

Auditing Concepts and Standards

BY PATRICK J. COSTELLO, CPPM, CF, SHAMROCK CHAPTER

This is the first in a series of articles addressing Auditing in general and Auditing as a function of Property Management. The second article will address the System Analysis process. The third article will look at the role professional organizations play in the field of auditing.

Understanding Audits

This article offers the reader an opportunity to understand audits and system analysis processes. In a broad context, audits and system analysis are “kissing cousins” – system analysis being a subset of audits that relates to government contracting, compliance, and property issues. The general category of audits covers a broad range of audit types, most of which relate to financial issues (e.g., real estate, financial portfolio, tax-related audits, or accounting practice business audits). Audits are complex processes that are defined by the relationship of the auditor to the authority requesting the audit and the entity being audited.

Today we see the discipline of auditing under fire because some major auditing and consulting firms have shown themselves lacking in compliance with industry-established ethics codes of conduct. The media is ripe with news describing the conflict generated by the consultants/auditors when they ignored the principles of their profession and advised clients to misrepresent themselves to the public. They created an inter-dependence between their customers and their firms that enriched both entities at the expense of the employees and stockholders. Auditors are required, by the nature of their profession, to render opinions (attestations) based upon valid evidence relating to the condition of their customers’ accounting practices. The auditor is liable for the accuracy of the opinion rendered. This liability is a constant reminder of the extensive responsibilities entrusted to a person identified as an auditor. Responsibilities are not to be taken lightly by people who conduct audits or desire to become auditors. A plaintiff may bring suit against an auditor under common, statutory, or both common and statutory law.¹

Auditing is a serious discipline. Auditors must be the most experienced, knowledgeable, professionally qualified individuals in a discipline. National Property Management Association represents the greatest potential for finding individuals uniquely qualified to be auditors in the discipline of Personal Property (Asset) Management.

The Role of Auditing:

The demand for auditing is a result of four underlying factors:

The complexity of the system refers to the activity in an institution or business, along with the interaction of the

exchanges of information, which often make the proper recording of transactions and allocations of costs difficult to track.

The physical remoteness of the system increases the likelihood both of intentional or unintentional error and of demand for an independent party to examine the records.

Bias and motives of the provider create a demand for an independent party to lend credibility to the company’s financial or property system statements. For example, management may be more optimistic about the status of the property system than the Government. The optimism may be based on accurate or inaccurate statements of the property department. The property department may have a vested interest in presenting an optimistic picture of the system.

Consequences associated with the reliability of information are cause for verification when the information is used for costly business decisions, such as buy-outs, new contracts, stock evaluation, market pricing, etc.

To understand the auditing process, you should become familiar with the definitions that are important to auditing.¹

Definition of Auditing: A systematic process of (1) objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and (2) communicating the results to interested users.

Systematic Process: As a systematic process, auditing is a logical, purposeful, structured approach to decision-making; it is not an unplanned, haphazard process.

Objectively Obtaining and Evaluating Evidence: Auditing involves the collection of evidence. Evidence represents the information collected by the auditor that will affect the auditor’s decision process. Although evidence itself may be more or less conclusive in nature, the process of collecting and evaluating evidence should be objective.

Assertions about Economic Actions and Events: Assertions are related to the financial statements of the organization being audited. The auditor is given information and statements from the auditee. These statements represent the auditee’s assertions about actions and events and include not only the statements themselves but also the accounting system and process. (This statement looks, at first glance, to relate only to economic issues and financial statements. However, if you understand that property is in fact a function of economic values and that financial statements include statements of assets and inventories, you can see where property issues fit.)

The Degree of Correspondence between Assertions and Established Criteria: Correspondence here means the

enhance the stature of the profession and its ability to serve the public.

The Auditor's Legal Liability: We live in a litigious society. The auditor today can reasonably expect his or her every action—regardless of how right or wrong it may be—to be questioned in a court of law and possibly to result in substantial damages being awarded.

