Module: 18
Handling an audit
This module looks into audits. It will cover a few of the audits that you may run into over the course of your business career. At the end of this module you should know what an audit is and be able to discuss the covered categories of audits. This course has given you the tools needed to create your financial system, prepare the appropriate reports, and understand how the business side of business works. This final module will help you navigate the world of auditing and how it affects your business.

What you’ll learn in this module:
18.1 What is an Audit?

18.2 Preparing for an Audit

18.3 External Audit

18.4 Internal Audit

18.5 Cost Audit

18.6 Performance Audit

18.7 Quality Audit
18.1 What is an Audit?

The word “audit” for many people brings a range of emotions and levels of anxiety. Why is that? For the majority of the population keeping records and important documents for their household and personal finances is an afterthought. So when the IRS comes knocking three years down the line to do an audit, a person’s reaction is justifiably strong. Now take that scenario and apply it in the business world. Audits are a routine practice in the corporate world and people still agonize over it. To get over the fear of being audited you should understand precisely what an audit is, what it hopes to accomplish and how you can prepare for it.

The act of auditing refers to the process of examining of the books, accounts, documents and vouchers of a business to figure out how well the financial statements present a true and fair view of the specific area or department being audited. The auditor performing the audit also attempts to ensure that the financial records of a company are being properly maintained and in accordance with the law. The auditor performing the audit, reviews evaluates and analyzes the records and evidence provided by the business. Based on the culmination of all of their processes the auditor will formulate an opinion or judgment that is then presented through the audit report.

It is important to understand that any subject matter may be audited. Audits are generally completed by a third party and provide assurance to various stakeholders that the subject matter is free from material misstatement. This term is most frequently applied to audits of the financial information relating to a legal person or business. Other areas which are commonly audited include: internal controls, quality management, project management, cost management.

As a result of an audit, stakeholders can more effectively evaluate and improve the effectiveness of risk management, control, and the governance process over the audited subject matter.

18.2 Preparing for an Audit

You got the news yesterday. Your company is up for an annual audit. What now? Don't panic. The previous section went over the basic principles of auditing. You know that an audit is merely looking
through your records that have already been prepared and archived according to the recommendations laid out in this course. So you have nothing to worry about.

Checklist for preparing for an impending audit:

- Call the auditing entity and find out what kind of audit they will be performing
- Verify the period they will be auditing – this can range from 1 month to 1 year to 5 years
- Request a list of the documents they will require for the audit
- Find out how long they anticipate the audit will take and if they will be on site for the duration of the audit
- If they will be on site, find out what infrastructure and facilities they may need
- Begin collecting the required documents and records
- Ensure they are filed in a logical way for easy retrieval (not a pile on the floor after you have pulled them out of the filing cabinet)

Now that you have the basics prepared let’s cover the technical side of the various kinds of audits that may be coming your way.
An external audit is an audit that is performed by an independent body which is not a part of the business or organization it is auditing. External audits are generally focused on the financial accounts and/or risks associated with the finances of the company. The external auditors are most often appointed by the company shareholders.

The main responsibility of an external audit is to perform the annual required audit of the financial accounts. At the conclusion of the audit they should provide an opinion on whether the current financial statements are a true and fair reflection of the company's financial position. To come to this opinion, external auditors will often examine and evaluate the internal controls put in place to manage the risks which could affect the financial accounts, in order to determine if they are working as intended.

**External auditing can be requisitioned to be performed for a number of reasons. The most prevalent and frequent one though is for fraud detection.**

- Detection of potentially fraudulent financial record keeping and reporting is one of the central charges of the external auditor.
- In the event that the auditor detects fraud, it is their responsibility to bring it to the management team's attention.
- They may also consider withdrawing from the audit process and job if management does not take the appropriate actions to rectify the fraud.
- External auditors will review the entity's information technology control procedures in relation to the finances when assessing its overall internal financial controls.
- They must also investigate any material issues raised by inquiries from professional or regulatory authorities, such as the local taxing authority.
- Fraud can present as false sales, recording revenues before all terms were satisfied, recording conditional sales, improper cutoffs of transactions at period end, overstated asset sales, improper use of
percentages of completion, unauthorized shipments, and recording of consignment sales as completed sales.

