United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
9:30 a.m.
Thursday
June 21, 1990

Audits of Small Business Investment Companies

Statement of
Brian P. Crowley
Director of Planning and Reporting
Accounting and Financial Management Division

Before the
Committee on Small Business
U.S. Senate

048785/141624

GAO/T-AFMD-90-23

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss certified public accounting firm audits of small business investment companies (SBICs). In particular, you asked that we address several questions concerning audits of River Capital Corporation, an SBIC that owed the Small Business Administration (SBA) $28.5 million when it filed for bankruptcy in August 1989.

In performing our work, we reviewed the working papers for the final River Capital audit conducted by the public accounting firm of Arthur Andersen and discussed the audit with officials from this organization. Further, we discussed the River Capital case with the examiner appointed by the Bankruptcy Court, the SBA inspector general, and officials from SBA's Investment Division. As agreed with the committee, we focused our work on the investment valuation area.

The following responses to your questions reflect the results of this work.

1. Was there any impropriety in the inspector general's staff sharing a copy of the draft audit report for River Capital with Arthur Andersen prior to its finalization?

Offices of Inspectors General (OIGs) are required, by the Inspector General Act of 1978, to perform their audits in accordance with generally accepted government auditing standards. These standards state that one of the most effective ways to ensure that a report is fair, complete, and objective is to obtain advance review and comments by responsible auditee officials and others as may be appropriate. In the River Capital case, the OIG's draft audit report questioned Arthur Andersen's adherence to generally accepted auditing standards during the company's audit of River Capital. Because the draft report was critical of the auditing firm, we believe that there was no impropriety in the OIG giving Arthur Andersen an opportunity to review and comment on the draft report.

2. Was there any impropriety in how the office of inspector general handled the River Capital case, including the lack of a final report on the failure of River Capital, considering that the company was in bankruptcy and that there existed the possibility of litigation between the agency and the accounting firm?

As the result of an allegation received late last year, we examined the OIG's handling of the River Capital case and found that no improprieties existed in its handling of the case. We considered several points in arriving at this conclusion.

Generally accepted government auditing standards state that written audit reports are to be prepared communicating the results of each government audit and that these reports are to be issued promptly so as to make the information available for timely use by management.

The OIG conducted its examination of River Capital during July 1988. Although it had not yet received the OIG audit report, SBA management was aware of serious problems at River Capital. The company had defaulted on its scheduled loan payments to the Small Business Administration and, in August 1988, SBA's Investment Division transferred River Capital to the Office of Portfolio Management. This office was responsible for recovering SBA's $28.5 million claim against River Capital. As a result of this transfer, River Capital could receive no additional SBA funding.

In November 1988, the Assistant Inspector General for Audit reviewed the draft OIG audit report on River Capital and instructed the auditor to revise it, in part, to provide more detailed support for the auditor's conclusions. We reviewed the November draft report and agree with the Assistant Inspector General's conclusion on the need for changes.

In February 1989, the Assistant Inspector General sent the revised draft to SBA management and Arthur Andersen for review and comment. He and his staff spent the next months revising the draft. This task was made more difficult by changes in personnel, including the retirement of the OIG auditor who conducted the audit and initially drafted the report.

River Capital filed for bankruptcy on August 24, 1989. In October 1989, the SBA General Counsel and the Assistant U.S. Attorney asked the inspector general not to issue the final audit report to avoid any potential impact on possible future litigation against River Capital officials and Arthur Andersen.

Based on our review of the draft report and discussions with OIG officials, and in light of the requests from those responsible for litigation involving the River Capital case, we do not believe the inspector general engaged in any impropriety by not issuing a final audit report.

3. Did Arthur Andersen follow generally accepted auditing standards in the performance of its 1986 and 1987 audits of River Capital?

When conducting audits, certified public accounting firms must conduct their work in accordance with generally accepted auditing standards. In addition to these standards, the American Institute of Certified Public Accountants (AICPA) issues interpretations and audit guides on the application of standards. These interpretations and guides do not have the authority of standards, but auditors and others rely heavily on them for specialized accounting and auditing practices within particular industries. The applicable AICPA guide for audits of companies participating in SBA's Small Business Investment Company (SBIC) program is Audits of Investment Companies. The guide contains the following with regard to the issue of investment valuation.

