and Urban Development (HUD)	Multifamily housing programs Nonsupervised mortgage companies Government National Mortgage Association (GNMA) Mortgage-Backed Securities Program
Small Business Administration (SBA)	Small Business Investment Companies (SBIC) Program Certified Development Companies (CDC) Program

^aDescriptions of these programs are included in appendix I.

These programs were chosen for our review because they represent major loan programs administered by the three agencies and, in total, result in approximately 35,000 annual audits being performed by CPAs. According to the Office of Management and Budget, in fiscal year 1986, the federal government's contingent liability for these programs was about \$363 billion.

To determine whether CPAs were experiencing problems in their audits of participants in federal guaranteed and insured loan programs, we (1) reviewed 28 randomly selected audits for compliance with applicable auditing standards and (2) evaluated and compiled the results of 182 audits selected and reviewed for quality by the office of inspector general (OIG) at HUD. Neither our limited sample of 28 audits, nor the HUD sample of 182 audits, was sufficient to estimate CPA audit quality for the United States or to estimate the extent of audit quality problems for the universe of participants in guaranteed and insured loan audits. However, we believe our review offers valuable perspective on the possible extent and nature of CPA audit quality problems.

We selected our sample of 28 audits from a universe consisting of the most recent audit reports received by the agencies in 1985 or 1986 for loan participants located in the states of Georgia, Michigan, New York,

and Washington. In reviewing the audits, we examined the audit report and supporting working papers, and we discussed our findings with the CPA firm personnel responsible for the audit. To ensure that our evaluations were consistent, we used a uniform data collection instrument to record our findings for each audit. Because standards require CPAs to retain the working papers for an audit, we performed the work mainly at the CPA firms' offices.

We used another data collection instrument to compile the results of HUD's CPA reviews. In reviewing HUD's work, we examined correspondence, checklists, and other documents in each case file. Because HUD has decentralized the audit quality review function to its regional offices, we conducted the majority of our work at four HUD regional offices—Atlanta, Georgia; Chicago, Illinois; New York City, New York; and Seattle, Washington.

Our evaluation of agencies' controls for receiving timely, quality audits was based on a model system as presented in our December 1985 report and on the guidelines for promoting the quality of single audits issued by the President's Council on Integrity and Efficiency (PCIE). The system is described in appendix II. We reviewed agencies' written policies and procedures and interviewed officials about their review practices. We tested agencies' records and files for a random sample of 494 audits to verify the extent to which these procedures and practices were, in fact, being carried out. We evaluated the controls for promoting the quality of audits for all seven loan programs.

We conducted our work primarily in Washington, D.C., for those programs which were centrally administered there. Those programs were REA telephone utilities, HUD nonsupervised mortgage companies, GNMA Mortgage-Backed Securities, and SBA Small Business Investment Companies. The other programs—FmHA multifamily housing programs, HUD multifamily housing programs, and SBA Certified Development Companies—were decentralized, and our work was performed at program offices in the states of Georgia, Michigan, New York, and Washington. We conducted our work between January 1986 and March 1987, in accordance with generally accepted government auditing standards.

Problems in CPA Audit Quality

CPAs often had problems in the quality of their audits of participants in federal guaranteed and insured loan programs. The problems were similar in many respects to those we reported in our earlier reviews of grant audits. The public accounting profession, however, has recently taken action which we believe should strengthen the quality of both types of audits.

Results of GAO's Review

We reviewed the working papers and reports on a random sample of 28 audits conducted by CPAs. To determine the quality of these audits, we assessed the extent to which CPAs satisfactorily complied with the applicable auditing standards and contractual terms in conducting the audits.

We found that 7 of the 28 audits we reviewed did not satisfactorily comply with standards. The predominant problem we identified was non-compliance with standards applying to planning and performing the audit and to the sufficiency and competency of evidence supporting the CPAs' reports or opinions.

For example, standards require that CPAs retain a written record—known as working papers—showing evidence that the CPA examined accounting transactions, balances, and financial items; evaluated internal controls; and tested compliance with laws and regulations. We found several instances where the working papers did not adequately show that the CPA appropriately tested financial transactions to support the opinion on the financial statements. In some instances, we found that there was little or no working paper evidence supporting the CPA's evaluation of internal control. In other instances, we found little or no evidence in the working papers to support the CPA's statements on the auditee's compliance with certain laws and regulations.

Results of HUD's Review

In fiscal year 1986, the OIG at HUD reviewed 182 CPA audits of participants in federal loan programs. The reviews generally consisted of reviewing the CPAs' reports and supporting working papers to ensure that the audits conformed with applicable auditing standards.

HUD found that 123 of the 182 audits—approximately two out of every three—had problems, particularly in obtaining and/or documenting sufficient, competent evidential matter to support the CPA's conclusions and recommendations. For those audits with problems, HUD required the CPAs to (1) perform more audit work, (2) provide additional working paper

evidence for the audit work performed, and/or (3) clarify the audit work performed.

HUD selected the audits for review largely based on its judgment as to which firms were more likely to have problems. Consequently, the results of the reviews were not necessarily indicative of the frequency of problems in the universe as a whole. Rather, they were skewed towards a higher level of problem audits. Despite this, we believe that the results of the reviews indicate that serious problems have occurred in a large number of audits.

Action by the Public Accounting Profession

In July 1985, the American Institute of Certified Public Accountants—the national professional association of CPAs and the most important private group affecting governmental auditing—established a task force to develop a comprehensive action plan to improve the quality of governmental audits. The task force was formed largely in response to the AICPA's recognition that CPAs were not satisfactorily complying with professional auditing standards on many of the governmental audits they performed.

