

**GAO**

Report to the Chairman, Committee on  
Banking, Finance and Urban Affairs  
House of Representatives

February 1989

# CPA AUDIT QUALITY

## Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems



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**Accounting and Financial  
Management Division**

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February 2, 1989

The Honorable Henry B. Gonzalez  
Chairman, Committee on Banking, Finance  
and Urban Affairs  
House of Representatives

Dear Mr. Chairman:

At the request of the Committee on Banking, Finance and Urban Affairs, we reviewed the quality of audits of savings and loan (S&L) associations in the Dallas Federal Home Loan Bank District. Our review generally focused on the most recent audits performed by independent certified public accountants (CPAs) of 11 S&Ls out of a total of 29 S&Ls which failed in the Dallas district during the period January 1, 1985, to September 30, 1987.

We concluded that for 6 of the 11 S&Ls, CPAs did not adequately audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards. The CPAs' problems involved (1) inadequate audit work in evaluating loan collectibility and (2) inadequate reporting on S&Ls' accounting practices, regulatory compliance, and internal controls. The nature of the audit and reporting problems was significant enough to warrant our referring the CPA firms performing the audits to regulatory and professional bodies for their review.

The latest audit reports for the 11 S&Ls before they failed showed combined positive net worth totaling approximately \$44 million. At the time of the S&Ls' failures, which ranged from 5 to 17 months after the date of the last audit reports, the 11 S&Ls had combined negative net worth totaling approximately \$1.5 billion.

We believe the public accounting profession plays an important role in ensuring the safety and soundness of the nation's S&L industry. We believe also that CPA firms performing S&L audits need to ensure that those audits are performed in a quality manner. As set forth later in this letter, we are making specific recommendations to the American Institute of Certified Public Accountants (AICPA) to provide improved guidance for ensuring that S&L audits are performed in a quality manner.

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## Background

Many of the S&Ls in the U.S. have failed or are insolvent largely because of uncollectible loans that resulted from extremely risky lending practices, fraud and insider abuse, and poor economic conditions. Because of the industry's financial problems, the federal savings and loan insurance fund is insolvent. GAO reported in January 1989 that the cost to resolve the crisis is likely to exceed \$85 billion.<sup>1</sup>

Many of the S&Ls' problems have been associated with the rapid diversification over the past decade of S&L asset portfolios into loans and investments for land and for acquisition, development, and construction (ADC) projects. S&Ls often provided 100 percent of the financing for such projects, with the borrower's ability to repay often dependent on the projects' completion and ultimate profitability. The projects were potentially more profitable than traditional home mortgages, but also riskier, particularly with many land and ADC projects predicated upon continued inflation in real estate values to make them economically viable. Several S&Ls have experienced rapid, massive growth in ADC loans, with such loans generally comprising the majority of assets. As noted in our January 13, 1989, testimony, many of those loans were concentrated in specific geographic areas and were based on appraisals that were not adequately or accurately substantiated. Also, many of the loans were made to related parties or "inside" management.

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## The Role of Auditing

Federally insured S&Ls are regulated by the FHLBB and are subject to examination by the Federal Home Loan Banks. In addition, the FHLBB requires that federally insured S&Ls be audited annually by independent public accountants. Federal Home Loan Bank examinations are made to help regulators know whether S&Ls are managed properly and in compliance with federal regulations. CPA audits are performed to express an opinion on the fairness of S&Ls' financial statements and to report any material weaknesses in internal controls. In rendering an opinion on financial statements, auditing standards require public accountants to consider the need to disclose conditions that raise a question about an entity's ability to continue in business.

Properly performed audits play a key role in the S&L industry. Independent audits are an integral part of the system of controls designed to identify and report problems in S&Ls when those problems arise. As

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<sup>1</sup>Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues, Statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Committee on Banking, Finance and Urban Affairs, House of Representatives, January 13, 1989.

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such, audits should provide useful information to federal regulators who oversee S&Ls, depositors and shareholders in S&Ls, and the public.

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## Objective, Scope, and Methodology

Our objective was to assess the quality of CPA audits of 11 failed S&Ls in the Dallas Federal Home Loan Bank District. We generally focused on the most recent audits performed by CPAs of 11 S&Ls out of a total of 29 which failed in the Dallas district during the period January 1, 1985, to September 30, 1987. The audits we reviewed were performed by nine separate CPA firms. The Dallas district includes the states of Arkansas, Louisiana, Mississippi, New Mexico, and Texas. The 29 S&Ls were identified from a database developed by GAO from Federal Savings and Loan Insurance Corporation (FSLIC) records. The database includes all the S&Ls in the U.S. that have been liquidated, placed in the Management Consignment Program (MCP), merged, or otherwise identified by FSLIC as having potential problems.

For the purposes of this review, we considered an S&L to have failed when FSLIC placed it either into receivership or into FSLIC's Management Consignment Program. The MCP was initiated by FSLIC in April 1985 to provide a means for stemming the losses of some of the most severely troubled S&Ls. Under the program, an S&L's management and its board of directors resign and are replaced by new management and directors, with new managers chosen by FSLIC, usually through a contract with another, healthier S&L.

In the context of our work, we measured audit quality against the extent of compliance with generally accepted auditing standards and FHLBB regulations in effect at the time the audits were performed.

We judgmentally reviewed the audits of 11 of those 29 S&Ls, generally focusing on the most recent completed audit prior to each S&L's failure. The audits of 9 of the 11 S&Ls were selected using the following three criteria:

- (1) there was high growth in the S&L's assets in the 3 to 4-year period before failing,
- (2) the S&L's financial statements did not reflect relatively large loan losses, and
- (3) the audit reports for the S&L did not question the extent of loan losses.

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We also selected the audits of two other S&Ls which met the first two characteristics, but in which the audit reports did question the extent of loan losses.

For the other 18 S&Ls, the CPA audit reports generally identified problems with loan collectibility or other factors affecting the S&Ls' ability to continue in business. GAO recently reported, however, that despite knowledge of critical S&L problems, federal regulators were not always effective in obtaining agreements from S&L management for corrective action. As noted in our January 13, 1989, testimony, regulators' failure to properly act on identified S&L problems has been partly attributable to inexperienced and insufficient numbers of federal examiners, FSLIC's poor financial condition, and conflicting responsibilities on the part of the FHLBB and the Federal Home Loan Banks as promoters of the S&L industry and regulators of S&L activities.

In our reviews of the audits, we reviewed the auditors' reports, which include the audit opinion and the internal controls report to management; the permanent and correspondence files; the audit program; and the supporting working papers. We also reviewed the reports by federal examiners for each of the S&Ls. We focused our review primarily on CPAs' work in the loan area because uncollectible loans have often been a major factor in S&L failures.

We also reviewed the auditing standards and guidance contained in various AICPA publications, including the AICPA Codification of Statements on Auditing Standards, and the AICPA Audit and Accounting Guide for Savings and Loan Associations, and various AICPA manuals regarding S&L accounting and auditing. We also reviewed an S&L industry analysis prepared by a major CPA firm, and the federal regulations for public accountants' audits of institutions insured by FSLIC—FHLBB, Bulletin Number PA-7a. We interviewed various officials of the FHLBB and the Dallas Federal Home Loan Bank District, and various S&L experts regarding requirements for S&L audits.

We conducted our work between January 1988 and January 1989 in accordance with generally accepted government auditing standards. We discussed our findings with the CPA firm personnel responsible for the audits to verify the accuracy and completeness of the facts in our report. However, in accordance with the requester's wishes, we did not request written comments on a draft of this report.

## Failures by CPAs to Properly Audit and to Report S&L Problems

Based on our evaluation, we believe that for 6 of the 11 S&Ls in our review, CPAs did not properly audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards. CPAs had insufficient working paper evidence that they had adequately

- evaluated concentrations in high-risk loans;
- identified and evaluated the potential financial effects of increases in the number of restructured and past-due loans;
- sought to independently verify oral assertions by management that problem loans were collectible; and
- followed up on problems identified by federal examiners, such as inadequate appraisals on the collateral underlying S&L loans.

