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HOW TO PERFORM AN AUDIT

There are four stages to each audit. They are preliminary survey, field-work, reporting, and follow-up verification that prior audit recommendations have been implemented with successful results. The most important stage of the audit work is the preliminary survey. This audit activity starts the planning effort, which is based upon extensive background research, including observation of each type of routine transaction by tracking the transaction's source document from its beginning through its conclusion, and by watching the handling of the organization's property, and any permitted access to it. The preliminary survey work sets the strategy and direction for the rest of the audit activity.

The plan of the audit is called an audit program; its purpose is to establish the theme of the audit research and reporting. If this effort is superficial, or misdirected, then the auditor will risk wasting his time and increasing the cost of the audit activity on insignificant or useless reviews, while serious problems could remain overlooked. The worst mistake that an auditor can make would be to report that all is well when, in fact, property continues to be misappropriated without detection. One problem with public accounting education is that most practicing auditors lack investigative experience, management training, or bookkeeping practice. The substance of their training is often theoretical and abstract from real-world activity. They lack both confidence and the understanding of those inherent risks that only persons who do the accounting work and routines that are being audited could perceive. Being insecure and overwhelmed with the complexity of unknown financial environments, the public accountant often acts pretentiously, like a sophist who claims to possess authoritative knowledge in areas beyond his limited skills and training. Close inspection of most public accountants' work papers will reveal volumes of time consuming clerical tasks that provide little, if any, substance of knowledge about those inherent risks or their exploitation by unscrupulous employees of the audited organization.

During the preliminary survey stage of the audit the auditor will randomly draw a small sample of documents to examine, in order to establish an expected error rate. The auditor will compare the actual error rate within the examined transactions and control practices that he has discovered in the small sample with previous audits' findings. He will then choose the larger of the error rates and use this variable in the statistical formula that will indicate the sample size of the universe that he must select during the field testing of those transactions and control procedures. During the later field work stage of the audit the auditor will select the larger sample size from the formula in order to avoid bias in his statistical sampling of the selected documents that are tested for compliance accuracy. If an error rate is found to be significantly greater than expected then the sample selection must be expanded.

A competent internal auditor should already know most of the problems that statistical sampling will uncover. His greater concern is in finding the truth of actual events through systematic scan-reading of the entire universe of documents, within reasonableness and practicability. He is looking for discovery of unknown problems that could be missed in more superficial public accounting audit methods. Both the public accountant and the internal auditor must be cognizant of the cost versus benefit of each audit activity. For example, it would make no sense to spend $ 60,000 perfecting the appearance of audit work papers if the likelihood of court testimony is remote. Time spent beautifying audit work papers and cross-referencing minor disclosures of errors is time that is not spent on investigating transactions and events of greater importance. Some auditors, however, prefer to dress well than to be thorough in investigations of actual problems.

This paper will offer examples of each activity that a field auditor must do, but first, the difference between public accounting and internal auditing should be defined. The title Certified Public Accountant (CPA) describes the duty of this profession. The CPA is not a Certified Public Auditor. He lacks adequate familiarity about the audited organization's staff to be an auditor. Additionally, he is not certified at all, but is licensed by the government to give an opinion on the fair and accurate presentation of financial statements in compliance with legal and professional requirements of financial reporting and disclosure standards. His credentials begin and end there. The CPA is not a member of the management team, he is not an employee of the audited organization, he is not a crime investigator, nor does he have the training or experience to act as a management consultant. If the public accountant will confine his work to his specially trained skills of advising and examining the preparation and presentation of legal and public financial reports, then he will perform the tasks required of his profession with comprehensive accuracy. Any activity outside of this scope detracts his attention and focus from his licensed purpose. Accordingly, CPA's should be barred from performing the generalist activities of internal auditing or of management consulting. Public accounting firms will resist, because they will lose a substantial percentage of income that is gained by performing consulting work, which correctly opens suspicion of conflict of interest. Like the skilled heart surgeon, the CPA should refrain from performing the varied tasks of a general practitioner. He should limit his work to his narrow, but complex, field of knowledge and to do it well.

Internal auditors are communicators. Public accountants are examiners. The internal auditor must thoroughly know the internal interactions of the audited organization and the open-loop external effects on the organization's growth and survival. An external auditor can not profitably or competently accomplish this role. The best he could achieve would be to pretentiously claim that he has done so–a very dangerous lie. Additionally, the public accountants' fees should be a fixed rate that is established by law and enforced by the courts. The CPA and management should not be allowed to negotiate a fee, nor should the CPA be permitted to receive indirect payments from the audited organization through consulting work or other means. Here again the public accounting firms will resist, as their lobbyist efforts before congresses and parliaments evidence. The licensed accountant can not be both a public servant and a profit-making commercial enterprise. The conflict of interest is obvious.

The internal auditor can not be wholly independent because of his position in the organization as a senior member of the management team, and he holds certain staff management duties and authority that require him to assess all aspects of the plans, operations, and handling of the physical resources of the audited organization. He makes recommendations in each sphere of management and is therefore not impartial in judging the results of his advice. He can interview virtually any employee of the organization and access any secured or open facility there, for the purpose of acting as a check and balance on the work of the line managers. He holds the duty and authority to critique the activities of his peers and higher officials within the management team. Additionally, he is free to discuss related activities with customers, government officers, union leaders, suppliers, and others, in order to appraise the internal and external influences that act upon the success of the audited organization. There are codes of ethics and laws of confidentiality that must be obeyed by both the CPA and the CIA (Certified Internal Auditor), but the internal auditor assumes greater latitude in his allowed communications. The internal auditors of governments possess even greater freedoms of disclosures, within legal guidelines.

