Understand the Audit Process to Save on Audit Fees

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The auditor's annual fee is a material, unavoidable cost for many companies, yet few companies manage their audit involvement the way they do other costs. Small companies are especially hard hit in this area. Studies show that, in fact, small companies pay a higher proportion of each sales dollar than large firms to produce audited financial statements.[1] For more than a decade, the FASB and the AICPA, through their committees and research staff, have debated the proposition that small companies should enjoy a reduced level of reporting.[2]

But there are steps other than lobbying for reduced requirements that a company–or a department within a company–can take to reduce the hassle, disruption, and cost of an annual audit. This article discusses the preparation that managers can make for an annual audit, preparation that can reduce the disruption caused by the auditor's presence (and requests) and result in substantial savings in audit fees and lost employee time.

External auditors examine a company's controls, books, records, and underlying source documents so that they can render an opinion attesting to the fairness of the company's published financial statements. Company managers should understand that auditing activities usually can be grouped into two general categories: obtaining accounting and related information about the company under audit, and performing audit procedures. To the extent that the auditors and company managers can identify the accounting and related information that they need before the audit, the company can gather that information at less cost than if the auditors do it and bill for their time at professional rates.

The ultimate purpose of the audit is to gather evidence that will both support the expression of an opinion and defend the auditors' firm if a lawsuit results from reliance on the audit opinion. Auditors examine three basic types of evidence:

- evidence regarding the company's internal control structure
- evidence specifically required by the AICPA Statements on Auditing Standards (SASs) about specific financial statement items
- evidence that the auditor decides, based on judgment, is required about certain financial statement items

Evidence About Internal Controls

Auditors examine internal controls so they can assess the risk of relying on controls and decide on the nature, timing, and extent of the audit procedures they must apply before rendering their opinion. For example, separating the custody of an asset from the maintenance of its accounting records is a basic internal control. One person has custody of raw materials inventory, for instance, while another maintains the accounting records for raw materials inventory. Collusion is required to conceal an error or theft. When the custody and accounting for raw materials are separated, auditors can rely more heavily on the accounting records and examine fewer documents than when there is no separation. If one person performs both functions, the auditors might believe that they have to examine 100 percent of the receiving tickets and materials requisitions before they can accept the cost of raw materials in cost of goods sold as fairly stated.

Auditors' responsibility for knowledge of their clients' internal controls has been greatly expanded by Statement on Auditing Standards (SAS) Nos. 55 and 78. These standards require auditors to understand the client's internal control to plan the audit and determine the nature, timing, and extent of substantive tests that they will perform.[3] The minimum audit effort in the internal control area must be sufficient

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to enable the auditors to understand the company's internal control.

Auditors examine internal controls to determine what controls are in place and then assess the risk that the controls will fail to detect or correct any material misstatements in the accounting records that might affect the financial statements. The risk that the controls will fail to detect or correct material misstatements is called control risk. The level of control risk determines the nature, timing, and extent of the substantive tests the auditors must perform to express an opinion about the company's financial statements. If control risk is assessed at 100 percent because there are no controls or existing controls are ineffective, or because the auditors choose not to rely on the controls, the auditors must expand their substantive tests. Auditors who wish to assess control risk at less than 100 percent and reduce their substantive testing must perform tests of controls and obtain evidence that supports an assessment of control risk at less than maximum. Then, they must document both the results of the tests of controls and the basis for their assessed level of control risk.

Before SAS No. 55 went into effect, the auditors' responsibility for internal controls was to study, evaluate, and rely on them in determining the extent of substantive tests. However, auditors were free to ignore a company's controls. Because of the new requirements for auditors, many managers and others who assist auditors in obtaining evidence will find that the auditors are spending much more time and effort documenting and testing control systems than in the past.

To understand the client's internal control, auditors must focus on five components: the control environment, risk assessment, control activities, information and communication, and monitoring. To flesh out these five components, auditors will examine documentation, make inquiries of personnel, and observe various accounting processes. At this stage of the audit, company managers can help the auditors (and reduce audit fees) by having personnel available to locate documents and answer questions.

The Control Environment: Managers can assist auditors to understand the control environment by supplying the six areas of documentation listed under Control Environment Documentation at the top of Figure One. There is, of course, other information the auditors will obtain through interviews.