The task force concluded in March 1987 that a CPA who undertakes an audit engagement has the ultimate responsibility to conduct the audit in accordance with standards. The task force also concluded that oversight organizations, such as the federal government, have responsibility to help ensure audits are conducted in accordance with standards. Based on those conclusions, the task force made 25 recommendations for improving the quality of governmental audits.² The recommendations were divided into the areas of education, engagement, evaluation, enforcement, and exchange of information. The following are summary statements of these five areas.

- Education: Training in governmental accounting and auditing should be mandatory for CPAs who perform governmental audits.
- Engagement: The process by which CPAs are engaged to perform governmental audits should be improved.
- Evaluation: Inspectors general and others should expand and improve their reviews of CPA audit quality.
- Enforcement: The disciplinary process for substandard CPA audits should be strengthened.

²Report of the Task Force on the Quality of Audits of Governmental Units, American Institute of Certified Public Accountants, March 1986.

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- **Exchange of Information:** There should be greater dialogue between the government and the public accounting profession on issues affecting governmental audit quality.

If properly implemented, we believe the task force's 25 recommendations should help correct many of the underlying problems CPAs have on audits of participants in federal grant and loan programs. The 25 recommendations are listed in appendix III.

Ineffective Federal Agency Controls

We found that the agencies in our review—USDA, HUD, and SBA—did not have effective controls for receiving and reviewing CPA audits of participants in federal loan programs. The problems centered around three areas: (1) untimely receipt of audit reports, (2) insufficient review of the audits, and (3) inadequate written guidance for the CPAs to follow when performing the audits. In addition, we believe the three agencies in our review could improve the usefulness of CPA audits if they uniformly required that the audits be conducted in accordance with generally accepted government auditing standards, which are more specifically tailored to the needs of the government.

Untimely Receipt of Audit Reports

As discussed in chapter 1, audits of participants in federal loan programs provide agency managers and others with information on whether the loans are being administered properly and whether programs are being conducted consistent with applicable laws and regulations. When reports are not received, or are received late, agency managers do not have timely information with which to oversee federal loan programs.

We found that the three agencies in our review did not have adequate controls for ensuring that audits were received on time. As a result, the majority of audits included in our sample of program participants were either received late or had not been received 1 year after their due date. The determination of when an audit report is due varies, depending on the particular loan program. Descriptions of the programs and the audit report due dates are included in appendix I.

Generally, administrators of the agencies' individual loan programs are responsible for ensuring that audits are performed and that reports are received in a timely manner. We found that program administrators did not have adequate controls to ensure that audits were received on a timely basis. In fact, only one of the seven programs we reviewed—HUD multifamily housing—had written procedures requiring program administrators to follow up on late reports.

We reviewed agency records for 558 program participants to determine whether they had submitted the audit report and whether the reports had been submitted on time. For 64 cases, we could not determine if audits had ever been received or received on time because agency records were not complete or accurate. For the 494 cases where we could make a determination, we found that 348—more than two-thirds—were submitted late or were not received within 1 year. The

majority of the audits received late were for the HUD and FmHA multifamily housing programs.

Table 2.1: Receipt of Annual Audit Reports

Receipt of reports	Number	Percent
Received on time	146	30
Received late:		
1-30 days	149	30
31-60 days	59	12
61-365 days	93	19
Not received within 1 year	47	9
Total	494	100

Ineffective Follow-Up Procedures

Only one of the seven programs—HUD multifamily housing—had written procedures requiring program officials to follow up on late reports. That program was ineffective, however, because officials did not always follow their own procedures. For example, one HUD field office had procedures for following up on audits which were more than 60 days late. However, we found that the office did not follow up on any of the 13 CPA reports that were more than 60 days late.

Officials for four of the other six programs said that they had unwritten procedures for following up on late reports. These procedures, however, were also ineffective in ensuring follow-up on late reports. For example, in one FmHA office in which unwritten procedures called for following up on reports more than 30 days late, we found that the office followed up on only 1 of 10 reports more than 30 days late and that the follow-up was not made until the report was 145 days late.

Because many audit reports are received late, we believe that each agency should have a system with written procedures requiring program officials to provide written follow-up on late reports and time frames for when follow-up action should be taken. Moreover, each agency should designate an official to ensure that its procedures are followed.

Insufficient Review of Audits

Federal officials should review the audits that they receive to ensure that they are of high quality. Without such reviews, there is no assurance that the audit reports and findings can be relied on for overseeing participants in federal loan programs.

Systems or programs for reviewing audit quality normally consist of a review of (1) the audit report and (2) the working papers supporting the audit to ensure that the audit conforms with professional standards. Models or guidelines for reviewing audit quality have been issued by GAO and the PCIE. (See appendix II.)

Of the three agencies in our review, only HUD currently reviews the quality of CPA audits of participants in federal loan programs. The results of HUD's reviews are included in chapter 2. The USDA IG concluded from a study completed in March 1987 that CPA audits of federal loan programs should be reviewed regularly for quality. REA, which discontinued its quality reviews of CPA audits in 1984, responded to the study by indicating it planned to resume quality reviews in 1987. FmHA responded to the study by indicating it planned to establish a program for such reviews.

SBA has not had a program to regularly review the quality of CPA audits for participants in its loan programs and, at the time of our review, was not considering any plans to implement such a program.

Inadequate Written Guidance

CPAs are responsible for conducting a quality audit. Auditing standards require CPAs to obtain knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. Federal agencies can facilitate CPAs' understanding of federal loan program requirements by providing written audit guides for CPAs to use when auditing participants in federal loan programs. To that extent, the audit guides can help federal agencies better ensure that they receive quality audits.