> "The independent auditor does not act as an appraiser for security values estimated in good faith by the board of directors, and is not expected to substitute his or her judgment for that of the fund's directors. Instead, the auditor should review the company's procedures for its continuing appraisal of such securities, determine whether the methods established for valuation are followed, and make certain that these methods have been reviewed and approved currently by the board of directors. The auditor should review the procedures applied by the directors in valuing such securities, and inspect the underlying documentation to determine whether the procedures are reasonable and the documentation appropriate for that purpose."

The valuation of investments was critical to the fair presentation of River Capital's financial statements because investments represented 85 percent of its assets. Based on our review of Arthur Andersen's working papers, it appears that Arthur Andersen took steps that were designed to carry out the guidance contained in the audit guide with respect to the valuation of securities. The partner and manager assigned to the audit attended the board of directors meeting at which the companies in River Capital's portfolio were discussed and year-end valuations for financial statement purposes were determined. The information provided the Arthur Andersen officials for the meeting included investment overview, investment strategy, and other financial information for the companies in River Capital's portfolio. The working papers also contained the audit manager's notes made during the board's annual meeting on the valuation of companies in the portfolio.

Although not fully documented in the working papers, Arthur Andersen representatives informed us that the audit staff evaluated the procedures used by the board during the valuation meeting and considered them adequate.

In addition, the working papers showed that the audit staff performed a number of other steps related to the investment account. For example, they confirmed equity and debt holdings and interest receivable from companies in which River Capital invested, physically observed securities and compared the results with company records, and tested changes in investment account balances.

Finally, Arthur Andersen qualified its audit report based on uncertainties concerning the investment and interest receivable balances contained in River Capital's financial statements. The report, which is in accordance with the AICPA's audit guide, stated that the investment values

> "were estimated by the board of directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the directors in arriving at their estimate of value of such securities and investments and have inspected underlying documentation, and in the circumstances, believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the board of directors' estimate of values may differ significantly from the values that would have been used had a ready market existed for the securities, and the differences could be material."

Arthur Andersen also qualified its report with regard to the collectibility of the interest receivable contained in the financial statements.

4. Would the use of generally accepted auditing standards in the River Capital audit by Arthur Andersen have revealed the

overvaluations of investments or other problems which led to River Capital's failure?

The River Capital audits by the OIG and Arthur Andersen were conducted prior to River Capital's bankruptcy and, as such, their working papers and other records did not specifically identify the reasons for its failure. Our work did, however, raise some questions about the adequacy of generally accepted auditing standards, as interpreted by the AICPA's audit guide, concerning the valuation of investments by SBIC companies.

Generally accepted auditing standards require that the auditor gather sufficient competent evidential matter as a basis for formulating an opinion on the financial statements. Therefore, their use should identify excessive overvaluations of investments recorded on a company's financial statements.

As mentioned earlier, auditors rely heavily on the AICPA's audit guide when planning and conducting their audit tests. However, while we agree with the investment company audit guide's statement that auditors do not act as appraisers, we believe that the guidance does not go far enough in detailing the types of documentation and records that auditors should examine when auditing portfolio valuations determined by boards of directors. In our view, the audit guide wording offers the opportunity to conduct less than a sufficient investigation. The guide should require that the auditors look behind the financial and summary business outlook information discussed during the annual board of directors valuation meeting.

For example, auditors should compare planned business activities and forecasts with reported results and seek out information on similar companies in the same industry for comparison purposes. When problems are indicated, auditors should consider visiting some of the companies and examining financial and other information in addition to the data provided during the board's meeting. In addition, they should consider contacting government officials whose decisions may have a material impact on a portfolio company's ability to continue operations or achieve its planned level of activity.

We believe that the audit guide should be revised by the profession after sufficient study and deliberation. We have contacted the Chairman of the AICPA's Investment Companies Committee who stated that no plans currently exist for revising the audit guide.

5. Could or should other changes be made in either the Inspector General's audit procedures or the Investment Division's review of SBIC audits which might help determine whether other licensees may be in jeopardy in spite of good reports from the public accounting firms which are performing annual audits?

We have not had the opportunity to perform the detailed analyses of the SBIC policies and procedures and inspector general examination work needed to fully respond to this question. However, in a May 1988 report, CPA AUDIT QUALITY: Improved Controls Are Needed to Ensure Quality Audits of Federal Loan Programs (GAO/AFMD-88-3), we made several recommendations to improve controls for relying on the work of certified public accountants (CPAs). These recommendations included agency reviews of the quality of CPA reports and a requirement that CPAs follow generally accepted government auditing standards when conducting their audits.

- - - - -

Mr. Chairman, that concludes my formal statement. I will be happy to answer any questions you or members of the Committee may have.