Risk Assessment: Auditors will need to obtain information about the client's risk assessment process and how it identifies, analyzes, and manages risks that are relevant to the preparation of financial statements. Managers can brief the auditors on how the client addresses risks that arise from circumstances such as changes in the operating environment, new personnel, new information systems, new technology, and new accounting pronouncements. The auditors will be interested in how management identifies risks, estimates their significance, assesses the likelihood of occurrence, and relates them to financial reporting.

Control Activities: Control activities are all policies and procedures that management has established to achieve company objectives. Managers can provide the policies and procedures manual, but probably the auditors will also fill out their own internal control questionnaires to document the control activities that are actually followed. Managers can aid auditors to understand the controls and complete the control questionnaire by documenting a transaction walkthrough.

Documentation of a walkthrough can be as simple as photocopying all of the documents used for a particular transaction. For example, a manager who wishes to document the procedure used to purchase inventory should choose a particular purchase and photocopy the requisition, purchase order, receiving report, vendor's invoice, voucher or check request, and the page of the accounts payable detail schedule on which the purchase appears. The copies should show the agreement between the documents as to the amount and price or explain the reason for, and authorization of, any differences. The auditors might duplicate this process for, say, 20 purchases, if they choose to test the controls, but their understanding of the process and the controls in place will certainly be increased by a documented walkthrough. Auditors will save billable time and may not require as much interaction time with company personnel.

Information and Communication: Auditors need to examine relevant financial reports, accounting records, subledgers, ledgers, journals, and any accounting manuals used to understand the information system that is used to generate financial reports. If a standard computer software package is used, management should provide the auditors with the software operating manual plus examples of the documents used to input transaction data for each type of report. The documentation will also aid in the auditors' understanding of the accounting system. The auditors need to know about significant classes of transactions, how

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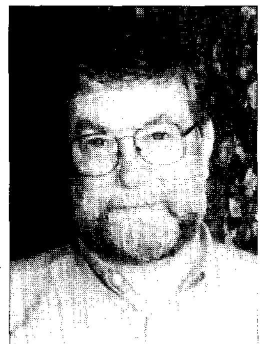

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they are initiated, how they are processed and reported, and the financial reporting process used to prepare financial statements.

The communication system is also important to auditors and the client should expect to be asked how managers communicate the roles and responsibilities for the process and the internal control over financial reporting.

Monitoring: The auditors will want to know how the client monitors internal controls. Management should explain the methods used to assess the quality of internal control and respond to situations that need improvement.

Evidence Required

There are a number of activities, common to all audits, that generally accepted auditing standards require auditors to include in the audit. Auditors are required to:

- Confirm accounts receivable
- Observe the inventory count
- Obtain the client representation letter
- Inquire of client's lawyers about litigation, claims, and assessments
- Evaluate the reasonableness of accounting estimates

Management can reduce the time necessary for auditors to perform their work in these areas by anticipating the types of information, schedules, and documents the auditors will need and preparing and providing those items early in the engagement.

Confirm accounts receivable: Confirmation of receivables is a generally-accepted auditing procedure.[4] Auditors who do not perform generally-accepted auditing procedures may not be able to justify their audit opinion (unless circumstances enable them to conclude that performing the audit procedure will be ineffective). As a result, it is virtually certain that a company's auditors will confirm receivables. There are two main activities in confirming receivables for which auditors are solely responsible and which cannot be delegated to company personnel: choosing the particular accounts to be confirmed, and mailing and receiving the confirmations.

But managers can reduce their audit fee by assisting in any of the other activities involved in confirming receivables. Before the audit begins, for instance, managers can prepare an accounts receivable detail schedule (or subsidiary ledger listing) that ties into the general ledger trial balance at the end of the audit year. In addition, management can make sure that all customer names and addresses are readily available and can have company personnel prepare and address the confirmations.

Observe the inventory count: Observation of inventories is also a generally-accepted auditing procedure.[5] External auditors may plan to observe the company's actual inventory count as it occurs or obtain the final priced inventory listing and make audit test counts shortly after the company has completed its inventory count. In the latter case, managers can save time by arranging for the personnel who made the original inventory count to accompany the auditors on their test counts. Company personnel are familiar with the layout of the warehouse and the organization of the inventory and can often count an entire palette of inventory before the auditors have determined the width, height, and depth of the stack.