- Accidental misstatements are almost always detected in routine financial audits.
- These errors should not be confused with actual fraudulent activity.
- Errors can occur at any time, in any place and with unpredictable financial statement effects.

- Fraud, on the other hand, is intentional and is often more difficult to detect than are errors.
- An external auditor must be able to recognize when conditions indicate potentially higher risks of employee or management fraud and then increase their scrutiny of all records accordingly.

**An external auditor is:**

- An audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization, and who is independent of the entity being audited.
- The users of the business's financial information and audit reports, including government agencies, investors, and the general public, rely on the external auditor to present an unbiased and independent audit report.

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The independent external auditor generally proceeds with an audit according to a set process consisting of three steps: planning, gathering evidence, and issuing a report.

**Planning the audit:**
- The auditor develops an audit program that identifies and schedules audit procedures that are to be performed to obtain the evidence.

**Gathering the evidence:**
- Audit evidence is proof obtained to support the audit's conclusions.
- Audit procedures include those activities undertaken by the auditor to obtain the evidence.
- Evidence-gathering procedures include observation, confirmation, calculations, analysis, inquiry, inspection, and comparison.
- An audit trail is a chronological record of economic events or transactions that have been experienced by an organization.
- The audit trail enables an auditor to evaluate the strengths and weaknesses of internal controls, system designs, and company policies and procedures.

**The audit report**
- This report lays out the auditor’s findings and opinions about the business’s financial statements. Including the level of compliance and conformity with the generally accepted accounting principles.
- A check is made to verify that representations over a period of years are consistent.
- Will assess if the existing financial statements are a fair presentation of financial statements that are generally understood and accepted by accountants and adhere to the accounting principles.

**These characteristics include such things as:**
- The accounting principles used in the company’s accounting method are appropriate in the circumstances
- The financial statements are prepared in such a way that they can be used, understood, and interpreted by a lay person
- The information that is presented in the financial statements is classified and summarized in a reasonable manner
The financial statements reflect the period’s events and transactions in a way that presents an accurate portrait of the business’s financial operations and cash flows within reasonable and practical limits.

The auditor's unqualified report generally contains three paragraphs:

- The introductory paragraph will identify the financial statements audited. It states that management is responsible for those statements. It then asserts that the auditor is responsible for expressing an opinion on the statements identified.
- The scope paragraph will describe what the auditor has done to examine and analyze the documents. It specifically will state that the auditor has examined the financial statements in accordance with generally accepted auditing standards and has performed appropriate tests to ensure accuracy.
- The opinion paragraph will express the auditor's opinion (or will formally announce the lack of opinion and why) on whether or not the statements are in accordance with generally accepted accounting principles.

Various audit opinions are defined by the AICPA's Auditing Standards Board as follows:

- **Unqualified opinion** – This opinion means that all materials were made available, found to be in order, and met all auditing requirements. This is the most favorable opinion that can be rendered by an external auditor about a company's operations and records.
- **Explanatory language added** – Circumstances may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report. When this is done the opinion is prefaced with the term, explanatory language added.
- **Qualified opinion** – This type of opinion is used for instances in which most of the company's financial materials were in order, with the exception of a certain account or transaction.
- **Adverse opinion** – An adverse opinion states that the financial statements do not accurately or completely represent the company's financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Such an opinion is obviously not good news for the business being audited.
- **Disclaimer of opinion** – A disclaimer of opinion states that the auditor does not express an opinion on the financial statements, generally because he or she feels that the company did not present sufficient information. Again, this opinion casts an unfavorable light on the business being audited.

18.4 Internal Audit

An internal audit is the process of the examination, monitoring and analysis of the operational activities of a company. These operations include its business structure, information systems, and employee behavior. An internal audit is designed to review what a company is doing in order to identify potential threats to the organization’s health and profitability. It also is designed to help the auditor make suggestions for mitigating the risks associated with those threats in order to minimize costs for the company.
An internal audit is performed by a group that reports directly to the audit committee but operates independently from other departments within the company.

