

## Substandard Government Audits: Are They Worth the Cost?

Awarding an audit contract to a CPA firm whose audit work is poor quality—but cheap—may seem prudent, even commendable, to government managers charged with controlling costs. After all, one might argue, what’s the harm if an auditor does substandard work?

Consider this line of reasoning with another type of procurement contract: building construction. Governments often try to save money by hiring inexpensive building contractors who do shoddy work. Although the economic impact is not always obvious, over time the costs become painfully clear. The agency must repair or replace structures, relocate tenants, fight legal battles. The long-term impact of substandard audits, while not always so apparent, can be just as great—especially when such audits are procured year after year.

What makes an audit “substandard”? Technically speaking, an audit is substandard when the auditor and/or audit firm does not comply with one or more auditing standards promulgated by three primary organizations: the American Institute of Certified Public Accountants (for firms who audit private sector and business-type government funds); the General Accounting Office (for governmental auditors); and the Office of Management and Budget (for firms who audit larger government agencies and non-profit entities). Often, standards from all three organizations apply to an audit of a governmental entity.

Auditing standards fall into three categories: general, fieldwork, and reporting. General standards deal with the qualifications of the auditor and the quality of his or her work. For example, an auditor should have adequate technical training to perform audits of governmental entities. Unfortunately, some firms rely on staff with little experience or training in the highly complex field of government auditing. In some cases, junior auditors are asked to perform significant portions of an audit without adequate supervision. For example, quality assurance reviews performed by the HUD’s Real Estate Assessment Center (HUD-REAC)<sup>1</sup> have identified instances in which unsupervised trainees at CPA firms performed 75% of the fieldwork at large public housing authorities. It should come as no surprise, therefore, when such audits fail to uncover the breach of a major contract, significant noncompliance with government regulations, or material liabilities.

Fieldwork standards deal with how the audit is performed. Specifically, the auditor should adequately plan and supervise the engagement, understand the organization’s internal controls, and obtain enough relevant evidence to support the audit opinion. When audit firms fail to meet minimum fieldwork standards, the results can be disastrous.

Take, for example, the fall of Barings Bank, one of the oldest merchant banks in Britain. In 1995 the bank incurred losses of over \$1 billion because a ‘rogue trader’

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<sup>1</sup> A division of the Office of Public and Indian Housing

operated on the bank's behalf in the Singapore futures markets. Liquidators subsequently sued the bank's auditors, Coopers and Lybrand, because the auditors failed to adequately identify and disclose weaknesses in the bank's internal controls. In another case, HUD's Office of Inspector General found that an audit firm performed a substandard cost certification audit of a nursing home. As a result, a mortgage was originated with an inflated level of risk. When the owner subsequently defaulted on the mortgage, HUD incurred a loss of over \$4 million. A Florida audit firm recently signed a settlement agreement with HUD in part because a quality assurance review identified substandard fieldwork. Under the terms of the settlement, the firm must pay \$50,000 in administrative costs, reduce the number and size of entities audited, and procure reviews of its subsequent work. Such substandard audits had a specific and identifiable economic impact on the entities being audited, the funding agencies, and/or the CPA firms performing the audits.

Reporting standards address the auditor's responsibility for reports and opinions. The auditor must opine on whether the entity's financial statements (and its systems of control and compliance for governmental audits) meet generally accepted accounting principles. A recent review of six audits by the Department of Labor identified, in one case, noncompliance estimated at \$64 million. Yet the auditor's internal control finding did not provide sufficient information to the auditee or the funding source to enable them to know the extent of the problem. In addition, the auditors did not perform additional procedures to gather sufficient evidence to support the opinion on compliance. Again, the potential economic impact of this substandard audit was significant to both the funding agency and the government being audited.

Even when an audit fully complies with professional standards, it cannot provide absolute assurance. As the AICPA has written, "Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement" (AU 230.10). Nevertheless, when a government procures an audit that fails to meet minimum professional standards, it assumes a very real risk. If an auditor cuts corners and fails to identify and disclose significant non-compliance, internal control weaknesses or financial liabilities, a governmental organization may face severe economic consequences.

When procuring an audit, it makes economic sense to look closely at the qualifications of the audit firm, the firm's past record of performance, and any evidence that the firm has been sanctioned as the result of a governmental or private sector quality assurance review.

Guidance about procuring a quality audit may be found at HUD-REAC's webpage (GAAP Flyer No. 6): ([http://www.hud.gov/offices/reac/products/fass/pha\\_flyers.cfm](http://www.hud.gov/offices/reac/products/fass/pha_flyers.cfm)).

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