
CHAPTER 7

AUDITING CONCEPTS

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INTRODUCTION

Even though the annual financial statements may be physically prepared by an auditor, the statements come from the project's records and are considered the representation of the owner. The project owners are expected to maintain books and records in accordance with Generally Accepted Accounting Principles (GAAP) and the auditor must thoroughly examine these records using Generally Accepted Auditing Standards (GAAS) and Government Auditing Standards (GAS). The purpose of an audit is to have the auditor render an independent professional opinion on the reliability of the financial statements as an accurate reflection of the project's financial condition and performance.

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AUDITOR/OWNER
RESPONSIBILITIES

The following table describes the responsibilities of the auditor and the owner in relation to the audit process. The ongoing nature of the audit process requires auditors to evaluate and comment on the adequacy of the accounting records and procedures and the system of internal controls. The auditors can make recommendations regarding internal controls, accounting procedures and systems but cannot administer any system, maintain the books or perform recordkeeping functions.

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OWNER RESPONSIBILITIES		AUDITOR RESPONSIBILITIES	
1)	Adopting sound accounting policies.	1)	To examine the records provided by management.
2)	Maintaining the required system of accounts.	2)	To express opinions on the fairness of financial information presented.
3)	Safeguarding assets.		
4)	Devising a system of internal controls	3)	To express opinions on the effectiveness of the

to help assure the production of proper financial statements.

internal control structure and compliance with applicable laws and regulations.

- 5) Complying with all laws, regulations, and project agreement.

Who is a qualified and independent auditor

For the purposes of HUD multifamily audits, a qualified independent auditor is an Independent Public Accountant (IPA) licensed by a regulatory authority of a state on or before December 31, 1970 or is a Certified Public Accountant (CPA). CPA's are licensed by the individual states following completion of specified educational and experience requirements which includes the attainment of a passing score on a nationally standardized, three day written examination. The licenses of the independent public accountant subject to the state chapter of the American Institute of Certified Public Accountants (AICPA) or state licensing boards which can suspend or revoke licenses for reasons such as failure to adhere to professional standards. Many states also have continuing education requirements for renewal of public practice licenses.

Note

Qualifications and standards such as the ones mentioned above can assist in preventing or removing an incompetent or unethical auditor from public practice, but they do not guarantee quality work on the part of the auditor. Nevertheless, they do provide potential penalties for poor performance. Reports of failure to adhere to professional standards can damage a firm's reputation,

Independence of the auditor

and, in extreme or repeated cases, can result in cancellation of license.

For the purposes of HUD multifamily audits, an independent auditor must have no business relationship with the owner except for the performance of the audit, systems work and tax preparation. Systems work includes the design and implementation of a system but not its continuing day-to-day operation. As such, monthly "write-up work" (such as the posting of ledgers and journals) goes beyond systems work and impairs the independence of the auditor. The independence standard does not prohibit audit related work, such as interim reviews or consulting on personnel or accounting matters.

Independence Standard	The AICPA discussion of the independence standard states that the auditor in accordance with GAAS "must be without bias with respect to the client under audit." Although it is difficult to be totally independent of anyone who pays you for services performed, the ability to remain independent "in attitude" is considered a professional requirement and responsibility. Its successful accomplishment is dependent upon the professional integrity of the auditor.
Engagement Letter	The engagement letter is, in effect, the contract between the auditor and the project. It describes: <ul style="list-style-type: none"> o the scope of the work to be done, and o the fee and billing arrangements to be followed.
HUD-required components	For HUD audits, the engagement letter must include: <ul style="list-style-type: none"> o a statement that the audit will include compliance with the HUD IG Handbook 2000.4, "Consolidated Audit Guide for Audits of HUD Programs", and o a statement that HUD specifically has the right to examine the working papers supporting the audit.
How audit fees are determined	Fee arrangements are between the project and the auditor, HUD is only a third-party beneficiary to the contract. HUD can exercise indirect control over fees through its review of rent increases and, in some cases, budgets. Although audit fees are

Why fees vary

often stated (or bid) at a specific dollar amount, they are initially computed by the audit firm at hourly rates times estimated total hours required to complete the job. Often times the audit fee will include charges for preparation of the necessary income tax forms. The preparation charge for project income tax reporting requirements are acceptable costs however, personal income tax preparation for project owner's is not an allowable project expense.

