Accounting and Auditing Update

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Understanding the Financial Statement Audit

The accounting profession is very highly regulated and CPA firms that perform audits and issue audit opinions are subject to various professional standards, rules and regulations. Although there is a significant amount of judgment involved by the auditor in determining high risk areas, audit scopes and procedures based on identified risks, the concept of an audit and many of the procedures are based upon rules and requirements from regulators.

We will take you through the basic steps involved in conducting your company's (or organization's) audit so that you understand the process and are prepared, where and when called upon, to furnish the necessary documentation and input to your audit team.

Planning

Under current auditing standards, auditors are required to perform certain planning and risk assessment procedures as part of the annual audit, prior to conducting detailed tests, in specific areas including: internal controls, fraud, preliminary analytical review and risk identification and assessment. A summary of some of the procedures in these planning areas are as follows.

Internal Controls

An understanding of the company's systems of internal controls must be obtained by the auditors. These systems can vary depending on the company's operations and may include the following areas:

- Completion of an auditors' questionnaire relative to the company's internal controls, including the names and titles of the individuals performing the functions noted
- Financial statement preparation procedures
- Company memoranda relating to internal control procedures, including narratives and standard operating procedures detailing and/or addressing the following functional areas:
    - Cash receipts and revenue recording
    - Cash disbursements
    - Payroll

Based upon the auditors' planned risk assessment levels, they may decide to test the company's internal controls in order to determine the level of reliance that can be placed on such controls. Based upon the testing results, the auditor will then determine the nature and amount of substantive testing to be performed on account balances and transactions.

Fraud

Fraud can exist through misappropriation of assets or an intentional misstatement of the financial statements. Your auditors will assess, based upon their review of the materials listed above as well as prior experiences and industry observations, where potential threats of fraud could exist in the company's operations that may result in a material misstatement of the financial statements. They may also interview various members of the company's accounting staff, management and those individuals charged with governance to obtain a better understanding of the company's internal controls and possible fraud risk areas.

Preliminary Analytical Review

Your auditors will request from management the current year-end, or interim, financial statements. These financial statements may be analyzed and compared to the prior year's audited financial statements, budgeted information, and/or industry averages or expectations. Based upon these preliminary analytical procedures, the auditors may make additional inquiries of management and will begin to design their planned substantive audit procedures.

Risk Identification and Assessment

After obtaining an understanding of the company's controls, the current year's operations and, based upon discussions with management and the results of preliminary analytical review procedures and, where applicable, experience in prior year's/s' audits, your audit team will assess where the risk of material misstatement of the financial statements may exist. Based upon this assessment, the auditors will then design their further audit procedures. Major risk areas in a financial statement audit will vary from company to company and generally include: significant account balances, complex or unusual transactions, related-party activity, revenue recognition policies, and any transactions or account balances that require significant estimates or judgments.

Preparing for the Audit

In addition to the internal control materials and other items listed above, the audit team will request from company management various documents to support the financial statement account balances and transactions. Such requests from your auditors should sensitize your staff to the need for financial and other records to be maintained on a timely and accurate basis during the entire year. Some of the more common document requests are as follows:

- Office and warehouse leases
- Equipment leases and contracts

- Employment contracts
- Loan and mortgage agreements
- Bank reconciliations
- Bank statements for all accounts as of the company's year-end and through current date
- Accounts receivable aging report, including analysis of bad debts
- Detail of inventory on hand together with invoices, to test costing of specified inventory items
- Memorandum or narrative stating how the inventory count is performed and how inventory is valued
- Reconciliation of inventory detail to year-end inventory count
- Fixed asset and depreciation schedules
- Analysis of current and deferred taxes
- Variance analysis between current year's operations compared to prior year and/or budget
- Detail of revenue and the company's revenue-recognition policy

During the Audit Process

Effective audit procedures require the audit team to be skeptical and make inquiries of, as well as challenge, management on all unusual or significant transactions and on account balances that require significant estimates and judgments. Some of these areas may include:

- Allowance for doubtful accounts
- Inventory reserves
- Realization of deferred tax assets
- Fair value disclosures
- Recording of contingent liabilities
- Revenue recognition

Management should expect to discuss these matters with the audit team and provide underlying documents or other supporting evidence. It should also be expected that additional information for testing during the fieldwork, including random selections of specific transactions, will be made.

As the time approaches to prepare the financial statements and note disclosures, management should consider the following:

- Assessing going concern considerations
- Impairment of goodwill, intangible assets, and any other long-lived assets
- Revenue-recognition policies
- Related-party transactions
- Subsequent events

Any original documents that you provide to your auditors should be returned to your company by your auditors. It would be to your advantage to maintain a control list of any original records given to them and to monitor subsequent return.

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The auditors are required to maintain a workpaper file that is well documented and supports the audit opinion which states that the financial statements are fairly presented. The need for the auditors to obtain underlying documents and other supporting items, including third party confirmations, is integral to completing the workpaper file and complying with the required documentation standards. Knowing what to expect and cooperating with your auditors to the extent possible can ensure that your company receives a timely and complete audit.

If you have any questions about this subject, please contact the partner in charge of your account, or John Haslbauer, an audit partner and member of the Firm's Accounting & Auditing Committee. He can be reached at 212-867-8000 or jhaslbauer@odpkf.com.