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THE MYSTERIOUS WORLD OF A CORPORATE AUDIT

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Audits are constructed like icebergs: what is visible—the auditor's report—is a minor portion of the total bulk. Most corporate financial people understand that the auditor's opinion on the fairness of a company's financial statements is based on a general set of professional standards—and that these standards help assure the quality of the work performed. But few non-auditors realize the extent of the activities required for the auditor to deliver his opinion.

Should the non-auditors be concerned about the nature of an audit? I think so, particularly if one is a member of executive management, the audit committee, or the board of directors. These groups have direct dealings with auditors. They make accounting and systems decisions, provide data to auditors to facilitate the audit, respond to auditor inquiries, and discuss a myriad of problems with the auditors. Such matters can certainly be dealt with more effectively by persons who understand the workings of the audit process.

From the auditor's perspective, an audit is a method by which he becomes reasonably satisfied, at an acceptable cost, that the economic events that represent the client's operations have been properly reflected in its financial statements. The balance between reasonable satisfaction and acceptable cost is important. For although the auditor must perform all work necessary to reach a proper opinion, there are economic limits to the scope of his work. Thus, a series of judgments must be made about trade-offs between audit costs and the value of the information to be obtained.

The concepts of reasonable satisfaction and acceptable cost also give a clue to what an audit is not. It is not a guaranty that there are no misrecorded transactions, incorrect accounting judgments, omitted disclosures, or committed frauds. However, the chances of these conditions existing in a material amount are greatly minimized through the audit process. They are minimized to the point where only a small fraction of all auditors' opinions have been found to be incorrect when professional standards were diligently followed.

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The essence of the audit process is threefold: first, it is objectives oriented; second, it is flexible; and third, planning is critical.

Basic Audit Objectives

The only way to deal with the breadth of an audit is to break it down into a number of smaller problems, which can be dealt with on a separate basis. Thus, a set of seven basic audit objectives is generally recognized:

- *Existence*—Are all transactions affecting the account recorded, and are all recorded items the result of actual transactions?
- *Ownership*—Are all assets present owned by the entity; are all liabilities owed to bona fide creditors; and are all outstanding shares of capital stock owned by bona fide shareholders?
- *Valuation*—Are all amounts recorded accurately, and do they reflect subsequent changes in value?
- *Classification*—Are all amounts recorded in the correct accounts?
- *Cutoff*—Are all amounts recorded in the proper fiscal period?
- *Mechanical Accuracy*—Are detailed amounts correctly summarized when arriving at aggregate amounts in the financial statements?
- *Adequate Disclosure*—Is all relevant information included that is necessary for the fair presentation of the financial statements in conformity with generally accepted accounting principles?

Thus, if the client's records contain 100 accounts, this approach creates a set of 700 separate problems.

Flexibility

To achieve the seven audit objectives, one must gather objective evidence about internal controls, transactions, and balances. To assure an absence of errors, moreover, requires considerable flexibility.

First, individual audit procedures—such as inspecting documents, examining inventories, making inquiries, and obtaining confirmation from outside parties—usually relate to more than one account and accomplish more than one basic objective. Thus, obtaining a confirmation from a trade customer concerning his account receivable deals with both trade accounts receivable and sales revenue. It also relates to four audit objectives: existence, valuation, classification, and cutoff. Thus, this one audit procedure helps to resolve a number of our separate problems.

What is the next element of flexibility? It lies in choosing the mix between an audit which emphasizes the accounting system and an audit which emphasizes the year-end account balances—in other words, whether to focus on the system that produces the numbers, the numbers themselves, or a combination of the two.

The general approach of most auditors is to focus on the client's systems. The accuracy of the information in such systems will depend, of course, on its built-in controls. Such internal control systems usually coincide with specific accounting systems—although certain internal controls, such as internal audit, may cut across all accounting systems lines. Since it is impractical to check *all* information recorded in the client's records, these internal controls assure the auditor that his information is reliable, which in turn enables him to reduce the extent that information must be verified.

