Preparing for a First-Time Communications Industry Audit

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01

What is an Audit?

Defining an audit

- “Formal examination of company records by which an independent Certified Public Accountant obtains a level of assurance to express an opinion as to whether a company’s financial statements are presented fairly in all material respects”
- Highest level of attest service a CPA firm can provide
- Has various stages – an audit doesn’t happen overnight
- Can help organizations identify areas for operational improvement

Defining an audit

- Materiality
  - A set threshold an auditor will calculate and use to help determine areas of focus on the audit
  - Established to set the quantitative “in all material respects” determination of presenting fair financial statements
  - An audit doesn’t look at every transaction during an audit period, some transactions are just too immaterial to look at

Who requires an audit?

Bank holding company debt

- A bank may require an audit annually to ensure a company is in a financial position to continue paying on its debt
- The loan agreement could have annual financial metric covenants that need to be met, such as TIER or Debt to Equity thresholds, for the debt not to be “called” by the bank

Governmental agency

- Federal or state governments could require an audit as part of a grant agreement
- This will help determine that the funding they have distributed to the company is being spent for its intended purpose, that the company is following grant agreement stipulations and that the company is in a sound financial position

Company by-laws

- A company may change or determine at inception in creating by-laws that they will obtain a financial statement audit annually
- Can be used to ensure the company financial statements continue to have quality use in years when an audit is not required by a contract or agreement and give piece of mind to owners that the highest level of attest service is being performed

Responsibilities of an auditor

- Conduct the audit according to Generally Accepted Accounting Standards (GAAS)
  - Rules of auditing established by the American Institute of Certified Public Accountants (AICPA)
- Identify and assess risks of material misstatement of the financial statements
- Obtain an understanding of internal controls relevant to the audit
- Evaluate appropriateness of accounting policies used
- Conclude on whether there is a going concern doubt

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Responsibilities of an auditor are <u>not</u> to

- Find all fraud within the company
- Find all errors within the company financial statements
- Opine on the effectiveness of the company’s internal controls
- Make managerial decisions as to how GAAP is applied

Responsibilities of company management

Provide audit support

- Unrestricted access to individuals auditors deem necessary to obtain evidence from
- Information management is aware that is relevant to preparing the financial statements and disclosures
- Events after the date of the financials that may affect them
- Known or suspected fraud affecting the company

Internal controls

- Design, implement, and maintain internal controls
- Alignment of controls to overall objectives, compliance and reliability of financial information
- Remedy for fraud and noncompliance reported by the auditor
- Processes to track and address findings or recommendations of auditors

Accounting and reporting

- Maintenance of adequate records
- Selecting accounting principles
- Safeguarding assets
- Record adjustments to correct material misstatements
- Confirm in a representation letter that uncorrected misstatements are immaterial
- Preparation and fair presentation of financial statements
- Distribution of audit reports to necessary parties

02

Initial Year Documentation

Internal controls

What are they?

- Internal processes designed to accomplish organizational goals
  - How an entity does daily tasks and how it tries to prevent errors or fraud
- Examples
  - Account coding of purchases is reviewed before the entry is posted
  - Manager review and approval of time sheets
  - Managers not being able to post journal entries
  - Individuals taking in cash from customers don’t have access to customers’ accounts
  - Month-end account reconciliations

Internal controls

What to expect

- Walkthroughs
  - Audit team gathers documentation of entity level and business cycle processes
    - Questionnaires and discussions with client personnel
    - First-year audits will take the most time, future engagements should take less time provided there aren't significant changes
- Evaluation and testing of key controls
  - The audit team reviews client policies, identifies significant risks, and tests controls related to those risks

Internal controls

Best practices

- Review and document company accounting and other organizational processes
  - Track any changes during the year
- Review risks within the organization annually, updating controls as needed
- Review relevant SOC1 reports
  - Internal control audit of service organizations (payroll providers, billing providers, etc.)
- Develop “paper” trails
  - Easier to monitor, easier to provide auditors with evidence of controls
- Consider utilizing guidance and tools from the Committee of Sponsoring Organizations (COSO)
  - COSO framework is a widely recognized system for establishing and maintaining internal controls

Contracts & agreements

Active contracts and agreements in place relevant to the financial statements

- Examples include
  - Employment agreements involving key personnel that are agreed to outside normal course of employee handbook
  - Debt agreements with banks, both long-term and lines of credit
  - Leasing arrangements - both as lessee and lessor
  - Grant agreements
  - Agreements to provide services outside the normal scope to other companies
    - Fiber or equipment rentals
- Most of these being long-term in nature, auditors obtain once and only ask about them annually as to whether any changes or renewals have been made to have the most up to date documents, but will need any new agreements entered into during the audit period

New Accounting Standards

Accounting Standards Codification (ASC)

Revenue Recognition ASC 606

- Identify the contract with a customer
- Identify performance obligations in the contract
  - Distinct goods or services promised
- Allocate the transaction price to each performance obligation
  - Bundle discounts need allocated based on stand-alone pricing
- Recognize revenue based on the above
- Disclosures
  - Include qualitative information about point-in-time vs over time recognition
  - Breakdown of revenue streams

Lease Standard ASC 842

- Balance sheet recognition
  - Right-of-use (ROU) asset and lease liability
- Lease classification
  - Finance or operating
- Measurement of lease liability and ROU asset
  - Involves present value calculation and subsequent amortization
- Disclosures
  - Must provide detailed disclosures about leasing activities, both qualitative and quantitative

Current Expected Credit Losses ASC 326

- Estimate credit losses over the life of financial assets
- Forward looking approach
  - Historical collections can be a starting point but not the end all support
- Scope includes
  - Customer accounts receivable
  - Held-to-maturity debt securities
- Immediate recognition rather than waiting until loss is probable
- Disclosures
  - Credit risk exposures
  - Methodologies for estimating credit losses
  - Changes in allowance for credit losses

03

Recurring Documentation

Maintained on an ongoing basis and will be asked for at each annual audit

Trial balances and general ledgers

- Auditors will ask for the trial balance as of the period end date that is being audited as well as a detailed cumulative general ledger of all activity for the full period being audited
  - Accounting software should be able to produce these items in an electronic format
  - These items are usually imported into the auditor's software to allow for the testing of balances and for possibly writing up the audited financial statements
- Once given to the auditors, any additional adjustments will need to be made by them
- Should get into the habit of running these reports monthly – comparing trial balance account balances to subsidiary ledgers and other support and reviewing the general ledgers for the correct activity
- Know how to run the reports annually – can often be different than running monthly ones

Account reconciliations

Best practices

- Review and document your reconciliation of material accounts
  - Focus on larger balance sheet accounts first and the corresponding income statement accounts will follow
- Utilize internal control structure to implement a preparation and review of reconciliations
  - Segregate the duties of preparing and reviewing to ensure a more accurate reconciliation
- Document the review of reconciliation physically or electronically
  - Also plays into internal control documentation
- Track key performance indicators to drive reconciliation improvement
  - Time spent completing reconciliations
  - Number of unreconciled variances
  - Accuracy of reconciliations
- Some reconciliation can be automated
  - Investigate capabilities of accounting software to reconcile accounts for you

Property, plant and equipment

- Maintain detailed comprehensive records of all PP&E transactions
  - Acquisitions, disposals, transfers between accounts and depreciation
  - Consider preparing continuing property records (CPRs) by general ledger account that have breakdown by property units within that account
- Establish depreciation rates for class of assets
  - Refer to guidance from Federal Communications Commission or RUS on asset lives
- Monthly reconciliations of PP&E accounts to ensure accuracy and balances are up-to-date
- Plant under construction
  - Establish and track projects currently under construction either through use of work orders or by other means of reconciliation of costs of equipment not currently in service
  - “Close” into plant in service in a time manner after construction of the plant has been completed
- Physically verify the existence of assets on hand (where are they so someone can go and look at if needed)
- Prepare roll forwards to track changes in PP&E balances from beginning to the end of the period

Materials and supplies (inventory)

- Can be accounted for under different methods
  - FIFO, LIFO or average cost (most common for the industry)
- Can consist of many different types of items
  - Fiber, ONTs and other circuit equipment, handholes, vaults, routers, modems, etc.
- Usually when construction materials are purchased, they are recorded here before moving to plant under construction or plant in service
  - Not depreciated until construction is completed and asset is ready for use
- Very easy for errors to happen in this area and have physical quantities and dollar amounts not tying to the books, especially when there is a considerable amount of construction
- Best practices
  - Do physical counts at the end of each month and tie the dollar amounts calculated on schedules to the ending account balances for the month in the general ledger
  - If possible, have someone in-charge of inventory and maintaining proper receiving, cut-off and usage procedures

Customer accounts receivable

- Need to have a strong system of accurately billing customers and maintaining a listing of balances due to the company
- Could have an allowance for credit losses that needs to be recorded
- Need to evaluate individual account balances monthly for delinquency and write-off accordingly
- Common errors
  - Billing system balances not reconciling to the company books
    - A cut-off period is likely, but this needs to be reconciled
  - Old, non-paying accounts not being written-off
  - Customers not being billed the accurate dollar amount or not being billed properly for the service(s) they are receiving

Accrued liabilities

- At the end of any period, companies can have a lot of other liabilities that are due to various entities
  - Payroll taxes, income taxes, excise tax, sales tax, property taxes, etc.
- Majority of companies have separate general ledger accounts for each of these types of items
- Common errors
  - Not accruing something that needs to be accrued
  - Recording a payment to the wrong general ledger account
  - Not having a good cut-off procedure
- Best practices
  - Compare account balances to the prior month and/or year and understand large fluctuations
  - When you are making payments in the subsequent month, compare the payment amount to the balance recorded at the end of the prior month

General accounts payable

- Can consist of normal, recurring monthly liabilities for goods or services received during the period that haven't been paid by the end of the period and/or large, one-time types of items (materials and supplies, contracted construction services, etc.) that maybe the funds weren't available to cover at the end of the month
- Similar to other accrued liabilities, having a strong cut-off policy is important
- Common errors
  - Large contractor invoices not being received till months later, but really due at the end of a period because the work had been completed
  - Materials and supplies being booked as payable because invoice is dated prior to the period end, but the materials were not received till after period end and not in inventory at period end
  - Booking a liability to a prepaid account – you don't have a "prepaid" and a payable
  - Not recording small or "one-time" items – if something is payable at the end of a period, it should be booked
- A solid listing of amounts due and to whom must be kept and reconciled to the general ledger account balance monthly

Closing Thoughts

- A first-year audit isn’t easy, there is a lot to think about and prepare for
- Understand the reasons for your audit and the stakeholders that need the audit report
- Know what each of your general ledger account balances consist of and be prepared to provide support for them
- Know the deadlines for your audit reports and work with your auditors to make sure these deadlines are going to be met
- Maintaining strong books and records throughout the year and closing months in a timely fashion is key
    - **You can get through an audit, many companies have ☺!**

04

Q&A

Thank You!

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