Annual Audits: Board Responsibilities

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Directors, managers, and advisers of new and developing cooperatives need to be well informed about the importance of an annual audit.

Reasons for Audit

Securing an annual audit of the cooperative's financial records is the responsibility of the board of directors. Because the board acts as the trustee of the cooperative's assets, it is responsible for safeguarding, auditing, and appraising the cooperative's financial resources. The audit is a fundamental part of this trustee responsibility, and the cost of the audit should be considered a normal business expense.

The fiduciary responsibilities of the board should not be taken lightly. If a board of directors is negligent in establishing and monitoring the operations of their cooperative, directors could be held liable. The first step in fulfilling this obligation is a complete, double-entry bookkeeping system; second is monthly financial statements; and the third is an annual audit of the accounting records and supporting document.

The fiduciary/trustee responsibility of the board of directors translates into five specific reasons why the board must provide for an annual audit of the cooperative's accounting records:

1. To prevent deliberate misstatement of fact. Misstatement of fact may occur for many reasons, such as to hide poor decisions or to cover fraud.
2. To assure the judgment decisions are not unduly biased in favor of management. It is the board's duty to develop and implement the accounting system, and management's duty to maintain the books.
3. To assure records are dependable. Accounting methods should be accurate as well as consistent. An audit will identify shortcomings in accuracy and/or consistency. Procedures lacking consistency fail to be dependable for purposes of analysis and decision making.
4. To assure Generally Accepted Accounting Practices (GAAP) have been consistently followed. The American Institute of Certified Public Accountants (AICPA) has set guidelines, laws, or rules in accounting practices to prepare financial statements. This will allow comparisons with organizations whose audits also follow standard practices.
5. To assure that the disclosure is complete. In many cases, what is not reported is often more important than what is reported. An audit will help the board of directors ensure that full disclosure of the financial well being of the cooperative business has been made.

Furthermore, there are other reasons why an audit may be required. Creditors and suppliers may require an audit before credit is granted and have an ongoing audit requirement as part of the loan agreements.

Audit Features

The term audit refers to actions that can be either internal or external in nature. The internal auditing function of a business is performed by an internal auditor to determine conformity in record keeping and operations with predetermined standards, such as inventory valuation, appropriate issuance of transportation contracts, etc. While this is an important function for cooperative businesses, in this report we are concerned with the external audit function.

The audit consists of:

1. A review of the balance sheet, income statement, and statement of cash flows;
2. A review of the underlying documents supporting the information given in these financial statements;
3. Verification of accounts receivable and payable balances with cooperative customers;
4. A review of inventory quality, quantity, valuation, records, and procedures;
5. Verifying the existence of recorded securities;
6. Reviewing justification for judgment decisions and estimates;
7. Assessing the effectiveness of internal controls including technology security and making recommendations for improvement
8. Sampling accounting records; and
9. Reviewing minutes of the board of directors meetings for policy changes and instructions to management.

Recommendations from other cooperatives in the region should be helpful in the selection process.

Some characteristics of auditors that should be considered when making a selection include:

1. Professional competence;
2. Ability to maintain independence and a high degree of integrity;
3. Understanding of cooperative law, philosophy, and methods;
4. Familiarity with cooperative accounting practices and the industry in which the cooperative operates;
5. Ability to develop and conduct an efficient audit pro-

gram;
6. Ability to communicate with the board and management;
7. Ability to provide competent suggestions for improving financial accounting practices;
8. Understanding the responsibility of their reporting directly to the board; and
9. Willingness to correct any oversights occurring during the audit program.

Selection Procedure

The first step in most audit engagements involves a meeting between the auditors and the audit committee or the entire board of directors. The cooperative manager and controller may also participate in this meeting. During this meeting, the board members should have a prepared list of questions directed toward the above characteristics to ask the auditor. Follow-up questions are often necessary to fully understand the auditor's position. It is the duty of the board to ask questions and to determine that the auditor selected is qualified, competent, and fully aware of the cooperative's needs.

During this meeting with the board, the auditors should attempt to do the following:
1. Become acquainted with the board and management;
2. Determine what the board wants included in the audit;
3. Determine the scope of work required to perform the audit;
4. Become familiar with the cooperative's accounting system; and
5. Identify specific areas requiring attention.

To satisfy these objectives, the auditor will likely have a list of prepared questions for the board and management. The board and management should be prepared to provide information needed of the auditor to meet these objectives in a timely manner.

Audit Procedures and Audit Report

Audit Procedures

An auditor takes certain steps or procedures when completing an audit. These procedures depend upon the audit engagement and the understanding between the auditor and the board of directors. In general, the auditor attempts to obtain evidence to support recorded figures in the financial statements. The audit procedures followed depend on the complexity of the tasks to be performed, the type of accounting system, characteristics of the records, and the nature of the cooperative.

The audit may post the closing and necessary adjusting entries for the cooperative. In the letter of understanding and the pre-audit meeting, it should be clear whether this is a service desired by the cooperative. Auditors will also enter the opening entries for the coming fiscal year if requested.

During an audit, the auditor will not review every transaction entered in the audit year. Rather, the auditor will test a sample of the various transactions. Audit sampling is the use of an audit test on part of the records being examined to derive a conclusion regarding the characteristics of the records as a whole.