- This group is made up of employees that are hired specifically to perform internal audits.
- The team is responsible for performing audits that can be both financial and non-financial in nature within a wide range of areas within a business. These are usually dictated within the annual audit plan.
- Internal auditors are not responsible for the execution of company activities;
- They advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities.
- Internal auditors may have a wide variety of higher educational and professional backgrounds due to their broad scope of involvement in the company.

Internal audits generally look at key risks facing the business right now and what is being done currently to manage those risks effectively with the end result of helping the organization to achieve its objectives.

- For example, they may look at risks to the company’s reputation when they are using resources such as the use of cheap labor in foreign countries, or strategic risks such as the company is producing too many products in comparison to resources available etc.
The scope of internal auditing within an organization is very broad and may involve topics such as:

- A business’s governance, risk management and management controls over the efficiency and effectiveness of their operations. This can include safeguarding of assets.
- The reliability of financial and management reporting
- Compliance with laws and regulations on all fronts
  Internal auditing may also involve

  - Conducting periodic proactive fraud audits to identify any potentially fraudulent acts within the company
  - Voluntarily participating in fraud investigations that are under the direction of outside fraud investigation professionals
  - Conducting post investigation fraud audits to identify internal control breakdowns and establish the company’s financial loss.
The cost audit represents the process of the verification of a company’s cost accounts and checks on the adherence to the existing cost accounting plan. A cost audit ascertains the accuracy of the existing cost accounting records to ensure that they are in conformity with the generally accepted cost accounting principles, plans, procedures and objectives.

**A Cost Audit will be comprised of the following:**

- A verification of the cost accounting records - Including the accuracy of the cost accounts, cost reports, cost statements, cost data and costing technique
- A comprehensive examination of these records to ensure that they adhere to the generally accepted cost accounting principles, plans, procedures and objective.

**The Objectives of a Cost Audit are:**

- **Prospective Objective:** The cost audit aims to identify the presence of unnecessary waste or the losses in producing a product, providing a service etc. and ensure that the costing system determines the correct and realistic cost of production.
- **Constructive Objectives:** The cost audit provides useful information to the company management regarding regulating their production, a more economical method of operation, reducing the cost of operations and reformulating cost accounting plans if necessary.
The Cost Audit is comprised of the following steps:

- Review – examine the provided documents and any other evidence obtained from the company
- Verification – Analyze, run appropriate tests and calculations to determine the effectiveness of the cost management system for business operations
- Reporting – compile an audit report that clearly lays out the auditor’s findings and subsequent opinion/recommendations for the company.

There are a variety of entities that can request a cost audit. The entity requesting the cost audit affects how the audit is reported and to whom. Some examples of the different entities are the company management, a customer of the company, the government, and a trade association.
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18.6 Performance Audit

Most people think of specific measurements when it comes to performance. For example, did Jon Smith make his sales quota this month or did Suzie make the right amount of widgets. These factors have no bearing on a performance audit.

Performance auditing differs from performance measurement, in that performance measurement is the responsibility of the management of the company. In addition, performance measurement may include a broad variety of activities that do not meet the rigor and standards of an independent external assessment.

A performance audit refers to an independent examination and assessment of a program, function, operation or the management systems and procedures of a governmental or non-profit entity. The goal is to assess whether the entity is achieving the maximum economy, efficiency and effectiveness with the use of the available resources.
The examination is wholly objective and systematic. In general the audit uses structured and professionally adopted methodologies.

- The performance audit assesses the policies and methods of an organization’s management of resources.
- Identifies the performance of current tactical and strategic planning and offers recommendations of how to improve.
- Reviews employee and organizational performance and identifies areas of improvement.
- Performance audits have also been referred to as management audits.

The objectives of a performance/management audit are to:

- Establish the current level of effectiveness
- Suggest improvements in problem areas
- Lay down standards for future performance that will improve on the current system

Management auditors (employees of the company or independent consultants) do not generally evaluate individual performance, but may critically evaluate the senior executives as a whole management team.