Being a member of the management team, the internal auditor owes a subordinate loyalty only to the concept of senior management and not to a particular individual who holds a title of senior authority in the company, if that person commits a crime. Public accountants fail to appreciate the principle of saluting the uniform and not the man who wears it, which is the core cause of much confusion over codes of ethics because of public accounting interference in the profession of internal auditing.

The internal auditor is an investigator, an economist and a managerial accountant during the performance of his reviews. He must perform compliance audits with the applied skills of a legal specialist, especially if he is a government auditor. He must have extensive training and experience in general and personnel management, education and experience as a financial accountant and bookkeeper, and reasonable knowledge about the operations of each department of the organization in which he works. Additionally, he must have developed an authoritative knowledge of internal controls. The CPA evaluates internal accounting controls for the purpose of establishing the size of his random sample tests. The CIA evaluates all internal controls for the purpose of identifying weaknesses in the system and then recommending corrective action before they are exploited by any dishonest employees.

Within the internal accounting office of many organizations, the financial accountants and managerial accountants disagree as to what data should be collected and categorized in the computer programs of the organization's accounting system. The financial accountants prefer that the recording be limited to that information that is required in financial statement reporting, whereas the managerial accountants demand a greater detail of cost and production data that will assist management analysis of internal daily operations and decision making. The CPA's are by professional training financial accountants and they are less likely to devote time and economic resources toward managerial accounting analysis and auditing of operations than a CIA would pursue. The choice of hiring an audit director who has CPA credentials versus one who holds a CIA certification will effect the expansion or limitation of audit attention toward those activities that do not directly relate to the verification of financial statement record keeping and preparation.

The internal auditor is an expert in the organization's system of internal controls that protect the organization's property and further the likely optimization of profits. Since these goals are not incorporated within the training and duties of writing audit opinions as to the fairness and accuracy of financial statement reporting, public accountants tend to avoid, and even obstruct, the internal auditing and accounting work that considers productivity and asset protection. For this reason, public accountants should be barred from internal audit practice and financial accountants should not hold higher authority within the organization over managerial accountants. The two functions serve different and equally important objectives and thus should be separated. A public accountant should not practice internal auditing any more than a heart surgeon should practice the daily routines of family medicine. Both are doctors, but with different skills and expertise. The same analogy is true between public accountants and internal auditors. They practice different professions that only overlap at certain tangent activities.

Within the internal accounting office of the organization, the accountants perform daily routines. They depend upon the public accounting firms to research and guide them as to the legal and professional changes in the rules and standards of financial statement presentation, which can be very complex for the multinational enterprises during the current transitions into the new world of globalization. No one person can be expert in these issues if his time is also divided into the verification of economy, efficiency and effectiveness of management policies and procedures of the organization, the protection of assets, or the exposing of frauds, embezzlements or other criminal activity within the organizational structure that often take years to resolve. Nor can a financial statement specialist divert his attention to the analysis and review of workers' activities that are required for compliance and successful result of management's policies, plans and procedures. It is impossible for anyone to perform all of these duties. A public accountant who tries to wear all of these hats cannot truthfully claim that he understands the detail and facts within the financial statements over which he has given an audit opinion.

The university faculty must consider these problems and should make recommendations to legislators and the business community that will improve the auditing and accounting practices, procedures, standards and codes of ethics. Additionally, the universities should divide their programs and staffing of teachers and professors in such a way that each may specialize in a certain sphere of business training and research. They must constantly review what they are teaching and decide if it is the information that today's bookkeepers, accountants and auditors need to know. As with accounting and auditing, it is counterproductive to spread the work of the teacher too thin. Some professors should concentrate on research while others should devote most of their activities to teaching. Although this is truer with scientific fields of learning, it also holds some importance in business education. The men and women of academic letters are trainers of professionals in both thinking and methodologies of practical knowledge, and they are the direction setters and guardians of standards in the professions that they have mastered. If there is a failure in business and society, its roots can be found in education. As Plato wrote, philosophers must return into the cave of darkness and lead the way into the daylight of truth and knowledge. They are the leaders, not merely the observers.

Now that the definitions and duties of auditors and public accountants have been explained, the steps of performing an internal audit can be better appreciated. The practical part of the university audit course should require the students to prepare each of the following documents:

1. Entrance Conference Letter (Engagement Letter).
2. Auditor's internal control questionnaire (additionally, the students will practice holding an entrance conference meeting and interviews with an assigned manager of the audited department in simulated training).
3. Formal and Informal Flowcharts.
4. Positive and Negative Confirmation Letters.
5. Audit Program, and Annual Audit Plan.
6. Audit sample selection work papers, field testing work papers, and the cross-referencing of the audit work papers.
7. Internal Audit Memorandum (IAM) of an audit finding, and the audit report.
8. Simulated pre-exit and exit conference meetings, with critique of the results.