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WHAT DIRECTORS AND MANAGERS SHOULD KNOW ABOUT FINANCIAL AUDITS

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The paper provides information on the function and scope of financial audits and auditors. Subject matters covered are: auditor selection, characteristics of outside auditors, comprehensiveness of audit report and review process of a final audit.

Introduction.

Retention of a qualified outside accounting firm is one means by which the financial resources of a company can be properly protected on behalf of outside investors and lenders. Outside auditors are retained to render an independent and impartial opinion on a company's financial statements. Their critique of accounting systems, records and controls is a by-product of the auditing they do in order to render an opinion on the financial statements. The report prepared by the outside auditing firm is known as the audit report.

In many cases, the outside auditor's competence may be relied upon for the development of a company's financial statements. However, an audit does not relieve management of its responsibility for a fair presentation of the numbers and information reported in the financial statements. Moreover, retention of an outside auditor does not shift the

responsibility for the financial statements onto the auditor. The auditor's responsibility for statements examined is confined to rendering an independent opinion based upon generally accepted auditing standards as prescribed by the American Institute of Certified Public Accountants (AICPA) in the Statements on Auditing Standards.

The point to be made: A company's financial statements remain the representations of management which also includes the board of directors in a corporate entity. Management can be held liable both personally and corporately for errors, misrepresentations or fraud. Therefore, it is important that every effort be made to insure fair presentation of accounting records and supporting information to be audited by the outside auditing firm.

Why Have An Audit?

The usual reasons for having financial audits are to:

1. Examine and verify the integrity of accounting records and internal control procedures.
2. Serve as a control instrument over the record keeping for which management and clerical personnel are responsible.

3. Examine, verify, and report the financial condition (balance sheet), results of operations (operating statement), and statement of changes in financial condition for a given time period.
4. Facilitate obtaining credit from banks and third party creditors.
5. Identify the need for financial consultation and guidance when appropriate.
6. Satisfy shareholders that their interests are being adequately safeguarded by management.

Occasionally, auditors will make recommendations on capital investments, organizational problems, and operating issues. These kinds of recommendations also may be provided by other experts such as professional management or financial consultants. Thus, management may also wish to consider consulting with professionals in fields other than auditing as the need arises.

Auditor Selection Characteristics

Some characteristics of auditors which might be considered when making a selection include:

1. Professional competence.
2. Ability to maintain independence and a high degree of integrity.
3. Familiarity with the company's accounting practices and the industry in which it operates.
4. Ability to develop and conduct an efficient audit program.
5. Ability to communicate with management.

6. Ability to provide competent suggestions for improving financial accounting practices.
7. Understanding of their reporting responsibility directly to the board in a corporate entity.
8. Willingness to correct any oversights occurring during the audit program.

The Auditor's Responsibilities

Outside auditors should be required to:

1. Make a systematic examination in accordance with generally accepted auditing standards which includes such tests of accounting records and other auditing procedures considered necessary under given circumstances. This examination should include a review of internal control procedures, selected financial records and legal documents, and verification of amounts shown on the accounting records.
- This process usually focuses upon accounts such as cash and securities, accounts receivable, inventories, fixed assets, insurance records, contracts, liabilities, equities, sales, expenses, operating margins, and taxes. Internal control examinations include: verifying the use of standardized accounting procedures; evaluating check writing authorization policy and procedures, bank reconciliation procedures, inventory control procedures, supply purchase procedures, and personnel record keeping assignments and responsibilities; and analyzing personnel responsibilities for safeguarding the assets of the company.
2. Ascertain that the company's financial condition (balance sheet),

results of operations (operating statement), and changes in financial condition are consistently presented in conformity with generally accepted accounting principles.

3. Render an expert and impartial opinion on the fairness of the company's financial statements as presented by management.
4. Determine compliance of the company's financial records and accounting practices with its articles of incorporation, bylaws, board policies as reflected in minutes of board meetings, and loan agreement terms.
5. Identify internal accounting control strengths and weaknesses and propose solutions for any identified problems. Recommended corrective measures should be outlined in a management letter.
6. Submit the final audit report on the agreed upon completion date.

The Auditor's Report

Standard audit reports include a report on the auditor's letterhead. This report includes two basic paragraphs. The first is the scope paragraph. It describes the work performed by the auditors. The second is the opinion paragraph. It expresses the conclusions derived from the examination process. Here is where an opinion is rendered as to the fairness of the numbers and information reported in the financial statements. Particular attention should be given to reviewing this paragraph.

The auditor's report should not be confused with the management letter mentioned earlier. Each deals with separate issues. The management letter specifically identifies internal accounting control weaknesses and suggests corrections.

Audited Vs. Compilation and Review Financial Statements

An opinion on the fairness of financial statements can be rendered only when the supporting records have been audited.

