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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. This publication summarizes information concerning audits and reviews of accounting systems in four areas: (1) Reasons for an audit; (2) auditor selection; (3) audit procedures and audit report; and, (4) other accounting services.

**REASONS FOR AN AUDIT**

Securing an annual audit of the cooperative's financial records is the responsibility of the board of directors. Because the board acts as trustee of the corporation'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 audit is a fundamental part of this trustee responsibility and the cost of the audit should be considered a normal business expense. In other words, adequate funds should be budgeted annually for an audit.

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. Thus, it is extremely important that board and management make every effort to ensure fair, accurate records. The first step in fulfilling this obligation is a complete, double-entry bookkeeping system, the second is monthly financial statements, and the third is an annual audit of the accounting records and supporting documents.

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. They are:

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. While it is not the role of the auditor to identify fraud, in the course of the audit fraud may be identified, and the auditor is responsible for reporting such findings to the board.

2. **To** assure that 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. In any business, judgment decisions and estimates, such as inventory valuation, will be necessary in bookkeeping actions. These decisions and estimates should reflect the cooperative’s best interests, not those of management. A review of these decisions in the audit process will help ensure that management is making appropriate judgment decisions.

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. This lack of dependability is a serious handicap for management and boards because many decisions are based on information reported in financial statements over a period of several years.

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 used in accounting practices to prepare financial statements. These guidelines are referred to as **GAAI?** During the audit, the auditor will determine if the cooperative’s procedures are consistent and adequately conform to **GAAI?** 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. This is a fundamental responsibility of the board to the cooperative members they represent.

In addition, there are other reasons why an audit may be required. Creditors and suppliers may require an audit before credit is granted and have ongoing audit requirements as part of the loan agreements. Furthermore, the statutes of some States require corporations to have an annual audit.

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 recordkeeping 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.

An external audit is an examination of accounting records by an independent Certified Public Accountant (CPA) for the purpose of expressing an opinion on the fairness of presentation of a company’s financial statements in conformity with GAAP.

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 judgement decisions and estimates (i.e., depreciation, inventory);
7. sampling accounting records; and
8. reviewing minutes of the board of directors’ meetings for policy changes and instructions to management.

In addition, auditors may prepare an end of year statement of operations, balance sheet, and cash flow statement after making needed adjustments and closing entries.

**Board Responsibilities**

To ensure a successful audit, the board should make special effort to have a complete set of accounting records and supporting information available to the auditor. It is important for the board to recognize that retention of an outside auditor does not shift responsibility for the financial statements onto the auditor.

The board retains the responsibility for the accounting system regardless of the audit. Therefore, it is important for the board to see that the cooperative’s records are an accurate and consistent representation of the business operations. It is also important for the board to exercise caution in selecting an auditing firm.

**AUDITOR SELECTION**

**Auditor Qualifications**

The board of directors should take special care in selecting an auditor. Given the fiduciary responsibility and potential liability facing the board, a complete annual audit conducted by a competent, qualified auditor is the best insurance available. If at all possible, an auditor with experience with cooperative accounting and familiarity with cooperative law is preferable.
The board selects and hires the outside auditing firm. Preferably, the auditor should be a CPA, either with a license from the State or territory in which the cooperative is incorporated or with a license recognized by that State or territory. 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 program;
6. Ability to communicate with the board and management;
7. Ability to provide competent suggestions for improving financial accounting practices. (However, accounting system design must meet the needs of the business rather than simply being designed for audit ease);
8. Understanding the responsibility of their reporting directly to the board; and
9. Willingness to correct any oversights occurring during the audit program.

Selection Procedures

The first step in most audit engagements involves a meeting between the auditors and board of directors. The cooperative's manager and controller may also participate in this meeting. During this meeting, the board should have a prepared list of questions directed toward the above characteristics to ask the auditor. Followup 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 the 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 beforehand to provide information needed for the auditor to meet these objectives in a timely manner.

Even if the auditor has completed several audits for the cooperative, the board should insist upon the pre-audit meeting. These meetings will allow new issues to be discussed and they help auditors understand they must remain vigilant and concerned in terms of their performance. These meetings also allow new directors to become acquainted with the audit process.

