Preparing Audit-Ready Financials:

Best Practices to Avoid Common Pitfalls

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Introduction

For financial professionals, independent external audits of GAAP financial statements are an inescapable reality. For public companies, it's a statutory requirement under SEC regulations and for many fast-growing private companies, it's a necessity to meet the demands of lenders, VCs, and other stakeholders. There is even a possibility that the IRS could require a financial statement audit as part of a broader tax audit.

Ultimately, every audit boils down to the risk of a material misstatement in the numbers. The responsibility falls to you and your finance team to ensure that your financials present the lowest possible risk of such errors, thereby earning a "clean" (unqualified) opinion from your independent auditor.

To achieve a smoother process in preparing audit-ready financials, you need well-documented transactions, balances that are calculated accurately, and financial statements and backup documentation that can be produced in a timely manner.

Audits Require Well-Documented Transactions and Balances

Although there are various types of risk that an audit will assess, the primary focus is on the subjective judgments, estimates, and processes you use to prepare the financial statements. The auditor tests various areas of risk in your controls, accounting measures, and reporting processes to determine the level of GAAP conformity. Effective internal controls reduce the risk of a material misstatement. While the auditor must develop an understanding of your company's control environment, a financial statement audit does not focus on controls to the same extent as a SOX audit requires.[1]

Based on the results of the controls testing, the auditor gathers evidence to substantiate and demonstrate the effectiveness of your accounting and reporting processes. This generally involves checking calculations; examining records and source documents to support balances and transactions; confirming certain balances and transactions with third parties; and physically observing assets. That's why audit-ready financials invariably depend on well-documented, organized transactions and balances.

[1] A SOX audit is performed as part of Section 404 of the Sarbanes-Oxley legislation in the United States that requires publicly traded companies to undergo a strict audit on financial information as well as internal controls. A SOX audit helps determine how well the company establishes and maintains adequate management controls over business and financial information.

Preparing for the Audit: Organization

The path to audit success begins by logically organizing your transactions so that they can be traced from the financial statements to the general ledger to the sub-ledger to the supporting documents, and back again. By taking a holistic view of financial-statement preparation and establishing a complete audit trail from transaction to report and reconciliation, you ensure the auditor can easily and effectively test your organization's accounting processes.

Of course, creating audit-ready financials is easier in theory than in practice. Every financial audit begins with the lofty goal of focusing on areas that involve accounting complexity and judgment – the riskier areas of the financial statements. However, the audit process often quickly bogs down in the reconciling and tracing of numbers through the accounting system because the accounting is not well-organized and documented. When the financials are not audit-ready, the auditor spends far too many hours understanding relatively mundane accounting issues and verifying data flows.

Typically, financial statement audits get derailed by accounting and documentation deficiencies in three major areas: revenue, receivables, and consolidation.

Preparing for the Audit: Revenue Recognition

GAAP-compliant revenue accounting is consistently a top challenge for finance professionals because the loosely defined regulations and evolving interpretations create a high level of complexity. In many instances, the timing of revenue recognition receives the greatest level of scrutiny, especially as it relates to multiple-element arrangements where software and services (such as implementation and ongoing technical support) are bundled into a single contract yet accounted for separately. The auditor wants to see that each element in the arrangement is separated, valued, assigned timing and amount for recognition, and reconciled back to source documents.

One of the best ways to be audit-ready for revenue recognition is to rely on an accounting system with a proven track record of automating, managing, and documenting complex revenue accounting. Whether it's for physical products, perpetual licenses, subscriptions, or services, the software should define separate revenue recognition templates and rules for each individual contract and line item, enabling you to easily defer recognition based on the fulfillment status for each item.

Preparing for the Audit: Accounts Receivable

While companies invest plenty of time and effort to ensure that customers are invoiced accurately and timely, auditors care much more about the realizable value of receivables. This requires an accounting judgment to calculate an allowance for uncollectible accounts. Your accounting software should track transaction details forever and maintain secure access to complete customer histories so that your judgment of collectability is well-founded and defensible.

What's more, in many instances, customers pay multiple invoices simultaneously, and if that payment covers multiple accounting periods, you must properly allocate the payment to the right invoices and periods. That means matching all cash receipts to specific invoices in a straightforward, documented, traceable way. To be audit-ready, use accounting software that automatically applies cash receipts to outstanding invoices, starting with the oldest invoice and taking into account any payment penalties and partial balances.

Preparing for the Audit: Consolidation

Organizations that report a single consolidated set of financial statements for multiple entities are at a greater risk of a misstatement because of the complexity involved in identifying and properly accounting for all of the intercompany transactions and eliminations. Most finance departments manage consolidations using a massive, complex spreadsheet workbook. Yet, any experienced auditor will tell you: these spreadsheets contain formula errors, lack some GL accounts, or are impossible for the auditor to untangle and follow.