Why is a systems approach taken? One reason is to achieve efficiency, since individual accounting systems will generate entries to a number of accounts. For example, if the auditor is satisfied that the cash disbursements system is reliable, he will have accomplished certain audit objectives for cash, inventories, prepaid expense, fixed assets, accounts payable, cost of sales, and operating expenses—and probably other accounts as well. In addition, auditing the system allows the auditor to perform work prior to year end. This reduces peak workloads and facilitates meeting tight reporting deadlines.

A systems approach, however, has certain disadvantages,

leading many auditors to choose instead the direct substantiation of year-end balances. If the accounting system is not controlled, for example, the effort required to audit its transactions will often be greater than the effort to audit balances, resulting in increased audit costs.

Planning

This review of audit objectives and audit flexibility should make it clear that careful planning is indispensable in every audit. It consists of two basic steps. First, the auditor must develop the procedures that are necessary to meet his objectives; and, second, for each of those procedures, he must decide how extensively each one must be performed in order to satisfy those objectives.

This introduces the concept of audit sampling—drawing conclusions about a group of transactions after applying audit procedures to less than all of the items. Sampling in auditing is important for minimizing audit costs, as well as a key to obtaining effective information. But sampling has elements of art as much as of science, and a skilled auditor will give careful attention to deciding what an effective sample is—and whether it is more appropriately accomplished by judgmental or by statistical techniques.

In addition to what, when, and how much substantiation is necessary, audit planning must be concerned with a multitude of logistical matters. These include staff assignments, work at outlying locations, coordination of the auditor's staff and the client's staff, and agreement on special client-prepared analysis and correspondence. On large audits, 20 to 30 auditors, or even more, may be involved. Planning and directing their activities will have a significant impact on the effectiveness of the examination.

The Touche Ross Audit Process

By borrowing from its industrial engineering consultants, Touche Ross has developed a new approach to planning and designing the audit. The basic idea is to perform each procedure with specific objectives in mind, and to use the carefully recorded and evaluated results of all procedures as input for continued planning. The benefit of this approach is that auditors will be assured of applying procedures designed to cover all basic objectives for all accounts, and yet will avoid unnecessary procedures.

This approach requires the auditor to learn a great deal about the client's operations and systems before performing the required procedures. Thus, the auditors spend a considerable amount of time making initial observations and conducting interviews, rather than examining transaction data, sending confirmations, and following other expected procedures. However, this information gathering phase is essential to achieve adequate planning and to properly evaluate later feedback.

The initial step is to identify every material type of transaction that must be considered, the accounts each one affects, and the available sources of evidence for those transactions and accounts. There will be two sources of evidence: those within the company's major accounting systems, and those outside the accounting systems.

This initial analysis is used to develop an overall audit plan. Then practical matters must be considered. For example, when does the client want the auditors to come in to do the work? What locations will be visited? How soon after year-end must the report be issued? And so forth. Within this set of constraints, the auditor decides the extent to which he will take the systems approach.

Next, the auditor decides the procedures he needs to follow in order to validate the accounting systems and the processing of transactions. Each transaction type, if the systems provide a source of evidence, is analyzed for errors that might occur when processing the transaction. There are usually about six to eight ways that things could go wrong. For example, in the purchase of an inventory item, either the price or the quantity of the purchase could be recorded incorrectly, it could be posted to the wrong inventory item record, or it might not get recorded at all. Not surprisingly, the definition of potential errors is

strongly associated with the seven audit objectives above.

At this point, the auditor has obtained a description of each major system, including the controls used to prevent, detect, and correct errors. By comparing possible errors to this description, he forms a preliminary evaluation of how well each type of error is controlled. Based on this evaluation, he prepares audit procedures which will either verify that critical controls do exist, or, where controls appear to be lacking, will measure the degree of errors. In addition, the auditor recommends systems improvements.