Audit guides were available for six of the seven programs we reviewed. However, we believe that some of the guidance was incomplete and/or outdated. For example, the audit guide provided by the FmHA to CPAs for audits of multifamily housing programs, last revised in 1979, was designed to be used for FmHA's various loan programs rather than specifically for the audit of multifamily housing programs. This audit guide is very general and, accordingly, it does not list or describe applicable laws and agency regulations related to multifamily housing programs, nor does it identify agency officials who could provide technical assistance to those performing the audit. The USDA IG March 1987 audit report also identified the need for FmHA to identify the laws and agency regulations applicable to the multifamily housing programs in the audit program used by CPAs. Based on the USDA IG's recommendation, FmHA said it will revise its audit guide accordingly.

As another example, two HUD audit guides—for multifamily housing and GNMA securities—require CPAS to conduct their audits in accordance with GAGAS. However, the suggested reporting language in the guides for internal controls and compliance has been inconsistent with the standards for several years.

More Useful Audit Reports

CPAS follow either GAGAS or GAAS, depending on requirements of the particular federal loan program. We believe audits conducted in accordance with GAGAS are more useful to the federal government.

In the area of financial auditing, GAGAS and GAAS are generally similar, except that GAGAS require additional reporting. Both sets of standards require the auditor to report on the financial statements. GAGAS, however, also require the auditor to report on internal accounting controls and compliance with laws and regulations. The primary distinction between GAGAS and GAAS is in reporting requirements—not auditing requirements. Both GAGAS and GAAS require that important internal accounting controls be evaluated. Likewise, if significant funds are guaranteed or insured through an arrangement that requires compliance with specific contractual or legal terms, then testing of compliance with laws and regulations material to the audit is required since noncompliance can significantly impact the entity being audited.

Because of the additional reporting requirements, GAGAS audits provide more information on how well participants in federal loan programs are managing their programs in compliance with federal laws and regulations. This information is important to the federal government because government organizations, programs, activities, and functions are usually created by law and have more specific rules and regulations than commercial organizations.

GAGAS audits also have other benefits. For example, GAGAS require CPAS to report all fraud, abuse, or illegal acts that are material to the audit and provide more criteria than GAAS for reporting problems or “findings.”

At the time of our review, only HUD required CPAS to follow GAGAS. At USDA, FmHA was in the process of revising its regulations to require CPAS to follow GAGAS, while REA indicated that it did not plan to require GAGAS. SBA also did not plan to require GAGAS.

Conclusions and Recommendations

Audit Quality

CPA audits of participants in federal loan programs have not always satisfactorily complied with applicable auditing standards or contractual requirements. When audits do not comply with standards and requirements, the credibility of the information in the report is affected and the usefulness of the report can be significantly reduced.

We believe that when auditing participants in federal programs, the CPA must perform audits that meet professional standards and agency requirements. We believe that implementation of recent initiatives by the AICPA's task force on the quality of audits of governmental units should bring about needed improvements in audit quality.

Federal Controls

We believe many federal agencies do not have adequate controls to ensure that they receive audits which are on time and which are performed in accordance with applicable audit standards and contractual requirements. Our review of seven loan programs for three agencies showed that the majority of audit reports were either received late or not at all. Further, many of the reports were not subject to quality control review by the agencies. One of the purposes of having the audits performed is to provide an agency with reliable information on how its programs are being carried out by program participants. When audit reports are not received on a timely basis, or are of poor quality, agency officials do not have current or reliable information they can use to make this evaluation.

Also, we believe each federal agency can strengthen its controls and better ensure that it receives quality audits if it facilitates CPAs' understanding of federal loan program requirements through detailed, up-to-date written audit guides.

Lastly, audit reports are used by program officials to help ensure that an entity is managing its program in compliance with federal laws and regulations. Because of the additional reporting requirements of GAGAS, we believe that audits performed in accordance with GAGAS would be more useful to the federal government. GAGAS require the auditor to report on internal accounting controls and compliance with laws and regulations that are material to the audit.

Recommendations

We recommend that the Secretaries of USDA and HUD and the Administrator of the SBA:

- issue written procedures requiring loan program officials to follow up on late audit reports, specify action to be taken when the reports are late, and improve controls to ensure that those procedures and actions are taken and
- provide CPAs with complete and current written audit guidance to use in the conduct of loan audits.

We further recommend that the Secretary of USDA and the Administrator of SBA:

- implement procedures to review the quality of CPA audits of loan programs, and
- require that audits of participants in loan programs be performed in accordance with GAGAS.

Agency Comments and Our Evaluation

We obtained comments on a draft of this report from USDA, HUD, and SBA. The comments are printed in their entirety in appendixes IV, V, and VI, respectively and discussed below.

Follow-Up on Late Audit Reports

USDA stated that REA provides adequate procedures for following up on late audit reports. We reviewed the REA regulations USDA provided us and concluded that they do not provide specific procedures for requiring loan program officials to follow up on late audit reports, nor do they specify the time frame in which they must follow up. The procedures address time frames for following up on audit review letters sent to borrowers following a review by REA of the audit report. USDA did not respond regarding how FmHA plans to follow up on the large number of CPA reports it received late.

HUD said it was going to issue written procedures in conjunction with an automated information system being designed for multifamily housing projects, but did not address what it would do for the other two HUD programs we reviewed—GNMA Mortgage Backed Securities and non-supervised mortgage companies.

SBA stated that regulations are in place which require that audits be submitted within specific time frames and that there are controls in place to implement these regulations. We reviewed the regulations and directives, and concluded that while they do address time frames for filing certain reports, the procedures do not require loan program officials to

follow up on reports when they are not submitted within established time frames.

Written Audit Guidance for CPAs

USDA did not formally respond to our report regarding FmHA's written audit guidance; however, FmHA officials informed us during our audit that they intended to revise the FmHA's audit guide in response to a similar recommendation made earlier by the USDA IG. The other USDA program we reviewed, REA, had adequate written guidance for CPAs to follow when auditing REA borrowers.