After the pre-audit meeting and before beginning the audit, the auditor should prepare an engagement letter. This letter will state the auditor’s understanding of the scope of the engagement, explain the work to be performed, detail the fees to be charged, and explain that the auditor is not responsible for the detection of fraud. The audit should include a review of internal control procedures, selected financial records, and legal documents, and verification of amount shown on the accounting records.
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. Examples of procedures include confirming accounts receivable and payable balances, physically inspecting assets, and testing the system of internal control.

The auditor may post the closing and necessary adjusting entries for the cooperative. This service is not an assumed portion of the audit, although it is quite common. In the letter of understanding and the pre-audit meeting, it should be made 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 (i.e., accounts receivable ledger, inventory records, etc.) to derive a conclusion regarding the characteristics of the records as a whole. The audit test is simply verification that accounting entries have been accurately made and that supporting documentation exists for sample transactions.

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. Thus, 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.

The auditor will determine the type and level of sampling to use based on the complexity of the accounting system, the discussions at the pre-audit meeting, and the budgetary limitations imposed for the audit. In conducting the audit, the auditor will be concerned with the audit trail. The audit trail is the complete recording and documentation associated with a single transaction (journal entry or posting) to source backup (i.e., document). A sound audit trail makes it easy and time efficient to trace a transaction to a source. In conducting the audit, the auditor will examine several audit trails. Faulty audit trails alert the auditor to potential problems.

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. CPAs conducting audits must conform to 10 Generally Accepted Auditing Standards (GAAS), set by the AICPA. In addition, audit guides for specific industries have been developed and are issued by the AICPA.

GAAS' 10 standards in three groupings — general, field-work, and reporting — are:

**General Standards**

1. The examination must be conducted by individuals with sufficient audit training and expertise.
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.

Standards of Reporting

1. The report should state if the financial statements are prepared in accordance with GAAP (Generally Accepted Accounting Practices).
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. If not, the reasons should be given. The nature of the audit examination and the degree of responsibility assumed should be contained in the audit report.

Audit Report

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
Illustration: Standard Audit Report Form

XYZ ACCOUNTING FIRM
1234 Oak Lane
Anywhere, USA

We have audited the accompanying balance sheet of X Company as of MM,DD,YY (Month, day, year), and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted your audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of MM,DD,YY, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

__________________________

(signature)
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. Accounts 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.

**Auditor 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 the statements fairly reflect the organization’s condition and performance. An unqualified opinion means the financial statements present fairly the financial position and operating results of the company in conformity with GAAI? 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 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. This qualification states that the financial statements are fairly presented except for the item in question, which is not fairly presented in the auditor’s opinion. This seriously reduces the credibility of the financial statements. A “subject to” qualified opinion states the financial statements are fairly presented subject to a particular modification. The effects of a “subject to” qualified opinion are not severe enough to warrant an adverse opinion.

When the auditor issues a disclaimer of opinion, the auditor is unable to form an opinion on the fairness of the financial statements. Possible reasons for disclaimers are that the underlying accounting records are so inadequate the auditor cannot verify accuracy of financial statement or the existence of uncertainty concerning a major item (i.e., pending lawsuit). The auditor is allowed to disclaim an opinion on some of the financial statements while at the same time expressing an opinion on the other statements. This means that the disclaimer of opinion may be given along with a qualified or unqualified opinion.

An adverse opinion is the most serious of all opinions offered by auditors. In addition, they are very rare. Typically, situations in which the auditor believes the statements are unfair get resolved in some way. Without resolution, when the auditor determines that the financial statements do not fairly present a cooperative’s financial position and operating results, an adverse opinion will be issued. In other words, the financial statements are considered misleading in the professional opinion of the auditor.

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 dis-
tributed to members either prior to or at the annual meeting. Inasmuch as 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. It is the responsibility of the board to see that these adjustments are made and that the books will yield financial statements that accurately and fairly represent the financial condition of the business. The board should also explain the problems found in the recordkeeping system and the changes implemented to correct the problems to the membership, either in a letter or at the annual meeting. The auditor may be able to help with needed changes or recommend an accountant to do so.

OTHER ACCOUNTING SERVICES

Other accounting services are available. Effective July 1, 1979, AICPA issued new guidelines on services rendered by accountants and/or auditors with respect to unaudited financial statements. These guidelines apply only to businesses that do not trade securities in a public market. These new guidelines do not affect audited financial statements.