After completing this systems-oriented evaluation, the auditor has a great deal of information. For example, he can now evaluate whether or not the types of transactions regularly processed by the major accounting systems have been properly treated in terms of the year-end financial statement balances. Under the Touche Ross audit process, this assessment is made explicit and serves as the basis for designing all of the remaining audit procedures. This is an important point. If there is a high likelihood of error based on the systems work, more year-end work will be performed. But if the systems work indicates a low likelihood of financial statement error, then significant reductions in potential year-end work are possible.

There are certain audit objectives that can be accomplished only at year-end. The two primary ones are ownership and disclosure. An event that culminates in a forfeiture of ownership, such as the pledging of an asset, is difficult to control by accounting systems. Adequate disclosure is also generally related to events that standardized systems are unable to produce, and so must be dealt with more directly.

Nor are certain types of transactions processed by formal systems. Identified either at the outset or later in the audit, they may be material items, such as sale of a plant or a major lease. Clearly, such an item must be audited at its source.

Finally, certain year-end procedures can accomplish some audit objectives more efficiently—i.e., at a lower cost—than can systems procedures. The auditor, based on his experience and knowledge of audit tests, will consider such efficiency in structuring the overall audit plan.

Final Definitions

Certainly, there are a large number of approaches to any audit that would be acceptable—because they result in compliance with generally accepted auditing standards, and they render a correct opinion on the financial statements. However, only a narrow range of approaches will be both acceptable and effective in minimizing audit costs. And, while an overly structured approach to auditing might make most audits acceptable, they would not

necessarily be cost effective. An optimal approach will be achieved only by a skilled auditor who has a variety of audit tools available to him, and is flexible in his audit planning.

But another factor is necessary—positive client interest. Not only must the auditor be able to do the right things, he must also do them well. Client attitude can either assist or impede this. Thus, client management has a responsibility not only for the financial statements but for the environment in which the audit is conducted.

To sum up, the audit can be made easier or more difficult (and more costly) by a number of factors. One of the most important is the attitude of the client and the degree of communication in both directions. My purpose here has been to suggest that the client's understanding of the audit process helps such communication.

Experience suggests, as well, that both auditors and their clients—either management and/or audit committee members—should formally discuss not only the auditor's general methodology but also his specific approach in the client's own situation. This, indeed, should be a regular and early part of every audit examination. △

How the Businessman Can Help the Auditor

What can a corporate officer or director do to assist the auditor and enhance the audit process?

- Ensure that communications with the auditors are free flowing—in both directions. This will occur when there is a vehicle established for that purpose. Use of an audit committee, regular status meetings, or regular engagement partner visits will usually work.
- Find out what the auditors plan to do. Have a formal meeting prior to the main period of audit work to receive a presentation of the overall approach to the audit planned. Discuss anticipated problem areas, such as work at specific locations, new government regulations, accounting changes, and the like.
- Inform company people what to expect of the auditors and what auditors will expect of them. Their cooperation in terms of schedule preparation, making available computer time and facilities, and making themselves available for interviewing will have a significant impact on audit time.
- If the company has an internal audit function, assure that the scope of its activities and the work of its personnel are coordinated with those of the external auditors.
- Plan the closing on a realistic timetable, then make sure that all personnel perform accordingly.
- Communicate to the auditors very early those areas in which you would like them to perform special procedures, since to the greatest extent possible these procedures should be integrated into the audit process.
- Examine new developments which may prompt accounting problems or decisions, and discuss them with the auditors as early as possible.
- Ask what new developments in the business environment (laws, disclosure rules, etc.) suggest a need for modification to internal control systems.
- At the completion of the audit, hold a formal debriefing session. Find out what problems were encountered and plan what can be done to avoid them next year.
- Follow up on the auditors' recommendations, particularly those presented formally in letters of recommendations, then provide feedback.
- Involve the auditors in orientation programs for new directors.