Also, CPAs did not adequately report certain problems, including

- S&L accounting practices not in conformity with prescribed accounting principles;
- regulatory violations, such as excessive loans to single borrowers and related parties;
- formal regulatory actions, such as cease and desist orders resulting from unsafe and unsound operations, and in one case noncompliance with those orders;
- concentrations of high-risk loans in limited geographic areas; and
- material internal control weaknesses.

## Insufficient Evidence of Audit Work

Audit standards for fieldwork generally encompass the planning and performance of the audit and the sufficiency and competency of evidential matter obtained to support a CPA's conclusions and opinions. Standards require that CPAs retain a written record of their audit evidence in the form of working papers. The information contained in working papers constitutes the principal record of the work that the auditor has performed and the conclusions that the auditor has reached.

Loans are a critical area for review in S&L audits because loans, and interest on loans, generally comprise the most significant portion of S&Ls' assets and revenue, respectively. When auditing loans, CPAs should be concerned with the amount that may be uncollectible. Independent auditors should obtain reasonable assurance that management has estimated the current amount of loans that have a high risk of not being collected. We identified a number of factors which we believe CPA firms should use in evaluating the estimates, such as significant increases in high-risk loans; delinquent or past-due loans; loans in which terms were

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modified or restructured; loans insufficiently collateralized; loans collateralized by assets with a high rate of recent ownership turnover, sometimes referred to as "land flips"; concentration of loans to individual parties, particularly related or "inside" parties; concentrations of high-risk loans in limited geographic areas; potential problem loans identified by regulatory examiners; and in regard to the value of real estate collateral underlying the loan portfolio, the qualifications and relationship of appraisers to S&Ls and borrowers.

The problems we found with the quality of the audit work involved inadequate evidence in the working papers to support that CPAs had properly evaluated loan collectibility. The problems are illustrated below. In all cases, we believe the dollar amounts involved were material in relation to the financial statements of the S&L audited.

- In a 1984 audit, a CPA firm lacked sufficient evidence in its working papers that it performed an independent analysis of the collectibility of ADC loans. The S&L had a significant portion of its assets in ADC loans.
- In a 1985 audit, a CPA firm lacked sufficient evidence in its working papers that it identified and evaluated the potential effect of significant increases in restructured loans. The working papers did not indicate that the CPA firm sought to determine the total amount of restructured loans, nor that the CPA firm sufficiently evaluated the collectibility of most of such loans. Federal examiners later found that the S&L did not report that it had restructured \$625 million in loans during an approximate 1-year period covering approximately one-half of the 1985 audit period.
- In the same audit as above, the CPA firm was aware of several past-due loans, including one past-due loan of \$30 million guaranteed by two principal shareholders; however, there was little evidence in the working papers that the firm adequately evaluated the collectibility of those loans, appearing to rely primarily on guarantors' unverified assertions that they could repay the loans.
- In a 1985 audit, a CPA firm did not have evidence in its working papers that it sought to independently verify oral assertions by S&L management that a number of problem loans were collectible. The firm itself had identified the loans as having collectibility problems. This included at least one major loan in which the CPA firm had no evidence that it sought to verify oral assertions concerning the loan's collectibility from a member of the S&L's management who was also one of the borrowers on the loan.
- In a 1985 audit, a CPA firm did not have sufficient evidence in its working papers that it followed up on severe loan problems and management



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deficiencies identified by federal examiners. For example, examiners found that some major loans had unsubstantiated appraisal values on the collateral underlying the loans. The CPA firm had also questioned the adequacy of appraisals in general. The firm's working papers, however, did not indicate that the firm adequately followed up on either the examiners' findings or its own findings. In one case, the working papers showed no evidence that the firm addressed federal examiner findings that the S&L had incurred unreported loan losses of \$7 million on a condominium construction project.