Financial statements prepared from unaudited records are usually based upon work papers and records compiled by a company's internal accountants. The criteria necessary to render an outside independent opinion have not been applied. Thus, auditors refrain from giving one. Historically, these kinds of financial statements were reported as having been prepared "without audit."

Effective July 1, 1979, the American Institute of Certified Public Accountants (AICPA) issued new guidelines on services rendered by accountants and/or auditors with respect to unaudited financial statements. They apply, however, only to a non-public entity (defined as an entity other than one whose securities trade in a public market or that makes a filing with a regulatory agency to sell its securities in the public market). These new guidelines do not affect audited financial statements.

As a result of the new guidelines, auditors now are allowed to provide two different types of services pertaining to unaudited financial statements. These are Compilation and Review of Financial Statements.

The compilation of financial statements deals with an auditor's compilation of data, in the form of financial statements, as provided by management (owners) of an entity without undertaking an audit of the company's accounting records. The auditor provides no assurance on such financial statements and, thus, issues a disclaimer of opinion. The review of financial statements by an auditor requires that inquiries be made and analytical procedures performed sufficient to provide the auditor with a reasonable

basis for expressing limited assurance that no material modifications need to be made to the financial statements in order for them to conform with generally accepted accounting principles. In this case, the auditor also refrains from expressing an opinion on the fairness of the financial statements reviewed.

In most cases, in terms of cost, compilation financial statements are the least costly; review financial statements, somewhat more costly; and audited financial statements, the most costly.

Many small and medium-sized firms in the United States can be defined as "non-public entities" and, thus, qualify for use of compilation and review services, if desired. Compilation and review financial statements may be used by directors, management, and bankers to assess a company's current financial progress. These kinds of financial statements are often relied upon for interim period evaluation, (monthly, quarterly, and semi-annually) because of the substantial cost savings associated with their preparation.

However, engagement of an auditor to provide compilation services appears practical only when a company does not have the internal capability of producing its basic financial statements. A review engagement can be useful under those circumstances where a company desires association with an auditor for publication of interim period financial statements, but wishes to avoid undertaking a full-scope audit examination because it is impractical, inappropriate or too costly. Because auditors provide no assurance on compilation financial statements and only limited assurance on review financial statements, neither type of service should be considered a substitute for a full-scope audit examination resulting in an auditor's expression of opinion on the financial statements taken as a whole.

Auditor Opinions

Auditors may render one of four types of opinions: 1) unqualified, 2) qualified, 3) adverse, and 4) the disclaimer.

The Unqualified Opinion

An unqualified opinion means application has been made of the audit criteria outlined earlier and that no restrictions were placed on the scope of the auditor's examination. The financial statements so prepared are believed to fairly represent the company's financial condition, results of operations, and changes in financial condition. Adequate disclosure of all essential information, including notes to the financial statements necessary to make the statements accurate, has been possible and no unusual uncertainties have been detected during the examination process. This is the most favorable opinion which can be rendered by auditors.

Unusual uncertainties may exist, and the auditor may still give an unqualified opinion. If the uncertainties could have a material effect on the financial statements, the auditor is required to explain them in a "middle paragraph" between the scope and opinion paragraphs. Then, in the opinion paragraph, the auditor explains that the opinion is "subject to" the resolution of the matters explained in the preceding "middle paragraph."

The Qualified Opinion

A qualified opinion does not negate the fairness of financial statements on the whole. It means that while conducting an examination, the auditor has found it necessary to take exception to a specific account or transaction. When the amounts in question are not material enough to state that the financial statements as a whole are not fairly presented, a qualified opinion will be rendered. The exception(s) which require the auditor

to render a qualified opinion must be explained in a "middle paragraph" or footnotes to the financial statements.

The Adverse Opinion

An adverse opinion means the auditor has found that the financial statements are not fairly presented in conformity with generally accepted accounting principles. Thus, the statements cannot be certified as fairly representing the company's financial condition, results of operations, and statement of changes in financial condition. The auditor's opinion usually will state reasons for taking exception to the financial statements and quantify the effect on them of the deviation from generally accepted accounting principles.

The Disclaimer of Opinion

An opinion is disclaimed or not given when sufficient information has not been gathered to form a conclusion as to the fairness of the financial statements taken as a whole. A disclaimer of opinion is rendered when financial statements are prepared from unaudited records such as compiled and reviewed financial statements and/or when the scope of the audit has been limited by the board or management. The latter condition is not a desirable practice.

The Auditor's Function in Preparing Audits

Audit engagements begin with a meeting between the auditors and management. In a corporation, the first meeting usually is with the board of directors at which management is present. During the meeting, the auditors should attempt to: 1) become acquainted with the board and management; 2) determine what is to be included in the audit; 3) determine the scope of work required to perform the audit; 4) become familiar with the company's accounting system; and, 5) identify specific areas requiring attention.