Owners should obtain competitive fee estimates from and evaluate the qualifications and experience of accounting firms that might be used. The following are some conditions or factors that may affect the fee charged by the accounting firm:

- o The size of the accounting firm. As a general rule, fees charged by large national firms are greater than those charged by smaller local firms.
- o Project fiscal year. Audit fees often depend on the level of work to be performed. Most accounting firms have their peak business from December through April.
- o Quality of the project's records and systems. This is the most common reason for the variance of audit fees from one project to another. High audit fees often indicate that management's systems and records are poorly maintained. For example, the auditor may be required, in the course of the audit, to post or reconstruct transactions or to make adjustments to the closing balances of the project accounts. The worse the condition of the records and systems of the project, the more an accounting firm will likely charge for the audit.
- o Audit fees should not be confused with bookkeeping or accounting fees. Accounting firms which provide bookkeeping and accounting services have to be independent of the firm that performs the actual audit. Bookkeeping and accounting fees vary and project owners should attempt to get quality services at the lowest price possible. In

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addition, the auditor may prepare the income tax returns required by IRS. These fees may also vary, therefore the conditions and factors listed above should be considered.

What an auditor does

Before rendering an opinion on the reliability of the financial statements, the auditor must perform certain tasks and make certain tests. These include, but are not limited to, the following:

- o review and evaluation of internal control systems,
- o tests of transactions,
- o tests of account balances, and
- o review of compliance with laws and regulations.

Certification

Owner/Management Agent. The financial statements must contain a certification, signed by the owner, and the management agent if applicable, stating that the owner and management agent, if applicable, have reviewed the financial statements and consider them to be complete and accurate. The management agent's certification should identify the individual, as well as the company responsible for the financial statements. The management agent is required to certify the financial statements so that the Department can identify any affiliations, interest or relationships that the agent may have with the owner or other management firms that do business with the Department. In addition to the management agent, if applicable, the following persons must certify the financial statements:

1. If the project is owned by an individual, the owner must certify.
2. If the project is a corporation, two officers, one of which must be the president must certify.
3. If the project is a cooperative, two members of the Board of Directors, including the president, must certify.
4. If the project is a limited partnership, two or more partners (including at least two general partners if there are two or more general partners) must certify.

5. If the project is a general partnership, all joint venturers or partners must certify.
6. If the project is owned by a trust, the trustee and appropriate beneficiaries must certify.

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ACCOUNTING
PRINCIPLES
AND STANDARDS

The purpose of auditing financial statements is to determine whether they are fairly presented in accordance with generally accepted accounting principles (GAAP). The auditor must conduct an audit in accordance with generally accepted auditing standards (GAAS) and Government auditing standards (GAS).

GAAP

GAAP can be defined as rules and practices necessary at a particular time that represent accepted accounting principles and practices. Accounting principles encompass unwritten rules and written rules. The written rules are commonly referred to as promulgated GAAP.

GAAS refer to the ten auditing standards that have been approved and adopted by the members of the AICPA. GAAS are divided into three groups: (1) general standards, (2) standards of field work, and (3) standards of reporting.

GAS (which are issued by the U.S. General Accounting Office (GAO)) are standards for audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. GAS pertain to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

The most important factor in any profession is the people who make up that profession. Desirable traits are difficult to describe in any individual, much less a profession. Therefore, general standards have been created that are open to a broad and considerable degree of interpretation.

The three general standards require that an individual:

- o have adequate technical training and proficiency as an auditor,

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- o maintain an independence in mental attitude, and exercise due professional care in performing the audit and preparing the report.

Fieldwork Standards

Before an opinion on the financial statements can be formulated, an auditor must be convinced about the fairness of the statements. The standards of field work provide the auditor with a basis for judging the quality of the financial statements. The three standards of fieldwork require:

- o the work to be adequately planned and assistants properly supervised,
- o proper study and evaluation of the existing internal control as a basis for reliance thereon, and
- o sufficient competent evidential matter is to be obtained to afford a reasonable basis for an

opinion regarding the financial statements under examination.