As a result of the new guidelines, CPA's are allowed to provide two different types of service pertaining to unaudited financial statements. These are Compilation and Review of Financial Statements. A large majority of the cooperatives in the United States can be defined as non-public entities, companies who do not have public offerings of stock, and qualify for use of compilation and review services.

Because auditors provide no assurance on compilations of financial statements, and only limited assurance on reviews of financial statements, neither type of service
should be considered a substitute for an audit examination complete with an auditor's opinion on the financial statements taken as a whole.

In a compilation, the auditor provides no assurance on such financial statements and thus issues a disclaimer of opinion. In a compilation, financial statement information is the representation of management or owners. No audit opinion or other form of assurance is given concerning the financial statements. As a result, the procedures conducted are limited. Hiring a CPA to provide compilation services is useful only when the cooperative staff is unable to produce the basic financial statements. In a compilation engagement, the practitioner should:

1. Obtain a letter of engagement;
2. Obtain a knowledge of the accounting policies prevalent in the industry;
3. Obtain an understanding of the nature of the client's transactions and accounting records;
4. Evaluate the competency of the client's accounting personnel;
5. Ascertain the basis of accounting used (accrual, cash);
6. Determine if the client's books have to be adjusted;
7. Obtain satisfaction regarding management representations that seem unsatisfactory and incorrect;
8. Modify the accountant's report if the client fails to prepare needed adjustments;
9. Read the financial statements to assure that obvious errors do not exist, including departures from GAAP, insufficient footnotes, or mathematical errors.

The compilation report includes:

1. Identification of the financial statements;
2. Statement that the compilation was conducted in accordance with standards established by AICPA;
3. Definition of a compilation, in that it is restricted to presenting in the form of financial statements information that is the representation of management (owners);
4. Statement that the financial statements have not been audited or reviewed, and as such there is no opinion or any other form of assurance involved;
5. Date the compilation was completed; and
6. Signature of accountant.

The review of financial statements is the level above a compilation and below an audit. Some assurance is expressed on the financial statements. The review is mostly composed of inquiry and analytical procedures applied to financial information so the accountant has a reasonable basis to express limited assurance that no material adjustments have to be made to the financial statements for them to be in conformity with GAAP? An opinion is not expressed.

In a review engagement, the practitioner should:
1. Obtain a letter of engagement;
2. Obtain familiarity with the accounting policies employed in the industry;
3. Obtain an understanding of the organization and operations of the client, including operating locations;
4. Become familiar with the nature of the client’s balance sheet and income statement accounts;
5. Look at the client’s production, distribution, and compensation methods;
6. Understand the product line or services performed by the client;
7. Note related party transactions;
8. Conduct inquiry and analytical procedures;
9. Read the financial statements and related footnotes;
10. Obtain a report from another accountant who is involved with reviewing a material component of the entity;
11. Inquire about changes in business activities, accounting methods, and practices;
12. Resolve incomplete, inaccurate, or questionable matters;
13. Obtain a client representation letter, if desired;
14. Document review procedures in the workpapers; and
15. Prepare the review report.
The following should be contained in the review report:
1. Identification of the financial statements;
2. Statement that the review was performed in accordance with AICPA standards;
3. Statement that all information included in the financial statements is the representation of management;
4. Definition of a review in that it consists mostly of inquiries of cooperative personnel and application of analytical procedures to financial data;
5. Statement that a review is significantly less in scope than an audit (no expression of an opinion on the financial statements taken as a whole);
6. If warranted, the issuance of limited assurance;
7. Disclosure of any material modifications needed to the financial statements;
8. Completion date of the review; and

In general, compilations of financial statements are the least costly; reviews of financial statements somewhat more costly; and audited financial statements the most costly

**SUMMARY**

Annual audits of the cooperative’s financial records are the responsibility of the board of directors. Inasmuch 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.

An audit is an examination of accounting records by an independent, licensed accountant for the purpose of expressing an opinion on the fairness of presentation of a cooperative’s financial statements in conformity with GAAI?

Four types of audit opinions are:
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 was not able to 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.

Two other types of examination for financial records are:

1. Compilation — the preparation of financial statements only, no opinion given as to the fairness or accuracy of the records.

2. Review of financial statements — a procedure that provides for limited assurance that no material modifications need be made. It does not test the fairness or accuracy of the records.

Sources:


