The Goal of the Audit

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We are all familiar with the phrase *perception is reality*. Consider the goal of the audit; is it also more a matter of perception than reality? I believe this to be the case. Everyone has a different view of what goals the audit should accomplish. Often, however, those goals are not aligned. This creates marketplace confusion and unmet perceived expectations, and ends up being referred to in audit profession as the expectation gap.

Very few companies would get an audit of their financial statements if it was not a requirement from a regulator or another user, such as a bank. When I speak to groups of CFOs and ask if they use GAAP financial statements to make business decisions, the resounding answer I almost always receive is, “no.”

Users of the financial statements also have their own views which are not flattering to services auditors provide. In a recent survey conducted by Investors Advisory Group of the Public Company Accounting Oversight Board, 45% of the respondents felt the current audit report does not provide valuable information. On the other hand, 18% of those users of financial statements respondents felt the audit was a waste of time!

One user, Steve Goldstein at MarketWatch, stated, “What precise purpose does it serve to have a supposedly independent auditor (paid for by the company) sign off on accounts? From Enron to Lehman to Satyam to Parmalat, it’s clear that the major accountants lack either the skill or the determination (or both) to ferret out fraud.”

Auditors (when asked) have a difficult time explaining the goal of an audit. In my experience, when asked about the goal of the audit, the auditor spends the majority of the time explaining what an audit is “not” versus what the audit “is.” For example, they will quickly say an audit is not absolute assurance the numbers are correct and the opinion is not a guarantee, and so on.

Talk about an audit dilemma.

- Most companies only get an audit because they are required to have one.
- Users of the audited financial statements say the audit doesn’t provide valuable information.
- And the auditor cannot effectively explain what an audit is all about.

Based on these facts, one could conclude the goal of the audit is to keep “milking this cash cow” until the audit we know fades away into the sunset? I refuse to let this be the case. We can work to change the perceptions that exist if we better understand and believe in the goal of the audit. The balance of this article will discuss the goal of the audit from various stakeholder perspectives and how the auditor can effectively deliver on those goals.

MULTIPLE USERS AND CONFLICTING GOALS

Most business owners would agree serving the needs of the users of financial statements is one of the primary objectives of an audit of their financial statements. Typically, users of audited financial statements can be categorized as either internal or external. Internal users include company management, owners and directors and employees. External users can be further divided into two groups:

1. Commercial and investment bankers, insurance companies, leasing companies, vendors and suppliers primarily focused on the company's collateral and credit worthiness.
2. External shareholders and potential investors typically more focused on price per share, dividends and future cash flows.

While all external users want to use the audited financial statements to make a decision, their decision needs are different, which can lead to their goals being different. The audit does help the external users by offering an independent viewpoint because:

1. There is a potential conflict between preparers and users of financial statements. For example, the company needs a line of credit and the bank only wants lend to a creditworthy source.
2. The users place a high degree of importance of information provided in the financial statements in making their decisions.
3. Most users do not have the opportunity to verify information by themselves.

For your clients, do you understand the needs of their external users? If so, how do you deliver on those needs? It is important to know who are the users for your client's financial statements and why they might want the audit opinion from your firm.

If there are conflicting goals from the external user community, the auditor should never lose sight of doing the right thing within the context of protecting the public interest. Doing the right thing at all times will work to temper the user's perception the auditor does whatever the client wants.

INTERNAL USERS: THE GOALS PLEASE

Even if it's not required, an audit can give internal users peace of mind and offers benefits. An audit provides assurance the company's financial information is accurate and that staff are following internal controls and reporting standards.

In addition to meeting the goals of external users, there are many areas where the audit can be beneficial and meet the goals of the company and/or its owners:

Accounting Team Accountability

An audit forces the internal accounting team to keep its act together. Knowing their work will be reviewed, the accounting department is much more likely to be more careful in recording transactions and complying with internal control policies and procedures. This increased level of accountability has a positive impact on the entire operation. The goal is to have the audit carry the message to management they are doing their job effectively and efficiently.

Operational Improvement and Business Practices

The basic nature of an audit requires the auditors understand a lot about the business. Auditors see the best and worst in how various companies are managed and operate. They can and should offer insight and input on the big picture at the company. Management's goal is to have the auditor bring ideas and suggestions to their attention.

Risk Management

Good auditors often uncover errors and new risks to the company. Because they are interviewing company staff and looking into their records, auditors can identify problems (or potential problems) of which management should be aware, ranging from straightforward mistakes to outright fraud. Management’s goal is to have the auditor bring errors and new risks to their attention.

Internal Control

As part of every audit, the auditor considers the company's internal controls. He or she also provides management an assessment of the adequacy and effectiveness of internal controls, which can go a long way toward preventing fraud, errors or omissions. It is expected the auditor communicate internal control weaknesses and areas for improvement to the company.

Tax Opportunities

Because of the in-depth analysis involved, it's not unusual for auditors to discover areas of tax risk or opportunities. Management’s goal is to have the auditor assist them in taking advantage of every legitimate tax opportunity.

These goals of management – whether stated or not – should be dealt with by the audit team, and then plan their audit process accordingly. Attending to these goals will work to mitigate management’s perception that the audit is of little value.

THE GOAL OF THE AUDITOR

I often ask audit team members their goal of the audit. To my surprise, I generally get a blank stare. Eventually they will say something such as, “to make it through review.” Partners will often say, “to make it through peer review.” What has happened to the true focus and goal of the audit?

The auditors goal should be to understand the need to balance the goals of the firm. The goals of the firm are generally threefold:

- Managing engagement risk
- Providing superior client service
- Achieving profitability targets

Managing engagement risk links directly to the goals of the users of the client's financial statements discussed above. The users want reliable financial information from which to make decisions. The firm that manages and controls engagement risk will generally issue an appropriate audit opinion to provide assurance the client financial statements are reliable.

The auditor must clearly understand the engagement risk profile on every client. In this manner, the auditor can plan and conduct the audit to manage this risk.

Providing superior client service as a firm goal will allow the auditor to satisfy the goals of the client. An audit delivered without superior client service will be viewed as a commodity by the client. When the audit is viewed as a commodity, most clients will make an audit firm selection based exclusively upon price.

The auditor should understand the client service goals for every client. If the firm does not establish client service goals for client, the auditor should take the lead to discuss client service with the entire audit team and work to establish some goals to work toward superior client service.

The final goal the auditor should work to balance is the firm goal of profitability. The auditor needs to be aware of audit time budget and fees and work to meet those targets. The profitability goal, however, should not overtake the other two firm goals, but should be balanced with those goals.

Firm profitability is generally considered an "outcome measure," which means profitability is a result to successfully delivering on the other two goals. Over the long term firm, profitability will occur when the auditor is effectively managing engagement risk and providing superior client service.

IN SUMMARY

There are multiple goals to an audit and those goals are different depending on the user. User goals are different than client goals, and often times conflict with each other. At times, the auditor goals are different that both the user and the client goals. It is crucial the auditor understands the goals of the users, the client and the firm to manage expectations and positively change the perception of the audit.