Reporting Standards

A critical part of the auditor's role is communicating the results of the engagement to a variety of financial statement users. The communication of information and opinions is always a formidable task. The four standards are:

- o The report shall state whether the financial statements are presented in accordance with GAAP.
- o The report shall identify those circumstances in which principles have not been consistently observed in the current period in relation to the preceding period.
- o Information disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- o The report shall contain either an expression of

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opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed.

Government Standards

The General Accounting Office (GAO) establishes standards for audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. These standards incorporate the AICPA standards of reporting for financial audits and prescribe supplemental standards of reporting needed to satisfy the unique needs of government financial audits.

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REVIEW AND
EVALUATION OF
INTERNAL CONTROL
SYSTEMS

What is required

Generally Accepted Auditing Standards require a review of internal controls and an opinion of the reliability of the system used by the project. This review includes considerations of type and quality of personnel, separation of duties and review processes. HUD

requirements, however, go further, specifying particular items which must be reported if not satisfactory.

Tests of
Transactions

What is done In most projects, it is neither practical nor necessary to test all transactions which occurred during the year. Testing a sample of the transactions is sufficient. The auditor normally uses "statistical sampling procedures" adopted by the AICPA and the U.S. General Accounting Office (GAO). Based on the results of these tests, the auditor determines the reliability of the transactions.

Example A complete test of a "disbursement" transaction would actually include examination of the cancelled check, the related documentation (invoice, purchase order, approval, etc.) and posting entries to the project journals and ledgers.

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Tests of Accounts
Balances

What it does In this part of the audit process, the auditor performs whatever tests considered necessary to determine or verify the balance of a specific account.

Example The test of the cash balance would include direct communication with the bank(s) involved, the review of the year-end section of cash receipts and disbursements journals, the ledger balance, examination of bank statements and cancelled checks, both before and after the Balance Sheet date. Evidence generated outside of the audit entity is a necessary component of tests of account balances.

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MATERIALITY

What it is Materiality deals with the importance of an item on the books of the project. Materiality is a basic concept in accounting and guides the accountant to disregard trivial matters and disclose all important matters. There is no obligation on the part of auditors to make corrections and disclosures which they view as not significant to a review of the statements by a knowledgeable reader. However the auditor is expected to include Notes to the Financial Statements which explain in greater detail any items that are material in nature but that may not have

been fully disclosed in the financial statements themselves.

How it is used

Materiality is used to determine whether or not a questionable item on the financial statements is important enough to require detailed disclosure and the necessity of the inclusion of Notes to the Financial Statements. The Asset Management/Loan Management staff's review of financial statements should include review of any Notes to the Financial Statements to determine if a more in depth investigation should be conducted of the transaction or group of transactions detailed in said notes. Materiality is the basis for the type of auditor's qualified opinion. Many auditors, especially those with only one or two HUD clients, are often unaware of the special concerns of HUD projects. To date, the quality of audit work in the compliance and internal control areas still appears quite varied. Therefore, the absence of findings cannot always be relied upon by HUD as an indication that no problems exist. In particular the following

Typical problems

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problems can exist:

- o Some auditors lack competence or diligence in performing compliance tests that are not thought of as part of a normal audit.
- o Items originally found as discrepancies are sometimes eliminated from the report after a conference in which the auditor is persuaded by the client that the item is insignificant and not worth reporting.
- o Items on the questionnaire may be marked "N/A" for questionable reasons, avoiding a "No" response which would require a negative finding and disclosure in the audit report.

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REPORTS

Six basic reports are required:

1. Auditor's Report on Financial Statements Audit. An independent public accountant shall examine the books and records of the owner in accordance with GAS, GAAS and GAAP and shall furnish an opinion on the annual financial statements. The independent accountant may be requested by HUD to justify any material departure from the "unqualified opinion" language.