Audit risk refers to the possibility that the auditor may unintentionally fail to identify and/or notify the board of seriously misstated financial statements. Audit risk must be taken into account in determining the number and type of audit techniques to be employed on the particular audit that, in turn, will affect the cost of the audit. Therefore, the board of directors must understand that cutting costs in contracting for an audit may increase the possibility the audit will fail to uncover seriously misstated financial statements.

During the audit process the auditor may pose questions to the board, manager and employees. Some of these questions may seem odd such as questions about fraud, waste and abuse. These questions are required in the audit process. The board, manager and employees should answer all questions presented by the auditor.

The auditor will determine the type and level of sampling to use based the on the complexity of the accounting system, the discussions at the pre-audit meeting, and the budgetary limitations imposed of the audit.

Standards Set for Auditors

As with many professions, a set of standards is assigned for auditors by their professional organization, AICPA. These standards provide guidance in assuring high-quality audit performance.

General Standards

1. Individuals with sufficient audit training and expertise must conduct the examination.
2. The auditor must be independent in performing his/her activities.
3. Due professional care must be exercised in conducting the audit and in preparing the audit report.

Standards of Fieldwork

1. The engagement must be properly planned and assistants adequately supervised.
2. Understanding of the internal control structure must be adequate so the audit can be properly planned and a determination made of the nature, timing, and degree of tests to be conducted.
3. Sufficient competent evidential matter must be obtained through observation, inspection, inquiries, and confirmations so a proper basis exists for an audit opinion.

Standard of Reporting

1. The report should state if the financial statements are prepared in accordance with GAAP.
2. The report should identify those circumstances in which accounting principles have not been consistently observed in the current year relative to the preceding period.
3. Footnote disclosures should be deemed sufficient unless indicated otherwise in the audit report.
4. The report should contain an audit opinion or an assertion that no opinion can be expressed.

Audit Report

The auditor will assess the adequacy of the firm's internal controls. These controls include polices and practices used to control operations, accounting controls and regulatory compliance. Some examples would include authorization of transactions, account reconciliation, and segregation of duties. Internal controls are a responsibility of management with oversight by the board of directors.

After the audit is completed, the auditor issues a written report containing his/her opinion to the board of directors. This report takes a standard form and various expressions confer the seriousness of any problems identified by the auditor.

In the auditor's report, the board should expect the introductory paragraph to mention the management's responsibility for the financial statements. In the second paragraph or scope paragraph, it is stated that an audit provides reasonable assurance that the financial statements are free of material misstatement. An explanation of what an audit involves is also given. The third paragraph or opinion paragraph provides the audit opinion. If a general lack of consistency exists, an additional explanatory paragraph should be given of that fact. In addition, the report may include supplementary information, such as:

1. Schedule of Insurance Coverages;
2. Accountants Receivable Aging;
3. More detailed information of asset and liability items on the balance sheet;
4. Fixed Asset Schedule; and
5. Schedule of Shipments in Transit.

Audit Opinions

Auditors have the option of issuing four types of opinions. These opinions are: 1) an unqualified opinion, 2) a qualified opinion, 3) a disclaimer of opinion, or 4) an adverse opinion.

The cooperative will receive an unqualified opinion if the auditor believes that statements fairly reflect the organization's condition and performance. This is the best report the cooperative can receive from the auditor and is typically issued in a short opinion report.

A qualified opinion is issued when the auditor cannot give a complete approval of the records. Qualified opinions vary in seriousness, but do raise red flags and should be taken seriously. A qualified opinion is given for one of two reasons. First, if the auditor is unable to obtain sufficient evidential matter for an unqualified opinion and/or is unable to apply a necessary auditing procedure, this is referred to as a scope limitation. Second, if the financial statements depart from GAAP and the client chooses not to make the needed modifications, this is referred to as an "except for" qualified opinion. The "except for" qualified opinion is offered if the effects are not so severe as to require an adverse opinion.

Four Types of Audit Opinion:

1. **Unqualified opinion** — financial statements present fairly the financial position and operating results of the company in conformity with GAAP.
2. **Qualified opinion** — statements are fair, "subject to" or "except for," because some area could not be tested or there was a situation that required deviation from the normal procedures.
3. **Disclaimer of opinion** — the auditor was unable to render an opinion on the fairness of the financial statements.
4. **Adverse opinion** — the auditor feels the statements are not presented fairly and the situation remains unresolved.

Post Audit Board Responsibilities

A copy of the auditor's opinion is usually included in the annual report of the cooperative. This report should be distributed to members either prior to or at the annual meeting. Since the cooperative is a member-owned business, the members have a right to this type of information.

If the auditor's opinion is less than unqualified, the board may need to take some action. In the case of a qualified opinion, the action may be limited to a minor adjustment or to better documentation. For a disclaimer of opinion or an adverse opinion, some considerable adjustments to the record keeping system of the cooperative are likely necessary. The auditor may be able to help with needed changes or recommend an accountant to do so.

Summary

Annual audits of the cooperative's financial records are the responsibility of the board of directors. As the board acts as trustee of the cooperative's assets, it is responsible for safeguarding, auditing, and appraising the cooperative's financial resources. The board performs these duties on behalf of members, stockholders, and creditors.

The Oklahoma Cooperative Extension Service
Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and research-based information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

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