For the three HUD programs in our review, we found that two of them—multifamily housing and GNMA securities—had incomplete and/or outdated written audit guidance. In its response, HUD stated that a revised written audit guide for multifamily housing would be completed by March 1988, but it did not discuss whether it planned to revise the guidance for GNMA securities.

SBA responded that it provides written accounting, but not auditing, guidance to CPAs. Relying on our reference to "governmental audits" in the report, SBA does not believe our recommendation is applicable to its programs because participants in its programs are "commercial" rather than "governmental" entities. We believe that our recommendation is applicable and that SBA misapprehended the meaning of "governmental audits" in our report. For purposes of this and other reports on audit quality, GAO has used "governmental audits" to include audits of participants in governmental grant, loan and other programs where the audit is required as a condition of participation in the program. Therefore, since SBA program participants are required to be audited by, and are otherwise subject to, SBA laws and regulations, SBA should provide written guidance which will facilitate CPAs' understanding of its loan program requirements. To that extent, the audit guides can help SBA ensure that it receives quality audits.

Review Quality of CPA Audit Reports

USDA agreed with our recommendation to implement procedures to review the quality of CPA audits. REA recently reactivated its review program, and FmHA, based on its earlier agreement with a similar recommendation by the USDA IG, planned to establish a review program.

SBA said its program office reviews financial statements for appropriate accounting, and pointed out that the quality of the CPA audit of the statements is subject to analysis by the SBA IG, as deemed appropriate by

the IG. Our review, however, showed that the SBA IG staff usually does not evaluate the quality of the CPA audits of its loan participants and, as a result, SBA does not have a means to ensure that quality audits are being performed.

**Following Generally
Accepted Government
Auditing Standards
(GAGAS)**

USDA did not formally respond to our report regarding FmHA; however, at the time of our review, FmHA was in the process of revising its regulations to require CPAs to follow GAGAS. USDA, with regard to REA, and SBA favor their current dual approach of relying on (1) CPAs to audit the financial statements of loan program participants in accordance with GAAS and (2) agency staff to audit participants' compliance with federal laws and regulations. Both agencies believe that requiring CPAs to perform financial and compliance audits in accordance with GAGAS would be inappropriate as well as more costly.

We believe that USDA, with regard to REA, and SBA misunderstand the nature of GAGAS audits performed by CPAs. In federal loan programs, significant funds are guaranteed or insured through arrangements that require participants to comply with specific laws and regulations. Failure to comply with those arrangements could significantly affect a participant's financial condition. Accordingly, a CPA—whether auditing in accordance with GAAS or GAGAS—would determine whether the participant was complying with federal laws and regulations that could materially affect the audit. As discussed in chapter 3, the primary distinction between GAAS and GAGAS is in reporting requirements rather than auditing requirements. Requiring CPAs to perform financial and compliance audits of loan program participants in accordance with GAGAS would result in only a nominal increase in costs to cover the additional reporting requirements. (See appendixes IV and VI.)

Description of Guaranteed/Insured Loan Programs

The following is a brief description of the seven programs included in our review. These programs involve guaranteed and insured loans for which annual audits are required. Approximately 35,000 CPA audit reports are received each year for these seven programs.

Programs Within the Department of Agriculture

Multifamily Housing Program

FmHA's multifamily housing program, authorized under Title V of the Housing Act of 1949, as amended, insures loans made through the Federal Financing Bank to individuals, corporations, associations, trusts, Indian tribes, or partnerships for the purposes of providing rental or cooperative housing for the elderly or lower-income³ families in rural areas. FmHA also insures loans for purposes of providing housing and related facilities for domestic farm labor.

FmHA requires borrowers to submit an annual audit report on each project having 25 or more units. FmHA currently requires borrowers to submit their reports 60 days after their fiscal year-end (at the time of our review, the requirement was 45 days after the borrower's fiscal year-end). Audits are to be performed in accordance with AICPA standards and FmHA requirements. Nationwide, FmHA receives approximately 9,000 CPA audit reports each year.

Rural Electrification and Rural Telephone Programs

REA, through its rural electrification and rural telephone programs, guarantees loans made through the Federal Financing Bank for the construction and operation of rural electric and telephone facilities, lines, systems, and improvements. REA borrowers are typically companies, cooperatives, public bodies, or nonprofit associations.

REA borrowers must submit an annual audit report to REA within 120 days of the borrower's fiscal year-end. Nationwide, REA receives approximately 2,000 rural electric and rural telephone CPA audit reports each year.

³Lower-income is defined as 80 percent or less of the median income for a particular geographic region.

Programs Within the Department of Housing and Urban Development

Multifamily Housing Programs

HUD's multifamily housing programs, under the National Housing Act, as amended, are designed primarily to assist lower-income households in obtaining adequate and reasonably priced housing. By assuring mortgage repayment, HUD encourages private lenders (mortgagees) to enter the housing market to provide financing which otherwise might be unavailable to project owners (mortgagors). The mortgagor may be an individual, a partnership, a trust, or a corporation, either nonprofit or profit motivated.

HUD requires a mortgagor to submit an annual audit report within 60 days after the project's fiscal year-end. Audits must be performed in accordance with GAGAS and HUD requirements. Nationwide, HUD field offices receive approximately 20,000 multifamily housing audit reports each year.

Government National Mortgage Association Mortgage-Backed Securities Program

The GNMA Mortgage-Backed Securities Program provides a means for channeling funds from the nation's securities markets into the housing market. Under section 306(g) of the National Housing Act, GNMA guarantees the timely payment of principal and interest on securities that are based on, and backed by, a trust or pool composed of mortgages which are insured or guaranteed by the Federal Housing Administration (FHA), the Farmers Home Administration (FmHA), or the Veterans Administration (VA).