2. Auditor's Report on Internal Control Structure. In accordance with GAAS and GAS, an independent public accountant shall obtain an understanding of the project's internal control structure and shall furnish a written report on their understanding of the entity's internal control structure and the assessment of control risk made as part of a financial statement audit. This report may be included in either the auditor's report on the financial audit or a separate report. The independent accountant shall justify any material departure from the language standards.
3. Auditor's Report on Compliance. In accordance with GAAS and GAS, an independent public accountant should prepare a written report on their tests of compliance with applicable laws and regulations. This

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report, which may be included in either the report of the financial audit or a separate report, should include all material instances of noncompliance and all instances or indications of improper acts which could result in criminal prosecution. The IPA's test of compliance with applicable laws and regulations should include tests to the extent necessary to comply with GAAS, GAS, and GAAP. The independent accountant shall justify any material departure from the standard language.

The report on compliance shall also include compliance with requirements applicable to nonmajor HUD program transactions.

4. Management Letter, or Schedule of Findings and Questioned Costs. When the auditor identifies a finding the following information should be provided to the mortgagor to permit timely and proper corrective action to be taken. The auditor should attempt to identify:
 - o condition (the nature of the problem),
 - o criteria (what the owner/agent should be doing),
 - o effect (what happened as a result of the problem), and
 - o cause (why the problem exists).
5. Auditor's Comments on Audit Resolution Matters.

This report is recommended by GAAS; it identifies whether a project owner has taken corrective actions on findings from the prior audit report. The auditor should provide the project name, prior audit report number, a brief description of the finding, and the status of the corrective action on the finding. This report also includes findings contained in program review reports, and state agency reports.

6. Auditee's Response, or Corrective Action Plan. This report, recommended by GAAS, must be prepared by the mortgagor. The report should provide a statement of agreement or disagreement with the findings and recommendations. If the auditee disagrees with a finding, specific information should be provided as to why the finding is considered to be incorrect. The auditee should

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also provide detailed actions taken or planned to correct the deficiencies noted in the report.

For examples of the reports discussed in this paragraph see Handbook 4370.1, Reviewing Annual and Monthly Financial Reports.

What audit work papers are

Audit working papers document the work performed by the auditor in the verification of financial data presented in the financial statements. The auditor retains ownership and possession of them at all times, however, they are subject to examination by HUD. In general, working papers are quite technical and are not intended to be easily understood by nonauditors. Accordingly, they should only be requested when persons qualified in auditing are available to review them.

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CHAPTER 7

ACCOUNTING KNOWLEDGE QUIZ

QUESTIONS

1. True or False. The auditor is responsible for devising a system of internal controls to help assure the production of proper financial statements. _____
2. For the purposes of HUD multifamily audits, the auditor must be _____ and _____.
3. The _____ is, in effect, the contract between the auditor and the project.
4. Audit fees charged by an accounting firm may be affected by the following:
 - (1) _____
 - (2) _____
 - (3) _____
5. _____ deals with the importance of an item on the books of the project.
6. True or False. The absence of findings in the audit report can be relied upon by HUD as an indication that no problems exist in the project. _____
7. _____ document the work performed by the auditor, and the verification of financial data presented in the financial statements.
8. _____ provide explanations of transactions or events that may not have been fully disclosed in the financial statement.

9. The three additional audit reports recommended by GAAS are:
 - a. _____
 - b. _____
 - c. _____

ANSWERS

1. False. It is the mortgagor's responsibility. The auditor reviews and evaluates internal control systems established by the mortgagor. (p. 7-2)
2. Qualified and independent. (p. 7-2, 7-3)
3. Engagement Letter. (p. 7-3)
4. (1) Size of the accounting firm (p. 7-4)
(2) Project fiscal year (p. 7-4)
(3) Quality of the project's systems and records (p. 7-4)
5. Materiality. (p. 7-9)
6. False. (p. 7-9)
7. Audit working papers. (p. 7-12)
8. Notes to the Financial Statements (p. 7-9)
9. a. Management Letter, or Schedule of Findings and Questioned Costs
b. Auditor Comments on Audit Resolution Matters
c. Auditee's Response, or Corrective Action Plan