Auditor Insight

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DO YOU KNOW HOW MUCH AN AUDIT ADJUSTMENT COSTS YOU? By: Jayme L. McWidener, CPA and Audit Manager at HJ & Associates, LLC

In a perfect world an audit of your financial information is as simple as the financial statements that they support; everything matches and all of the schedules, invoices, and reports tie out to the penny. However, in the real world, auditors seem to have a way of always finding something that you, or one of your accounting team members, had overlooked. Whether it's transposing a number, a data entry error, or just a formula in a spreadsheet that wasn't updated or had an incorrect reference, there is always something, and your auditors always seem to find it.

Knowing that to be the case, why should you be worried if you're positive that by the end of the audit all of your material misstatements will have been identified and corrected? I suppose the answer to that is relative to your audit budget. Often errors, regardless of their size, are required to be analyzed and addressed. If such errors are considered material they are recorded as audit adjustments, which are more likely than not contributing to higher billings from your audit firm.

In order to understand why audit adjustments equal higher billings, we have walked through aspects of the audit process below, identifying ways in which client errors impact the overall execution of the audit.

The audit process consists of a combination of different procedures that will identify unusual amounts or transactions within a company's financial information. Do you wonder how auditors always find that one unusual transaction? That one transaction that was the exception to the norm? It comes as a result of the risk assessment process and an audit teams experience with the Company, with the industry, and in the profession. Depending on the company and their operations, as well as their accounting department's competence and experience, an auditor will design an audit approach that identifies risks and ensures those risks are addressed with the audit. The audit approach often will identify those transactions that seem unusual because those transactions have a higher risk that a company has not accounted for the transaction correctly.

The process of finding an audit adjustment begins when the auditors identify a questionable matter or something that doesn't make sense based on all of their knowledge, experience, and their expectations and they start trying to investigate what happened. Because the auditors don't have access to the same information the Company has and instead are only given certain information to begin their audit, it is the auditors' natural tendency to try to find an explanation in order to avoid "bugging" their client or asking a stupid question. An auditor's experience in the profession and their comfort level with the client will affect how much time is spent on this process. Once the auditor begins to ask questions and gets a better understanding of the matter they can identify and point out the error, but the time is already spent.

Once the auditor has completed their investigation, they can then identify and usually quantify the error. For the most part, auditors want you to get everything right, so they often will search their memory bank and creative minds for ways in which you are right. Auditors will consider materiality, as well as the qualitative impacts of the error to determine if the error can be overlooked. Additionally, once an error is identified, auditor skepticism increases and auditors may be required to consider 'what caused this error,' 'what else could have been impacted,' and 'what does this mean to the overall audit testing.'

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The time for the recalculation process, the evaluation process, and the additional consideration process just keeps adding time to a clients audit bill.

Noted material misstatements then must be communicated to the client. This process can get lengthy when an auditor has to explain what they've found and how they determined the adjustment (which includes walking through amounts, calculations, accounting literature, etc.). Any disagreements or misinterpretations at this point become apparent and will sometimes involve bringing superiors into the picture. What was initially a difference between the controllers' calculation and a staff auditor's findings becomes a difficult conversation between a CFO and an audit partner. Conversations and calculations have to be discussed and walked through again where more people are involved in the conversations and different considerations are raised by the newcomers.

As part of the additional consideration process, auditors may be required by audit or firm policies to expand testing. This additional test work adds more time to the audit and requires extra efforts from both the client and the auditor.

After all adjustments have been agreed upon and all additional test work has been completed, the auditor must adequately explain, in their audit workpapers, the misstatement and how it was arrived at or calculated. The adjustment must be run through numerous schedules in order to ensure all amounts continue to match the audit documentation.

Additionally, adjustments must be analyzed for control deficiencies, they must be summarized in a significant audit findings memo, and they must be addressed in letters to management and the Board of Directors. The time it takes for an auditor to finalize an audit when pushing an adjustment through an audit file and then the time it takes for all the reviewers (manager, partner, and quality reviewer) to sign off on the adjustment can sometimes double the normal time it takes to finalize the audit.

Because audit adjustments cause increases in the time it takes for audits to be completed they also can cause significant billing overruns and delays. Additionally, audit adjustments identify control deficiencies, which also take time to analyze, document, and communicate to management and the Board of Directors. A strong internal control environment, including additional care taken in a Company's internal accounting review process, can greatly reduce the number and frequency of audit adjustments and likely ensure your audit fees meet your expectations.

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