Issuers of GNMA securities are private firms, such as mortgage banking companies, savings institutions, and commercial banks. Issuers must submit an audit report to GNMA each year within 90 days following their fiscal year-end. Audits must be performed in accordance with GAGAS. Nationwide, GNMA receives approximately 1,300 CPA audit reports each year.

**Nonsupervised Mortgage
Companies**

Under the National Housing Act, as amended, HUD is authorized to provide insurance protection to private lenders who provide mortgage financing to purchasers of single-family homes.

HUD requires private lenders who are not subject to supervision by a government agency, referred to as "nonsupervised mortgage companies," to submit annual audit reports, within 75 days following the close of the mortgagee's fiscal year. Currently, the audits must be performed in accordance with GAGAS; however, at the time of our review, the audits were performed in accordance with AICPA standards and HUD requirements. Nationwide, HUD receives approximately 2,000 audit reports of nonsupervised mortgagees each year.

**Programs Within the
Small Business
Administration**

**Certified Development
Companies Program**

The CDC Program, under provisions of the Small Business Investment Act of 1958, as amended, helps communities by stimulating the growth and expansion of small businesses within a defined area of operation.

CDCs, operating as either a private nonprofit corporation or a for-profit corporation, provide long-term, fixed asset financing by selling debentures with SBA's 100 percent guarantee for an identifiable small business concern.

Each CDC is required to submit an annual report within 90 days after its fiscal year-end. Annual reports contain management reports and financial statements which are audited, generally by a CPA. CPAs, during the course of their examination, must adhere to AICPA standards. Nationwide, SBA receives approximately 500 CDC annual reports each year.

**Small Business Investment
Companies Program**

Under the SBIC Program, SBA licensed investment companies, with their own funds and with funds borrowed at favorable rates from the federal government, provide small businesses with equity capital, long-term loans, and management assistance. Eligible SBICs can apply to the SBA for a guarantee of their debentures. A major incentive for SBICs to invest in

**Appendix I
Description of Guaranteed/Insured
Loan Programs**

small businesses is the chance to share in the success of the small business if it grows and prospers. By law, an SBIC can be organized in any state, as either a corporation or a limited partnership.

Each SBIC is required to submit an annual report within 90 days after its fiscal year-end. Annual reports contain management reports and financial statements which are audited, generally by a CPA. CPAs, during the course of their examination, must adhere to AICPA standards. Nationwide, SBA receives approximately 500 SBIC annual reports each year.

System for Promoting Quality Audits

The following is a brief description of the key elements of a model system for federal agencies to follow to promote quality audits. A more comprehensive description for the majority of these elements can be found in GAO's prior audit quality report on IGs' quality control activities (GAO/AFMD-86-20) and the guidelines issued by the President's Council on Integrity and Efficiency (PCIE) for promoting the quality of single audits.

Tracking Receipt of CPA Audit Reports

Required audits should be tracked to ensure they are performed and reports are received by the agency in a timely manner. Agencies should establish and maintain a system for controlling the due dates and receipt dates of audit reports, contact program participants when an audit report is not received, and invoke sanctions as necessary.

Providing Adequate Audit Guidance and Technical Advice

Agencies should provide CPAs with accurate, up-to-date audit guidance at the earliest stages of the audit and actively provide technical advice during the course of the audit to ensure that the CPAs have a clear understanding of the audit requirements.

Conducting Desk Reviews and Quality Control Reviews

Desk reviews (review of CPA audit reports) should be made on all audits, and QCRs (quality control reviews of supporting working papers) should be made on a sample basis to determine auditor conformance with professional standards and agency requirements. Because of the technical nature of these activities, both reviews should normally be performed by the agency's audit group or the IG staff. Reviewers should use standardized checklists annotated to standards while conducting their reviews and, when completed, notify appropriate parties of review results. Agencies should then invoke sanctions as necessary. Further, agencies should summarize their reviews and report overall results to appropriate agency officials and to the Congress.

Conducting Periodic Assessments of Agency Audit Quality Systems

Periodic assessments of agency audit quality systems should be conducted to determine whether the systems are being followed as required. Assessment results should be reported to appropriate agency officials so that any needed improvements can be made.

Recommendations of the AICPA Task Force on the Quality of Audits of Governmental Units

Education

1. Auditors of governmental organizations, programs, activities, and functions should be required to complete continuing professional education courses in the unique aspects of governmental accounting and auditing.
2. The AICPA State and Local Government Committee should review and approve all new governmental accounting and auditing courses offered by the AICPA before presentation, and the committee should review them for continued relevance annually thereafter.
3. Policies and procedures should be established to assure that the instructors of the AICPA governmental accounting and auditing courses are properly qualified and adequately trained to teach the courses.
4. Self-study programs in governmental accounting and auditing, including video programs, should be marketed actively, particularly in geographic areas where it would be difficult for auditors to participate in a group study program.
5. The AICPA should work with other organizations that offer governmental accounting and governmental auditing courses to receive or provide information that would improve the quality of such courses.
6. A statement on auditing standards relating to auditing for and reporting on compliance with applicable laws and regulations should be developed and issued.
7. The AICPA Technical Information Division's capacity to respond to members' questions relating to governmental accounting and auditing should be strengthened and maintained.
8. The regional offices of inspectors' general capacity to provide timely and proper guidance to recipients of federal financial assistance and their independent auditors should be strengthened and maintained.
9. The Compliance Supplement for Single Audits of State and Local Governments, published by the Office of Management and Budget (OMB), should be reviewed annually and updated as necessary.
10. The compliance requirements and suggested audit procedures for federal financial assistance programs not included in the Compliance Supplement should be developed and published by the respective agencies.