Managers can also prepare for the audit of inventories by obtaining names and addresses of public warehouses in which the company stores its inventory. Auditors may choose to confirm those inventories with the warehouse custodian instead of performing an on-site count.

Obtain the client representation letter: Auditors are required to obtain written representations from management to confirm oral representations made by management in response to various inquiries made throughout the audit.[6] Management takes responsibility for its oral representations to the auditors by signing a representation letter prepared by the auditors. Auditing standards include a list of 20 matters that might be included in a representation letter. Auditors determine the specific written representations required based on the circumstances of each audit.

Matters for which auditors require written representation include information that may be difficult or time consuming to collect. Management can save audit time by being prepared to provide certain documents or information and to answer inquiries about each of the 15 items listed under The Client Representation Letter section in Figure One.

Inquire of client's lawyers concerning litigation, claims, and assessments: Auditors must gather information about contingent liabilities that result from lawsuits and other judgments against the company. A letter of inquiry to the client's lawyer is the auditor's primary means of corroborating information obtained from management about active and pending litigation, claims, and assessments.[7] Management can prepare for this aspect of the audit by accumulating the following items before the auditors' request:

- policies and procedures used to identify, evaluate, and account for litigation, claims, and assessments
- descriptions of litigation, claims, and assessments existing at the balance sheet date and up to the date the information is provided
- documents related to litigation, claims, and assessments, includ ing correspondence and invoices from lawyers
- information concerning unasserted claims that are probable of assertion

Evaluate the reasonableness of accounting estimates: Auditors are responsible for evaluating the reasonableness of accounting estimates made by management in such areas as bad debts or warranty expense accrued.[8] Management is responsible for establishing procedures to prepare the estimates needed for financial statement presentation and can facilitate the audit of

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Figure One
Audit Preparation Checklist

Evidence About Internal Controls

Control Environment Documentation
- Organizational structure
- Functions of the board of directors, audit committees, and internal audit department
- Bylaws
- Control methods used by management, such as budgets and variance analysis
- Personnel policies and practices
- Policies and practices used to meet requirements imposed by outside regulatory agencies

Accounting System and Control Procedures
- Computer manuals for accounting systems
- Flowcharts of the accounting systems
- Policies and procedures manuals for accounting systems

Evidence Related to Audit Procedures Required by the Statements on Auditing Standards

Accounts Receivable: Confirmation and Other Evidence
- Aged Trial Balance of Accounts Receivable as of year-end
- Accounts Receivable Detail Schedule or Subsidiary Ledger
- Sales register and shipping records for dates surrounding year-end
- Record of Accounts Assigned or Pledged
- Analysis of Bad Debt Expense and Allowance for Doubtful Accounts
- Documentation for approvals of write-offs
- List of Accounts Due from Directors, Officers, Employees, Stockholders
- Addresses of customers to receive confirmations

Observation of Inventory Count
- List of Final Priced Inventory
- Final Receiving Report used at year-end
- Perpetual Inventory Record
- Record of Inventory Out on Consignment
- Record of Inventory subject to pledge or lien

The Client Representation Letter
- Minutes of the meetings of stockholders, directors, and committees of directors throughout the year
- Listings of related parties and information about related-party transactions and the related amounts payable or receivable
- Contracts and information about possible noncompliance with contractual agreements that may affect the financial statements
- Information about subsequent events, especially those that may not yet be recorded in the accounting records
- Irregularities involving management or employees
- Communications from regulatory agencies concerning deficiencies in reporting practices
- Circumstances that may affect the carrying value or classification of assets or liabilities
- Compensating balances or other restrictions on cash balances, and lines of credit
- Excess or obsolete inventories
- Losses from sales commitments and purchase commitments
- Liens on assets and assets pledged as collateral
- Repurchase agreements on assets previously sold
- Possible loss contingencies caused by violations of laws or regulations
- Litigation, claims, or assessments (including unasserted claims or assessments that are probable of assertion)
- Capital stock repurchase options or agreements and capital stock reserved for options, warrants, conversions, or other requirements

Litigation, Claims, and Assessments
- Policies and procedures used to identify, evaluate, and account for litigation, claims, and assessments
- Descriptions of litigation, claims, and assessments in existence at the time of the balance sheet date and up to the date the information is provided
- Documents about litigation, claims, and assessments, including correspondence and invoices from lawyers
- Information about unasserted claims that are probable of assertion
- List of all attorneys consulted by client during the year and working on continuing litigation, claims, and assessments
- Description and evaluation of litigation, claims, and assessmentsfrom the inside general counsel