Performance audits are being conducted globally which results in a wide number of standards and generally accepted guidelines. However there are some uniform expectations across the board.
In most countries, performance audits of governmental activities are carried out by the external audit bodies at a federal or state level.

Many of these audit bodies have established guides for conducting performance audits which explain how performance audits are planned, conducted and its results reported. Global auditing also results in different governing bodies in different countries.

INTOSAI, the International Association of Supreme Audit Institutions, has published generally accepted principles of performance auditing in its implementation guidelines.

In the United States, the standard for government performance audits is the Generally Accepted Government Auditing Standards (GAGAS), often referred to as the "yellow book", which is maintained by the federal Government Accountability Office (GAO).

The European Court of Auditors (ECA) has developed a "performance audit manual" for its audits of the sound financial management of the European Commission and for the programs that are funded through the EU budget.

Performance audits may be conducted by Internal Auditors who are employees of the entity being audited. However, it is important to note that some national governments require agencies,
departments and branches to periodically retain outside auditors to conduct performance audits to ensure that there are checks and balances.

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In the USA, all auditors who follow GAGAS standards are required to maintain:

- Independence from the entity being audited
- Supervision of all assistants
- Continuing professional education to stay abreast of new developments and requirements
- Conduct the audit using a specific process that is designed to increase the quality of the audit and reduce the politicization of audit work

Although there are separate professional credentials and certifications for Financial Auditors, the auditors that conduct Performance Audits in the USA are most often Certified Public Accountants, Certified Internal Auditors, or have a broad background in public policy, business or public administration.

The scope of performance audits may include the detection of fraud, waste and abuse, although often these are not included in the scope. Prior to engaging in a performance audit, the auditor must have a scope defined and a plan laid out which will be used to guide the audit process. The entity requesting the audit may have some input into what is in the scope.
18.7 Quality Audit

A quality audit examines your company's existing quality management system. A quality system auditor will generally closely guard the checklist they use to audit and will adapt the list to ensure it applies to your business. If you understand what areas and what types of information a quality audit examines, then you can make your own checklist and take steps to maximize the likelihood your quality management system measures up to the generally accepted standards.

- Regardless of size, all businesses that must meet specific quality requirements must also face quality audits.
- A registrar will conduct the audit of your quality management system. They are an independent company with no financial interest in the outcome of the inspection or audit.
- A registrar certifies the system's compliance with the International Organization for Standardization's ISO 9001 standard.
- Audits usually are triggered by your quality management system's annual re-certification requirements.
- They can also result from changes in customer demands or your own need to evaluate the system's effectiveness.

The audit starts with the quality management system's paperwork.
• The auditor expects quality system documentation to include a quality policy, a quality manual and the appropriate quality standards for each process or product
• A quality management system is judged in the audit against the ISO 9001 standard only

Your quality management system’s records should help remedy quality problems and issues that arise during the normal course of production and business operation. Quality records will also assist you in effective planning and in execution and control of your processes and methods. Maintaining these records in a clear and concise is imperative to a successful audit.

• An auditor inspects these records to determine whether your record-keeping complies with the requirements of each standard that applies to your products or processes.
• Auditors will also use the records to determine your system’s effectiveness usually based on the level of problem resolution that appears in the records. The records will identify the part or system, all of the issues involved and the means by which the problems were resolved.

The quality manual for your business operations is an integral part of your quality management system. The auditor will review the quality manual and will look for the following:

• The quality manual describes the scope of the quality system.
• The manual serves as the directive for implementing the company’s quality policy
• It guides your approach to quality.
• The manual describes how the quality system interacts with other departments to achieve the company’s quality goals.
• The manual specifies how quality documents are controlled and reviewed for accuracy, including updates and distribution.
• The quality manual is up-to-date and readily and easily identifiable as the most recent edition.
• The company’s quality manual includes
  o A copy of the company’s quality policy
  o A list of the standardized techniques related to quality management found in ISO 900
  o An understandable chart showing the relationships and responsibilities regarding quality control between your company’s departments
  o A clear and concise timetable for disposing of old quality documents that are no longer needed
  o A plan for the company’s record-keeping system for all documents related to quality