11. The Questions and Answers on the Single Audit Provisions of OMB circular A-102 "Uniform Requirements for Grants to State and Local Governments" published by OMB, should be updated to reflect the issuance of circular A-128.

Engagement

12. A comprehensive study should be undertaken of the procurement of audit services and the way in which that process influences audit quality.

13. A model request for proposal for audit services should be developed and widely distributed.

14. The federal government's numerous rules that govern the conduct of a single audit should be consolidated into a single rule. The rules should be expanded to incorporate the applicable recommendations addressed.

15. Requirements for audits conducted for or on behalf of the federal government should be established and monitored by an office of inspector general.

Evaluation

16. The guidelines for conducting desk and working paper reviews included in the Federal Cognizant Agency Audit Organization Guidelines should be expanded in order to assure comprehensive, consistent quality control reviews.

17. The audit deficiency data collected during desk and working paper reviews should be categorized by type of deficiency and solutions sought for recurring and systemic problems.

18. A "positive enforcement program" that includes reviews of audits of governmental units should be instituted in each state.

19. Auditors and audit organizations performing audits of governmental funds should be required to participate in a peer review program that includes reviews of governmental audits.

Enforcement

20. The system for referring allegedly substandard audits to licensing authorities and professional organizations should be modified to lessen the paperwork required to initiate a referral, enable the investigation to

be completed in less time, and provide feedback to the referring and other appropriate officials.

21. Guidelines should be developed and distributed to explain the referral process to organizations that would have a need to make referrals.

Exchange

22. Membership in the National and regional Intergovernmental Audit Forums should be opened to CPAs in public practice.

23. The dialogue and exchange of information among the various individuals involved in governmental auditing should be expanded.

24. The governing bodies and committees of the AICPA should include individuals from the government audit community, and the governing bodies and committees of the government auditor and financial management associations should include CPAs in public practice.

25. Federal and state auditors should be included as co-instructors for the AICPA governmental accounting and auditing continuing professional education courses; complimentary registrations should be given to members of their organizations.

Comments From the Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

DEC 15 1987

J. Dexter Peach
Assistant Comptroller General
Resources, Community, and Economic
Development Division
General Accounting Office

Dear Mr. Peach:

A review has been made on the proposed GAO report dated November 1, 1987 entitled, CPA Audit Quality: Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs." We offer the following comments.

In Appendix II, "System for Promoting Quality Audits," does not credit FmHA with the proposed use of contractors to conduct quality control reviews of a sample of working papers and to sample desk reviews made or caused to be made by FmHA.

For purposes of the following reply, the pertinent documents are 7 CFR Part 1789, REA Policies Concerning the Audits of REA Borrowers (Part 1789), and REA Staff Instruction (SI) 185-4:465-4, Processing and Review of CPA Audit Reports. We have enclosed copies of these documents for your review.

Audit Report Tracking System

REA requires each of its borrowers to submit an annual audit report within 120 days of the borrower's fiscal year-end. Detailed procedures for the processing and review of these audit reports are set forth in SI 185-4:465-4. Responsibility for obtaining the audit report within the required time constraints is assigned to the appropriate Program Area Office with the responsibility for oversight given to the Deputy Administrator - Program Operations. Audit reports are considered delinquent when they have not been received within 30 days of their due date. At that time, REA initiates its follow-up procedures. In 1986, we strengthened these procedures and as a result, we have increased the percentage of audit reports submitted on time to 78% thereby reducing our percentage of delinquent audit reports to only 22%. I believe this strengthening of our procedures has greatly attributed to our high percentage of audits received on a timely basis.

See comment 1.

-2-

Quality Review Program

GAO's report specifies that a system or program for reviewing audit quality consists of (1) a desk review of each audit report submitted and (2) a sample quality control review of the supporting workpapers. Each audit report submitted to REA is reviewed for compliance with REA's audit requirements as specified in Part 1789. It is also reviewed for any unusual or unsatisfactory conditions that may be presented. A standardized review checklist has been developed and is used for all reviews. Any problems noted during the review are addressed in a letter to the President of the Board of Directors. The President is requested to respond within 60 days notifying REA of the corrective action to be taken. Specific responsibility for obtaining this response and for assuring that the necessary action has been taken is assigned to the appropriate Program Area Office. REA's standardized review checklist and review procedures are detailed in SI 185-4:465-4.

REA's program for the quality review of CPA working papers is twofold. REA has developed an in-house review of working papers for adherence to REA's audit requirements as set forth in Part 1789 and we have adopted a mandatory peer review program for adherence to quality control standards and generally accepted auditing standards (GAAS). Effective January 1, 1988, all CPAs auditing REA borrowers are required to submit to a peer review of their quality control standards and their audit working papers. The peer review requirement provides REA with program-wide coverage and assurance while the REA quality review provides specialized assurance of adherence to REA's audit policies.

During fiscal year 1987, REA staff reviewed six CPA firms auditing 62 REA borrowers for compliance under our quality review program. Two of the firms were determined to be substandard. REA issued a report denoting each firm's deficiencies and followed up with one firm with a second review six months later. Significant improvements in the quality of the working papers were found during the second review. The second follow-up review is pending a six month waiting period.

I believe that the combination of these two programs--the quality review program and the peer review program--provide the highest degree of assurance that the audit reports received by REA are of the highest quality.

Audit Guides

Part 1789 sets forth REA's policies concerning the audits of REA borrowers. Included in Part 1789.38, Audit documentation, are specific documentation requirements and audit procedures for each major account classification on the

-3-

balance sheet and income statement. We have also provided sample financial statements in the Appendices to Part 1789 to assist the CPAs in the classification and presentation of the financial information. Part 1789 was last updated in 1986 and we believe it provides a current, comprehensive format for the CPAs.