The auditor should prepare an engagement letter after being hired by the company and prior to commencing work. Typically, this letter spells out the auditor's understanding of the scope of the engagement, explains the work understood to be performed, explains the fees to be charged, and clarifies that the auditor is not responsible for the detection of fraud (although this often results). However, if fraud is detected during the audit program it must be brought to management's or the board's attention!

While this pre-audit meeting often is conducted with new clients, it sometimes is neglected in subsequent engagements. Management and/or boards of directors should insist upon pre-audit meetings in order to avoid overlooking newly developed issues of importance. These meetings let auditors know they will not be allowed to routinely "settle in" in terms of their performance requirements and provide opportunities for improving communications and reclarifying audit preparation responsibilities. Finally, these meetings provide new directors and/or new members of the management team an opportunity to become acquainted with the audit concept.

The Audit Process

Audits usually are prepared in a stepwise manner. Auditors generally:

1. Develop an understanding of the company's accounting system and who is responsible for different portions.
2. Record this understanding via interviews, narratives, and flow charts.
3. Examine and verify the correctness of accounting transactions by selecting and analyzing these at random.

4. Evaluate internal accounting controls for weaknesses using flow-charting techniques and internal control questionnaires.
5. Determine additional information required to complete the audit.
6. Prepare a final written report, management letter, and render an opinion.
7. Present and explain the written report, including the auditor's opinion attached to the financial statements, and the separate management letter to the board of directors and management.

It is the responsibility of the auditor to see that the audit is properly reviewed and that full disclosure is made.

Audit Report Contents

Basic Information

The audit report should include at a minimum the following:

1. Auditor's opinion.
2. Balance sheet (statement of financial condition).
3. Operating statement (statement of operating results).
4. Reconciliation of equity accounts illustrating changes in net worth and shareholder ownership.
5. Statement of changes in financial condition illustrating sources and uses of funds and changes in working capital.
6. Notes to financial statements required to provide adequate disclosure of pertinent financial information.

Additional Information

Other information which also could be included in the written or oral report includes:³

1. Analysis of principal assets and liabilities.
2. Accounts receivable agings.
3. Inventory certifications.
4. Analysis of contingent liabilities (usually contained in the notes to financial statements).
5. Analysis of insurance and bond coverage.
6. Review of tax status.
7. Provision of industry comparative data.
8. Analysis of any internal accounting disclosure irregularities.
9. Review of depreciation schedules.
10. Analysis of sales proceeds, costs of sales, operating expenses, margins, and inventory positions by department or branch categories.
11. Analysis of overhead expenses.

Management's Function in Preparing Audits

Basic Responsibilities

The board of directors or management in a non-corporate entity is responsible for:

1. Hiring a competent auditor.
2. Securing an audit engagement letter (this may not be necessary each year assuming a recurring situation with no major changes in audit requirements).

3. Devoting special attention to the audit by:

- a. Asking discerning questions about the contents of the auditor's engagement letter.
- b. Requesting sufficient clarification of proposed audit fees.
- c. Requesting periodic informational reports on the audit's progress from the company's president, general manager, financial officer or controller.
- d. Providing auditors with a completion date requirement prior to the audit's inception.
- e. Establishing policies aimed at minimizing annual audit expenses.

Time Saving Techniques

Several techniques can be used by a company's management and internal accountants to save time, and, thus, the cost associated with retaining outside auditors. They can:⁴

1. Prepare work records and papers for use by auditors prior to and during on-site examinations.
2. Provide auditors with ample working space free from in-house operating distractions and which permits working with confidential data.
3. Be accessible during the audit, especially near its completion, to respond to questions and/or problems encountered.
4. Review the audit findings prior to the auditor's departure in order to provide any necessary clarification helpful for completion of the report.

Audit Committee

Some corporations have established a board audit committee to give special attention to the annual audit. The purposes, composition, and responsibilities of an audit committee are briefly discussed below:⁵

An audit committee usually is established to:

1. Help protect the board of directors in their legal and liability responsibility area regarding safeguarding the company's assets. An audit committee, however, does not limit the board's liability in terms of serving as trustee of the firm's assets.
2. Help meet financial reporting responsibilities to shareholders, creditors and the public.
3. Improve the quality and contents of published reports.
4. Improve the use of financial controls over management.
5. Improve board-management communications.
6. Encourage management's use of sound accounting methods.
7. Encourage management to work closely with auditors to avoid possible information disclosure error and/or omission.

The pros and cons of an audit committee should be evaluated prior to its establishment. For example, the professional pronouncements of the National Society of Accountants for Cooperatives suggest that an audit committee may not be appropriate if there are nine or fewer members on the board.

If an audit committee is to be established it should be formalized by resolution of the board. Additionally, the committee's specific authority and responsibility, including its mode of operations, should be clarified in writing.