Accounting Estimates
- List of the accounting estimates included in the financial statements
- Data used to derive the estimates
- Relevant factors that affect each of the estimates
- Assumptions used by management to judge the most likely events and circumstances related to the relevant factors
- Determination of the estimate based on the assumptions and other relevant factors

Additional Evidence Required Because of Auditor Judgment

General
- Trial Balance (of Balance Sheet and Income Statement)
- General Ledger
- Chart of Accounts
- List of members of Board of Directors and major stockholders

Cash
- Cash Receipts Journal (including transactions after year-end)
- Cash Disbursements Journal (including transactions after year-end)
- Bank statements and canceled checks
- Bank reconciliations
- List of banks used by the client
- Schedule of interbank transfers
- List of undeposited cash receipts at year-end

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(Figure One continued)

Accounts Payable
- Accounts Payable Detail Schedule or Subsidiary Ledger
- List of vendors used during the year
- Addresses of vendors to receive confirmations
- Vendor invoices
- Vendor statements

Payroll
- Payroll Register
- Personnel records
- Time cards and time report
- Record of deductions authorized by employees
- Canceled payroll checks

Prepaid Expenses
- Analysis of each prepaid expense account (beginning balance + additions - amortization = ending balance)
- Insurance policies
- Lease agreements
- Statements (invoices) from advertising agencies

Marketable Securities
- Analysis of Marketable Securities and Investments
- Names and addresses of trustees and brokers used by clients
- Financial statements of subsidiaries and other investees over which the client has influence
- Records of dividends received
- Records of interest rates applicable to investments

Property, Plant, and Equipment
- Analysis of each PPE account and its accumulated depreciation
- Fixed assets subsidiary ledger
- Invoices for all purchases of plant assets during year
- Repair and maintenance expense account
- Records of cost buildup for all additions made during current year
- Record of retirement work orders
- Depreciation policy

Notes Payable
- Analyses of Notes Payable for the Year (beginning balances + additions - payments = ending balances)
- Copies of notes originating during the year
- Loan Agreements
- Names and addresses of holder of all notes
- Canceled notes
- Analysis of Interest Payable for the year
- Debt covenants
- Lien agreements
- Loan agreements

Other
- Correspondence with taxing agencies
- Correspondence with insurance and bonding companies
- Conflict of Interest statements
- Tax returns
- Pension plans
- Stock certificate books
- Names and addresses of registrars and transfer agents used by client
- List of related parties

these estimates by documenting the procedures developed and their implementation. Management should document the following:
- a list of the accounting estimates included in the financial statements
- the data used to derive the estimates
- the relevant factors that affect each of the estimates
- the assumptions used by management to judge the most likely events and circumstances related to the relevant factors
- the determination of the estimate based on the assumptions and other relevant factors

Management should also document any other factors that will help the auditors obtain sufficient evidence that all material accounting estimates have been developed and are reasonable. Management can support the reasonableness of its estimates by documenting comparisons between past estimates and subsequent actual results, such as last year's estimate of bad debts expense and the actual uncollectible accounts in ending accounts receivable.

Additional Evidence Judged Necessary

There are many areas in which the Statements on Auditing Standards do not require particular audit procedures, but audit procedures exist in case the auditors wish to use them. For example, in an audit of cash balances, auditors usually confirm the cash accounts with the banks that hold them. To do this, the auditors need a list of the names and addresses of all banks with which the company did business during the year, even banks where there is no cash balance at year end. This list can be prepared before the auditor arrives.

Managers can save audit time by preparing a list of the names and addresses of the following outside entities with which an auditor may need to communicate to confirm the company's business activities and account balances:
- banks
- bond trustees
- brokers
- transfer agents
- registrars
- dividend paying agents
- major vendors

For some account balances, confirmation from outside entities is simply not feasible. In those audit areas, auditors may test transactions that occurred throughout the year rather than obtain evidence about ending balances from outside sources. For example, for property, plant, and equipment, the audit approach will typically involve preparing an analysis of additions and dis-

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posals and obtaining corroborating evidence of those additions and disposals. Company personnel can prepare this analysis of plant asset accounts and ensure that beginning balances agree with the prior year's audited balances and that ending balances agree with the current year's trial balance. Management can save the auditors time by also ensuring that purchase orders and vendors' invoices are available to corroborate all additions and that appropriate documentation (such as a retirement work order) is available to back up any disposals.