The best way to get audit-ready is to automate financial consolidations with completeness and accuracy. The software should automatically calculate currency conversions and translations and manage allocations for minority interests and complex ownership structures. In addition, the software should ideally provide a full set of consolidating and eliminating journal entries and let you (and your auditor) see the transaction details behind each entry. Automation reduces the chances of human error when dealing with this high volume of data and calculations, which reduces your overall risk of a material misstatement.

Preparing for the Audit: Efficiency

Once your accounting process is well-documented and auditable, you need to present your financials, reconciliations, and supporting documents in a timely manner. A fast accounting period close and well-organized system takes up less of the finance department's time and lets you be more responsive to auditor requests for information—saving your auditor time as well. They might even reduce your audit fees if the automation can sufficiently reduce the time spent on fieldwork and testing.

Another way to speed your close and accelerate audit prep is through the use of sub-ledgers. By keeping a separate sub-ledger for receivables, for example, you can close the sub-ledger before you completely close the general ledger. This enables the auditor to start testing accounts receivable while you complete your financial close process. The best accounting systems support multiple sub-ledgers for each company or entity in your organization, not just a single set of subledgers for all entities to use at once.

Preparing for the Audit: The Right Software Foundation

In addition to streamlining and automating your daily accounting and period-ending financial closes, the right software platform also makes life easier for your auditor. Automation removes the risk of manual spreadsheet errors, makes your calculations faster and more reliable, and reduces the time the auditor spends rechecking your accounting calculations.

A successful audit depends upon your auditor's ability to easily trace all transactions from the original transaction and supporting documentation through the business processes and up through the financial statements. An accounting system that is purpose-built to manage and demonstrate the accounting path sets the stage for you and your auditor to have a positive audit experience.

You can also make life easier for your auditor by providing access to read and investigate all data within your accounting system, while preventing the auditor from editing or creating any data. Cloud-based accounting systems are ideal for meeting this need. With a cloud accounting system, your auditor can have complete read-only access to your accounting system and log in any time, from any location. But you can also control when the auditor can access your system (such as during quarterly and year-end review periods).

Cloud accounting systems allow you and your auditor to click on any figure in the financial statement and drill all the way down to the general and sub-ledgers, reports, reconciliations, and original transactions—exactly what the auditor needs to test and investigate key accounting processes. The best cloud accounting systems let the auditor go one step further and run built in reports and reconciliations on-demand to confirm your accounting process. That provides a level of confidence that all transactions are complete and accurate. In addition, leading systems let you attach supporting documents to each transaction, so the auditor can click to view source documents that support your accounting treatment. This self-service model for reports and documentation speeds up the audit, allowing the auditor to investigate all reconciliations and transactions without having to come to you for every single document request.

Cloud auditing can make for an efficient, paperless audit that saves both you and your auditor time, and provides full transparency because the auditor can see everything that is in your accounting system.

Additional Ways to Get Audit-Ready

- **Make it easy to test the accuracy of numbers that come into your GL from another system**—when it comes to payroll expenses, stock option accounting, or other data from external applications, be sure that the audit trail is well-documented and that the calculations that determine the journal entries are accurate.
- **Have your documents ready**—be sure to have key foundational documents ready: articles of incorporation, long-term lease agreements, and other legal agreements.
- **Document your approvals**—your auditor must ensure that a system is in place for approvals for purchase orders, employee expenses, sales contracts, and more. Be ready to demonstrate that certain transactions cannot be completed without proper approvals—every time. That will give your auditor greater faith in the accuracy of your accounting process.
- **Get ready for SOX**—if your organization is growing and plans to go public, a SOX audit is in your future. The best cloud accounting systems allow you to set powerful controls in a straightforward, centralized configuration area without expensive custom programming—controls such as thresholds for transaction approvals or rules to ensure certain transaction types like revenue or prepaid expenses are always posted to the proper accounts. With all the controls in one defined place, a SOX auditor can easily review, test, and verify those controls.

Conclusion

To generate audit-ready financials, you need well-documented transactions and balances that are calculated accurately and that can be produced in a timely manner. Revenue recognition, accounts receivable, and consolidations tend to create greater complexity in financial audits. However, cloud accounting software can streamline and automate the organization of source materials, documentation of accounting treatments, calculation and reconciliation of all figures, closing and consolidation of the books, and preparation of financial statements. Cloud accounting software will save your finance team and your auditor time and prove to your key stakeholders that your financial statements are audit-ready.

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