Generally Accepted Government Auditing Standards (GAGAS)

GAO's report states that CPAs who audit participants in Federal loan programs are required to follow either GAAS or GAGAS. GAO, however, is suggesting that GAGAS is the preferable set of standards to be followed. One of the reasons cited is that GAGAS requires the auditors to report all fraud, abuse, or illegal acts to the government agency.

REA regulations as set forth in Part 1789.5, Audit Standards, require the CPA to perform the annual audit of a borrower's financial statements in accordance with GAAS. GAGAS expand the scope of a financial audit performed in accordance with GAAS to include a determination that the entity has complied with all laws and regulations that may have a material effect upon the financial statements. This area of expanded coverage is fulfilled by the compliance reviews (loan fund reviews) performed by the REA field accountants. In addition, in Part 1789.7, Disclosure of Irregularities, REA requires the CPA to report all irregularities, whether material or not, to REA. As used in Part 1789, irregularity is defined to include any defalcation, fraud, false report or false claim affecting a borrower or the interest of the Federal government.

The Administrator of REA is empowered by the Rural Electrification Act to make guaranteed and insured government loans to cooperatives, companies, and municipalities which provide telephone and electric service to persons living in rural areas. Accordingly, he has been charged with the responsibility and accountability of assuring that Federal funds loaned under the provision of the Act are properly accounted for and disbursed for proper loan purposes. To guarantee this assurance, REA has developed a two-tier review program consisting of:

- a. A financial statement audit performed in accordance with GAAS by an independent CPA; and
- b. A loan fund compliance review performed by REA field accountants.

This separation of audit responsibility has proven that it provides the greatest degree of positive assurance and financial information at the lowest cost to both the Federal government and the REA borrowers. After having considered the many ramifications of adopting GAGAS as an REA

-4-

requirement, the Administrator does not feel that he can properly discharge his responsibilities under the REA Act if the loan fund review was to be performed by the CPA. Several of his concerns are detailed below.

Audit Responsibility - As stated in part 1789.2, REA Audit Requirements, each borrower is responsible for having its financial statements audited by a CPA firm selected by the borrower and approved by REA. As such, the borrower is responsible for all audit fees incurred. Similarly, the borrower possesses the authority to discharge a CPA without recourse or explanation to REA. If the borrower was to employ a CPA to perform the additional compliance testing required in the loan fund audit, the borrower would have the authority to discharge that same CPA if loan funds were disallowed as result. Subsequent CPAs could be employed until the borrower located one with a philosophy similar to that of the borrower, thereby greatly reducing the assurance afforded REA.

Statistical Sampling - Independent CPAs performing compliance reviews utilize statistical sampling techniques to determine the nature and extent of transactions to be tested. As specified in the "Standards for Audit of Government Organization, Programs, Activities, and Function," the CPA is required to provide positive assurance on those items not tested. Whereas, the REA loan fund review tests each loan fund advance for compliance with 7 CFR Part 1711, Advance of Funds, and each loan fund disbursement for compliance with policy rules and regulations. In 1985, \$28,800,000 of improperly disbursed loan funds was disallowed and in 1986, \$16,000,000. An additional \$1,900,000 of advances received in violation of Part 1711 was repaid with interest to the Federal treasury. The degree of assurance afforded REA, as well as the disallowance of loan funds, could be significantly reduced through the use of statistical sampling.

Audit Fees - Our discussions with the Office of General Counsel indicate that there may be limits on the extent to which REA may impose additional audit obligations on its borrowers without REA, itself, sharing in the financial burden. Based upon current estimates consistent with the audit fees incurred for audits performed under the Single Audit Act, the assignment of compliance reviews to the CPA would increase annual audit fees by approximately \$6.9 million. This increased cost far exceeds the current cost to the Federal government of \$1.5 million.

Quality of Reviews - In separate studies conducted by the Office of Inspector General and GAO, they found that 70% of the reports filed under the Single Audit Act contained material inadequacies and of those, 35% were rejected as

See comment 2.

**Appendix IV
Comments From the Department
of Agriculture**

-5-

being totally inadequate. If approximately 70% of the audits filed under the Single Audit Act contain material inadequacies, the question arises as to the quality of work we can expect to receive from a highly specialized report such as the loan fund review.

Based upon these reasons, I do not believe that enlarging the scope of the CPA audit is an acceptable alternative. I believe that the quality of assurance provided by the REA field accountants far exceeds its cost to the Federal government.

Sincerely,



ROLAND R. VAUTOUR
Under Secretary
for Small Community
and Rural Development

Enclosures

The following are GAO's comments on the Department of Agriculture's letter dated December 15, 1987.

GAO Comments

1. See end of chapter 4 for our evaluation of USDA's response.
2. Subsequent to USDA's response, officials at USDA told us that the statistics noted were reported by the ninth annual conference of the American Institute of the Certified Public Accountants' Private Companies Practice Session, not by GAO or by the Office of Inspector General.

Comments From the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

DEC 28 1987

Mr. J. Dexter Peach
Assistant Comptroller General
Resources, Community, and Economic
Development Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Peach:

Your letter of November 6, 1987, addressed to the Secretary of Housing and Urban Development transmitting a proposed report to the Congress entitled: "CPA Audit Quality: Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs," has been referred to me for reply.

We are in general agreement with the recommendations in the report. Therefore, we will explore ways to improve CPA training and will also examine the disciplinary process for those submitting poor quality CPA audits.

I will answer the recommendations in the order that they are presented in the report.

Recommendation No. 1: Issue written procedures requiring loan program officials to follow-up on late audit reports, specify action to be taken when the reports are late, and improve controls to ensure that those procedures and actions are taken.