> ***"The communication system is also important to auditors, and the client should expect to be asked how managers communicate the roles and responsibilities of the process and the internal control over financial reporting."***

Consideration of Fraud

A new statement on Auditing Standards (SAS No. 82), entitled *Consideration of Fraud in a Financial Statement Audit*, impacts the scope of the auditors requests for information from clients. Will it add time and expense to the audit? Not necessarily, especially if the client has gathered all of the needed information. Of course, other factors could also influence the amount of time spent on fraud.

Under SAS No. 82, effective for audits of financial statements for periods ending on or after December 15, 1997, auditors must plan and perform the audit in such a way as to detect material fraud in the financial statements. Auditors will be required to assess the degree of risk that fraud will cause a misstatement of the financial statements, document the fraud risk factors, and explain how the client has responded to them.

Much of this information will be identified in discussions with managers. Managers should disclose their knowledge of any fraud that has occurred and how it has used the experience to identify fraud risk factors. Any anti-fraud programs established by the client will also be of interest to the auditor.

Auditors' assessment of the risk of fraud will be used to determine the nature, timing, and extent of the audit procedures to be performed. Clients that have strong internal control that are designed to prevent and detect fraud will likely see less audit time spent on fraud than clients without such controls.

SAS No. 82 also requires auditors to document the identified fraud risk factors, and how management has responded to them, in the categories that are relevant from the following possible categories:

- Categories of risk factors relating to fraudulent financial reporting
- Management's characteristics and influence over the control envi ronment
- Industry conditions
- Operating characteristics and fi nancial stability
- Categories of risk factors relating to misappropriation of assets
- Susceptibility of assets to misappropriation
- Controls to prevent misappropriation

Any consideration that management has given to fraud risk factors present in these categories will surely smooth the incorporation of the new requirements of SAS No. 82 into the annual audit. The likely result is a more efficient audit.

Cooperative Attitude

Sometimes the most effective factor in reducing audit time and cost is a spirit of cooperation between the auditors and the company. Employees who are hard at work do not like to be interrupted and sent in all directions to obtain documents that the auditors request. Management must set the cooperative tone at the top and stress the importance and cost-saving potential of being approachable and willing to aid the auditors to the greatest extent possible.

The cost of management preparation before the audit and employee cooperation during the audit pays handsome returns in both lower audit fees and less disruption of ongoing operating routines. For most companies, the benefits of proper audit management far outweigh the costs.■

1 For a study that shows the cost of CPA services to be more than twice as high per dollar of sales for small businesses as for large, see R. D. Nair and Larry E. Rittenberg, "Privately-Held Business: Is There a Standards Overload?" Working Paper 3-18-13, Graduate School of Business, University of Wisconsin, March 1982.

2 For early consideration of the problem of standards overload for small businesses, see Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses, *Report of the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses*, New York: AICPA, 1976; FASB, *Invitation to Comment. Financial Statements and Other Means of Financial Reporting*, Stamford, CT. FASB, 1980; and, FASB, *Invitation to Comment. Financial Reporting by Private and Small Companies*, Stamford, CT. FASB, 1981. At present, small private companies are not required to adhere to the FASB Standards Nos. 21, 35, 43, or 79.

3 Statement on Auditing Standards No. 55, No. 78, AICPA, Professional Standards, Vol. 1, AU section 319, "Consideration of Internal Control in a Financial Statement Audit."

4 Statement on Auditing Standards No. 67, AICPA, Professional Standards, Vol. 1, AU section 330, "The Confirmation Process."

5 Statement on Auditing Standards Nos. 1 and 43, AICPA, Professional Standards, Vol. 1, AU section 331, "Inventories."

6 Statement on Auditing Standards No. 19, AICPA, Professional Standards, Vol. 1, AU section 333, "Client Representations."

7 The client's inside counsel can provide corroborating information, but corroboration by inside counsel is not a substitute for information that outside lawyers refuse to provide. Statement on Auditing Standards No. 12, AICPA, Professional Standards, Vol. 1, AU Section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments."

8 Statement on Auditing Standards No. 57, AICPA, Professional Standards, Vol. 1, AU Section 342, "Auditing Accounting Estimates."

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