Privity of Contract is a relationship between two or more parties that creates a contractual duty. In an auditing context, the auditor and client have a privity or contractual relationship that is usually established by a contract called an engagement letter. Usually, however, third parties such as investors or creditors are not parties to the contract and are said to have a nonprivity relationship.

Due professional care is the performance of, and reporting on, a professional engagement with the degree of care, competence, learning, and experience commonly possessed by other members of the auditing profession and required by professional standards.

Negligence is the failure of the auditor to perform or report on an engagement with the due professional care and competence of a prudent auditor. The auditor is negligent if he or she fails to do what the ordinary, reasonable, prudent auditor would do, or does what the prudent auditor would not do. Sometimes negligence may be referred to as simple or ordinary. Simple negligence, ordinary negligence, and negligence are synonymous.

Gross negligence (a.k.a. recklessness or constructive fraud) is a serious occurrence of negligence tantamount to a flagrant or a reckless departure from the standard of due care. These terms are frequently used interchangeably and are equivalent to sloppy auditing or lack of a reasonable basis for a belief. A plaintiff in establishing gross negligence must prove each of the following assertions:

- The auditor made a representation about a material fact with lack of reasonable support.
- The purpose of the representation was to induce reliance by another (for example, a client or a third-party user of the financial statements).
- The representation was relied upon by the client or a third party.
- The reliance caused damages to the client or third party.

Fraud occurs when an auditor issues an opinion on the financial statements knowing that the financial statements or the audit report thereon are false. Fraud differs from gross negligence in that the auditor does not merely lack reasonable support for belief, but has both knowledge of the falsity and intent to deceive a client or third party.

Types of Audits (not an exclusive listing)

Audits of Financial Statements
Compliance Audits
Contract
Federal and State law

Policies and Procedures
Operational Audits
Effectiveness
Efficiency

Why do we need audits?

Discovery: A Discovery Audit is conducted to affirm or disaffirm a suspected problem.

Investigative Reasons: Investigative Audits are conducted to determine the facts when it has already been ascertained that a problem exists and the answers to questions are needed.

Risk Assessment: A Risk Assessment Audit is conducted to determine the risk and the magnitude of the risk.

Validation: A Validation Audit is conducted to conclusively verify a finding.

The Relationship between Audits and System Analyses

Audits have a broader financial scope than System Analyses in that most audits cover a spectrum of financial functions that tie to corporate financial reporting rather than a focus on property management. The underlying issue with audits and system analyses is the actual loss or the risk for loss (money) associated with the system of controls established at the organization being audited.

System Analyses are a form of Compliance Audits focusing on contract materials, capital type assets, and real estate that are part of the contract. A financial impact is associated with System Analyses. All of the previous discussion of Audits is applicable to System Analyses. A System Analysis is an audit of the organizational property control system.

Summary

I have addressed many of the basics of auditing in this article; however, all of us must understand that this is only a glimpse of a vast discipline. ♦

Notes: 1 Auditing, Dan M Guy/C Wayne Alderman, Harcourt Brace Jovanovich, 1987

2 Statement on Audit Standards (SAS) No 1, Generally Accepted Auditing Standards (GAAS)

PATRICK J. COSTELLO, CPPM, CF, lives in Nashville, Georgia. He has been a consultant for the last five years. Pat retired from the U.S. Army in 1985 as a LTC after serving 31 years. He worked as a Property Manager with several Aerospace Corporations for thirteen years until he retired in 1997. Pat directed inspection teams during his military career that audited the logistics and maintenance of military units in the United States and overseas. He has participated in the conduct of hundreds of inspections and audits, external and internal, in his forty-six years as a logistician. Pat developed and teaches a course in Auditing/System Analysis for NPMA. He has served on the national level of the NPMA as Director of Professional Development for more than six years, as Secretary of the Eastern Region, and as President of the Nutmeg Chapter, formerly the Pioneer Valley Chapter. Pat has published numerous articles on property topics over the past seven-teen years.