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## Inadequate Reporting

Auditing standards require that CPAs report whether financial statements are presented in conformity with generally accepted accounting principles. In doing so, standards require CPAs to ensure that the statements are informative of matters that may affect their use, understanding, and interpretation. Accordingly, CPAs are required to (1) disclose instances in which financial statements do not conform with generally accepted accounting principles, and (2) report any information undisclosed in the financial statements that may affect their usefulness, including factors that they consider may affect the auditee's ability to continue in business.

FHLBB regulations require CPAs to study and evaluate an S&L's internal controls and report the results of their study and evaluation to the S&L and the FHLBB. The report should include any material internal control weaknesses noted and any recommendations for strengthening internal controls.

We identified reporting problems which predominantly involved CPAs not disclosing in their audit reports instances in which financial statements were improper; not disclosing matters, such as regulatory violations and enforcement actions, that we believe might have affected the usefulness of financial statements to others; and not following FHLBB regulations and auditing standards for reporting on internal controls, such as disclosing all material weaknesses in internal controls. The problems are illustrated below. In all cases, we believe the dollar amounts involved were material in relation to the financial statements of the audited S&L.

- A CPA firm did not properly disclose in its audit report that an S&L incorrectly reported \$12 million in potential recoveries from pending lawsuits. Accounting principles prohibit reporting such recoveries until the

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lawsuits are resolved. The S&L used the potential recoveries to help offset its reported losses from uncollectible loans. Also, the CPA firm did not fully disclose its own finding that the S&L might likely incur even greater losses than it reported.

- A CPA firm did not disclose in its audit report that its client improperly reported a \$3 million unrealized gain in investment securities, even though the firm had evidence in its working papers that the S&L did not follow prescribed accounting principles in reporting the gain. The firm also did not take exception for a finding in its working papers that the S&L improperly reported the risks associated with \$86 million in investments.
- Two CPA firms did not disclose evidence that S&Ls had exceeded FHLBB regulations regarding limits on the amount of loans that could be extended to any one borrower.
- Two CPA firms did not disclose that S&Ls had received formal enforcement orders from the FHLBB to cease and desist from their unsafe and unsound lending practices. In one of those two cases, the CPA firm not only did not comply with its own policy to disclose such action, but it also had information from federal examiners that the S&L was failing to comply with the cease and desist order.
- One CPA firm did not disclose that an S&L had several hundred million dollars of loans secured by property in a limited geographic area; a majority of such loans were to principal shareholders in the S&L.
- Two CPA firms reported that S&Ls had no material weaknesses in internal controls even though the S&Ls were under formal regulatory enforcement actions from the FHLBB for severe internal control weaknesses relating to appraisal and other underwriting and managerial deficiencies.

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## Referrals

We believe the audit and reporting problems we found at 6 of the S&Ls in our review were significant enough to warrant referral of the CPA firms performing those audits to regulatory and professional bodies for their review. In determining whether to refer, we took into account the nature and significance of the problems we found and the effect those problems had on the audit as a whole. Review by regulatory and professional bodies of CPAs' audit work and reporting, and disciplinary action if warranted, would increase the public accounting profession's awareness of the consequences of performing poor quality audits.

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## Conditions Leading to Audit Problems

Based on our discussions with CPAs and reviews of their work, we believe that the CPA firms did not always have sufficient knowledge of the risks associated with land and ADC loans, and that the CPA firms did not always respond quickly to the dramatic changes in the financial operations of their individual clients or the S&L industry.

In those audits where we found problems, the working papers generally did not contain sufficient evaluations of the collectibility risks associated with land and ADC loans. One CPA firm, for example, informed us that it did not evaluate the collectibility of ADC loans because the loans were new and assumed to be collectible. Most of the firms in our review also had insufficient evidence that they independently verified the appraised value of collateral underlying land and ADC loans, even though such loans are more speculative in nature than residential mortgages. Most of the CPAs in our review, for example, did not hire or request S&Ls to hire independent appraisers to verify collateral values assigned by appraisers hired by the S&Ls or by the borrowers, nor did they verify oral assertions by management of loan collectibility and collateral values.