In general, an audit committee is kept small. Usually, it is comprised of three to five directors who should be: 1) knowledgeable about their company's affairs; 2) experienced in financial and general management matters; and, 3) able to ask pertinent and penetrating questions. The head of the committee should believe in its function and be able to interact and communicate effectively with company management and outside auditors.

An audit committee should:

1. Nominate or select the outside auditors.
2. Specify the scope of the audit.
3. Conduct a pre-audit meeting with the auditors to review auditing procedures, areas to be covered, fees to be charged, etc.
4. Review and interpret audit results.
5. Review overall internal financial control methods.
6. Review the opinions of auditors on the competency of management personnel responsible for handling the company's financial affairs.
7. Make recommendations to the entire board.

Reviewing the Audit Report

Procedures

The following is a suggested procedure for reviewing the final audit report:

1. Require auditors to make their first oral report to the board or audit committee in a corporate entity. Otherwise, it is to be made to top management in a non-corporate entity.
2. Schedule a regular or special meeting to review the audit report with the auditors. If company operating management or staff is present during this meeting in a corporate entity, it should be followed by a private executive meeting between the board or audit committee and the auditor.

It is also desirable to have copies of the audit report in hand prior to meeting with the auditors. This would allow time for individual or group study and analysis. It also provides board members and management with an opportunity to identify questions they may wish to ask during the formal oral audit report.

3. Develop an agenda for the meeting with the auditors. The agenda could be as follows:
 - a. Present and discuss the overall audit results.
 - b. Discuss any controversial accounting or reporting problems revealed by the audit.
 - c. Discuss appraisal of the company's record keeping procedures.
 - d. Review any recommendations to improve internal accounting control methods.

- e. Discuss appraisal of management's ability to handle the company's financial affairs.
- f. Review areas requiring corrective board and/or management action.
- g. Review any discrepancies or procedural problems not corrected by management as recommended during the conduct of the current and/or previous audit program.
- h. Discuss new accounting developments, future trends, and issues.
- i. Discuss any services rendered in addition to the audit.
- j. Discuss the financial condition and performance of the company.

Presentation of the Report

The senior member of the audit team or partner in charge of the audit should be required to appear before the entire board in a corporate entity or before top management in a non-corporate entity to present the audit report, management letter, and discuss any other related issues of importance.

The board of directors and top management in both corporate and non-corporate entities should act quickly and with professional assistance, if appropriate, to verify and follow up on any exception (qualified), adverse or disclaimer opinion. In some instances, failure to have certified financial statements may adversely affect opportunities to borrow capital.

Pertinent Questions

It is imperative for top management and directors to ask auditors discerning questions when reviewing the audit report

and the company's financial condition and performance. This enables directors and management to satisfy themselves that the auditor's examination has been thoroughly conducted and helps improve their understanding of and ability to direct their company's financial affairs. Questions which might be asked include:

1. What is the trend in the sales level?
2. What is the trend and outlook for the company's working capital position?
3. Have the financial books and records been kept current (up-to-date) and in good condition?
4. Have all taxes been paid when due?
5. Have operating margins been adequate?
6. Can current cash flow adequately service existing debt repayment requirements? What about future cash flow needs?
7. Have assets and liabilities been properly managed and safeguarded (i.e., insurance coverage)?
8. What is the current position, condition, and outlook for net worth accounts by category and in total?

Other questions which might be asked of the auditors but which probably could best be answered by a company's internal accounting staff include:

1. What is the quality (current versus delinquent) and level of accounts receivable? How fast are receivables being collected (turning over)?
2. What is the physical condition of inventories, and how fast are they turning over?

3. What is the physical condition of fixed assets regarding age, quality, deterioration, maintenance, and replacement needs?
4. What is the status of accounts and notes payable (current versus delinquent)?

Summary

This paper has outlined the function and scope of financial audits and auditors. Directors, company presidents, general managers, controllers, internal accountants, attorneys, auditors, and bankers should find it an informative aid as they seek to make effective decision-making contributions to the continued existence and future of the companies they serve.

Footnotes

¹Additional information on the specifics of compilation and review financial statements can be obtained from practicing accountants and auditors.

²The opinion of some auditors is that a company is best served by an auditor who is retained on a consulting basis throughout the year to provide continuing services to the board and management. Under these conditions, it is believed that pre-audit meetings may be superfluous in many cases.

³This information may be more economically furnished by a company's internal accounting staff, if they have the capabilities to provide it.

⁴For a more detailed outline of how to minimize the expense of using an outside auditor, see Areas Open to a Company to Reduce, or Keep at a Minimum, The Cost of the Annual Audit, Cooperative Accountant, XXV, No. 2 (Summer, 1972), pp. 43-45.

⁵More information on the role and function of an audit committee can be obtained from booklets published by many of the major U.S. accounting firms.

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