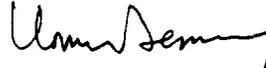
Reply: There is an application to be automated under the Multifamily Information Processing System (MJPS) entitled Financial Statements which covers date tracking, data entry, and performance risk analysis. This application will be implemented and operational by the end of the third quarter of Fiscal Year 1988, and written procedures and instructions will be in place, accomplishing this recommendation.

See comment 1.

Recommendation No. 2: Provide CPAs with complete and current written audit guidance to use in the conduct of loan audits.

Reply: On January 30, 1987, HUD issued a revised version of Audit Guide for Use by Independent Public Accountants in Audits of HUD-Approved Nonsupervised Mortgagees, Loan Correspondents, and Coinsuring Mortgagees (Handbook IG 4000.3 REV-2). This audit guide provides complete instructions to Independent Public Accountants (IPAs) in performing the respective audits and requires that the IPAs follow generally accepted government auditing standards (GAGAS). HUD is presently developing a revised version of Audit Guide for Mortgagors Having HUD Insured or Secretary Held Multifamily Mortgages (Handbook IG 4372.1, dated June 1978). The latter audit guide, which will be completed by March 31, 1988, will also require the IPAs to follow GAGAS.

Sincerely yours,



Thomas T. Demery
Assistant Secretary

**Appendix V
Comments From the Department of Housing
and Urban Development**

The following are GAO's comments on the Department of Housing and Urban Development's letter dated December 28, 1987.

GAO Comments

1. See end of chapter 4 for our evaluation of HUD's response.

Comments From the Small Business Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

DEC 17 1987

Mr. J. Dexter Peach
Assistant Comptroller General
Resources, Community and Economic
Development Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Peach:

We have reviewed your draft report entitled, "CPA Audit Quality: Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs", (GAO/AFMD-86-33), and recognize the importance of the subject matter. To the extent the deficiencies indicated by the study exist, the recommendations proposed appear to have merit. Although we support the recommendations, we feel that the conclusions and suppositions in the draft in many cases do not apply to the Small Business Administration (SBA), or need clarification or correction. The difference between financial audits and compliance audits is not clearly articulated. While they could be performed by the same practitioner, each has its own unique characteristics.

The draft also appears to equate audits of governmental units with those of commercial enterprises. An example is the recommendation regarding courses in governmental accounting for CPAs doing audits of commercial entities who secure Government loans. The draft also appears to address the situation wherein CPAs have been contracted by the program agency.

SBA program participants are presently audited from two perspectives -- one financial, and one regulatory. We recommend that the requirement for a financial audit, to be performed by CPAs of Small Business Investment Companies (SBICs) and Certified Development Companies (CDCs) at the licensees' expense, be continued. A compliance audit is the responsibility of the Agency Inspector General, and should he choose to utilize CPAs to do the work, he would then contract for their services, provide guidance, and oversee the quality of their work. This is essentially the current practice at SBA.

See comment 1.

The following are our specific comments on the four recommendations made in the report:

Recommendation 1 - ensure that agencies have controls for receiving CPA audit reports on time. SBA regulations clearly require that audits be submitted within specific timeframes and there are controls in place to implement these regulations. Failure to submit in a timely manner subjects the entity to administrative sanctions. Internal directives establish the responsibility and procedures for tracking the timely receipt of audit reports.

Recommendation 2 - ensure that agencies have controls for reviewing audit quality. This is a two-pronged situation. First, all annual financial statements submitted by CPAs are reviewed and analyzed for appropriate accounting by the program office. Any anomalies, questions, or apparent errors are resolved. Second, the quality of the audit is subject to analysis by SBA IG examiners, as they deem appropriate in the circumstances. The regulations provide for access to the CPA's working papers should the examiner consider it necessary.

Recommendation 3 - ensure that agencies have controls to provide adequate written guidance to CPAs for performing governmental audits. In the context of the overall draft, this recommendation seems ambiguous. SBA program offices provide considerable guidance to CPAs as to the proper method of accounting for program participants; (e.g., Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies, 13 CFR Part 107 Appendices I and II). The ambiguity arises in determining the meaning of "governmental audits". This would appear to concern the audit of governmental entities, which is not applicable to the discussion. On the other hand, it could concern audits performed directly under contract to a Government agency. In that case, specific guidance is required; however, such a case is not currently applicable to SBA.

Recommendation 4 - ensure that agencies have controls for requiring CPAs to follow generally accepted government auditing standards (GAGAS). The SBA program requirements for CPA audits of SBA program participants are strictly those of a financial nature. Compliance or regulatory audits of those participants are the responsibility of the IG. To require CPAs to follow GAGAS in the conduct of a financial audit would not only be costly to the participant, but also would duplicate the

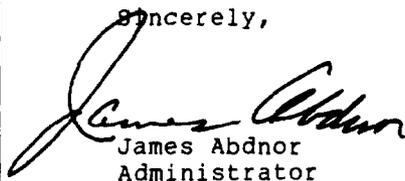
Page 3

efforts of the IG. As was mentioned previously, however, should the IG decide to employ CPAs to conduct compliance audits, they would then be required to follow GAGAS.

In summary, we believe the recommendations that concern timeliness, guidance, and review of audits are essentially in place at SBA, and controls in these areas currently exist. The recommendation to require conformance to GAGAS so that the CPA assures compliance with laws and regulations is not currently applicable to SBA programs. At such time as a contracted CPA is charged with determining such compliance, adequate controls will be in place to ensure proper Agency review.

We appreciate the opportunity to comment on this draft report. If you need any additional information, please contact Mr. Raymond F. Randolph, Assistant Inspector General for Audit, at 235-8203.

Sincerely,



James Abdnor
Administrator

**Appendix VI
Comments From the Small
Business Administration**

The following are GAO's comments on the Small Business Administration's letter dated December 17, 1987.

GAO Comments

1. See end of chapter 4 for our evaluation of SBA's response.

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First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100