Further, while assets were greatly increasing for most of the S&Ls in our review, audit approaches from year to year often appeared to generally contain little substantive change and, in some cases, appeared to allocate relatively little audit work to high-risk land and ADC loans. The problem was compounded in those cases where CPAs did not adequately follow up on evidence they had, such as federal examiners' findings, that S&Ls were beginning to experience problems in their loans.

Also, we believe that the AICPA has not responded quickly to all the major changes in the S&L industry. The AICPA is the national association of CPAs and the most important private group promulgating standards for S&L auditing. The AICPA's auditing guide and procedures for S&Ls, the AICPA Audit and Accounting Guide for Savings and Loans Associations, was last substantively revised in 1979. It contains little discussion of the risks associated with land and ADC loans; the effect of increases in restructured and past-due loans on collectibility; coordinating audit work with the results of regulatory examinations; the importance of disclosing regulatory actions and violations to depositors, shareholders, regulators, and other users of audit reports; nor does it include the requirement to report all material internal control weaknesses. Although the AICPA has issued guidance on the financial statement classification and recognition of income from land and ADC activity during the last several years, it has not addressed the extent of the collectibility risks

that such activity poses to S&Ls and the audit process. The AICPA currently plans to publicly issue a draft revised guide in late 1989 or early 1990.

## Conclusions

A major portion of the S&L industry is in a financial crisis. It is important that CPA audits be performed in a quality manner to help the FHLBB evaluate the financial condition of federally insured S&Ls and to help the FHLBB and others accurately gauge the extent and magnitude of the S&L industry's problems.

Although based only on a limited review of 11 failed S&Ls, the results of our study indicate that significant improvements are needed in order to ensure that CPA audits of S&Ls are of adequate quality to permit the FHLBB and others to rely on CPA audits to determine whether S&Ls' financial statements are presented fairly and whether effective internal controls are in place. We believe there is ample opportunity for CPA firms and the AICPA to bring about improvements in the quality of S&L auditing.

## Recommendations

Because of its role and influence in S&L auditing, we recommend that the AICPA expeditiously revise the AICPA Audit and Accounting Guide for Savings and Loan Associations to include specific steps for ensuring that those audits are performed in a quality manner. The guide should include detailed discussion and specific requirements for, among other things,

- identifying the nature and inherent risks of land and ADC loans;
- evaluating the potential effects of increases in restructured and past-due loans;
- following up on the work of federal examiners;
- ensuring that regulatory violations and formal regulatory actions are disclosed; and
- properly reporting all material weaknesses in internal controls.

In addition, we recommend that the AICPA communicate the results of our review and other noted S&L audit problems to all AICPA members, instructing them on the types of problems that may occur in auditing S&Ls. Such instruction should recommend that CPA firms performing S&L audits review the quality of those audits to help ensure that

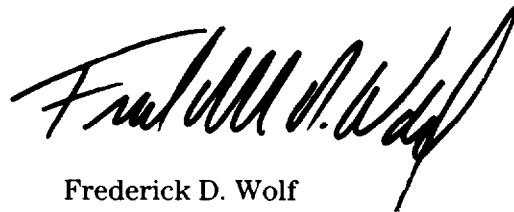
- staff performing the audits have sufficient knowledge in S&L operations;

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- audit methodologies are specifically tailored to take into account changes in the operations of their individual S&L clients and the S&L industry environment;
  - evidence of all audit work is properly documented in the working papers; and
  - financial risks, regulatory violations and formal regulatory actions, and internal control weaknesses are fully disclosed in audit reports.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from the date of this report. At that time, we will send the report to the Chairman, Federal Home Loan Bank Board; the Chairman, American Institute of Certified Public Accountants; and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of John J. Adair, Director, Audit Oversight and Policy, and David L. Clark, Assistant Director, Audit Oversight and Policy. Other major contributors are listed in appendix I.

Sincerely yours,



Frederick D. Wolf  
Assistant Comptroller General

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