Cost or benefit?

How to understand and prepare your business for today's new audit standards **Interviewed by Kristen Hampshire**

How well do you really know the business processes that are driving forces behind your financial statements? Your organization has systems for shipping orders, collecting customer payments, buying materials from distributors — and all these systems work to your knowledge. But do you have controls in place to test their efficacy?

With new changes issued by the Auditing Standards Board, effective as of Dec. 31, 2007, public accounting firms must approach audits of nonpublic entities with a sharper eye on controls. Auditors can no longer automatically default to substantive auditing methods — where they only document a general understanding of a company's controls. The audit process now requires a "digging in" to find out how a business really works. They must analyze and test the real moving parts of an organization.

"The more visibility we have into an organization, the greater value we can provide in an advisory role," says Anthony Caleca, CPA, a member-in-charge of the Audit Group at Brown Smith Wallace LLC. "The more moving parts an organization has, the harder it is to determine whether or not a process is taking place as it should."

Many owners, too busy working in the business and managing daily operations, do not set aside time to work on the business, Caleca adds. Or, they intend to take time out to establish formal processes and controls, but other activities take priority.

Smart Business spoke with Caleca about ways to analyze the processes that make your business tick.

Why the focus on auditing now, and how will financial statements be audited differently?

The users of financial statements have demanded a significant increase in efforts to improve financial reporting. Publicly held companies have had to implement Sarbanes-Oxley; now private companies and organization have to adhere to these new audit risk standards. These new public and private company standards are a reaction to failed audits and financial reporting that have occurred in this marketplace. Accountants must have a real understanding of every process that drives their clients' financial statements. Essentially, the new private company rules will prompt a fresh look at how transactions are being processed and where time and money may be wasted.

Anthony Caleca, CPA
Member-in-charge, Audit Group
Brown Smith Wallace LLC

Are business owners surprised when they learn the truth about whether their processes are effective?

Yes, in many cases, they thought a department was performing a certain task that wasn't being executed properly. Or, they thought a system was working when it was not. For instance, say you own a $50 million business and you expect all customers to go through a credit application process. You assume that your credit department is scrutinizing customers' creditworthiness. Under the new standards, an auditor actually walks through the credit application and approval process and discovers that many customers' accounts receivable balances exceed their pre-established credit limits. The system, if there is one, clearly does not work. The company risks shipping products to customers who can't afford to pay for them. Our goal as auditors is to gain a detailed understanding of the processes and controls in the significant areas of a business. In doing so, we make value-added discoveries. We may notice a 10-step process that can be condensed into five steps without undermining the controls and performance of the company. This can be a real eye-opener for business owners.

What resources must businesses invest in to adopt better controls?

First, developing high-level controls takes time and buy-in from key individuals who manage significant departments in your organization. If your company doesn't have a narrative or a relatively detailed description for every process from sales to posting customer payments and everything in between, that's step one. Step back and consult with managers to find out how they handle every transaction. Put it in writing. Examine each system and decide whether there are holes that present opportunities for financial reporting errors. Every process must be documented before meeting with an auditor, who will begin to dissect these systems and analyze them for potential 'leaks.' Under the new standards, your auditor will likely be on site with you at least three times a year. Ultimately, the time and work required to test controls will drive up auditing costs by as much as 25 percent. We prepared our clients for this new effort by rolling out a readiness process and detailed information package to explain how greater scrutiny can work to their advantage. It can — and it has.

What benefits result when business owners fine-tune their internal controls?

First, you improve interdepartmental communication within your organization as you assemble a team of leading managers and employees who help you define processes and understand the working parts of your company. Second, your auditor serves as an active, valuable adviser who truly understands your business, beyond your general goals and objectives. Taking time to evaluate every system, the nuts and bolts of a business, sheds light on areas that may need improvement. And by taking the time to step back from your business, you'll have a clear idea of where you stand today and where your business is headed. <<

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