Trust and Verify

Don't Monitor Alone

by Martha Whitman

When you think of audits and accountants, do Enron and Arthur Andersen come to mind? Bad things happened when auditors failed in their ethical responsibilities by giving Enron a clean bill of health when the company was really a house of cards. The Sarbanes-Oxley Act of 2002 was enacted in response to Arthur Andersen's unethical auditing practices, and now accountants are required to increase the scope of their services. Currently the rules of Sarbanes-Oxley apply only to publicly traded corporations. It may be that someday nonprofits and cooperatives will have to comply, but until then, we have a great deal of flexibility in contracting for external financial monitoring.

Even if accountants and audits aren't on your radar, as a board member it's good to know what they can and can't do for you and the role they play in the independent external monitoring of your financial statements. There may be excellent reasons why your board doesn't contract for financial auditing; below are reasons why you might consider it.

Have you ever questioned why your board might contract for a professional audit of the co-op's financial statements? They're pretty pricey, right? And aren't you sending a message of distrust to the general manager? The answers are yes—they can be expensive—and no, independent external monitoring is simply a smart business practice. Oftentimes general managers do benefit from information that comes out of an audit, but that's just a nice by-product. What's really happening is that one of the key responsibilities of a board, protecting the members' assets, is achieved. Contracting with someone from outside the co-op to examine the numbers is not a statement of a lack of trust but rather a prudent path to fulfilling the board's duty of care and diligence. And the professionalism can cut both ways; a new general manager might insist on an audit to establish the baseline for which he or she will be held accountable. Another reason your board might contract for an audit is to fulfill a lender's requirement, in which case there isn't a choice about the scope of external verification. In this case, the cost of the audit is essentially one cost of procuring a loan.

This article is excerpted from Issue #10 of the LEAD*er* (Leadership Education and Development newsletter), published in winter 2011. The topic of this issue was monitoring the co-op's finances with other articles about why the board monitors finances, eight key financial indicators to monitor, and how financial reports should influence board decision making. The study guide features a table for the board to use in reviewing the co-op's trends in these eight indicators, as well as a checklist on what current financial reports the board is getting. Find the full issue here.

Trust and Verify

If you aren't required to do an audit but still want to verify through independent external monitoring, your board might consider engaging an accountant to perform a financial review. You and your board have to weigh the pros and cons of an audit versus a review—your decision will depend upon your particular circumstances. A financial review consists of the accountant verifying financial records using data provided by management. With a review, the accountant is not required to obtain any independent corroboration to substantiate the records. In contrast, as part of an audit, the auditor must obtain independent evidence to verify account balances. (This accounts for much of the price difference between a review and an audit.) A review doesn't provide the auditor's statement of opinion, which is required under standard rules for an audit. This is a significant difference. An audit, through the statement of opinion, provides the co-op legal assurance, whether or not the financial statements are free of material misstatement. A review, on the other hand, due to its scope, offers what is technically referred to as limited assurance.

Some co-ops have an audit every year, while others decide an audit every three years is adequate. Another common approach is to have reviews during interim years between audits. Such was the case at La Montañita until our independent accountant presented us with another option. Since we don't have a loan covenant requiring an audit, our business has been stable, and our accountant understands the cooperative model, he suggested we switch to reviews, with the caveat that he would monitor year-end inventory, so if the need arose, we could switch back to an audit in any given year.

What has made this plan particularly appealing (beyond the obvious cost savings) is how we now tailor each year's review with an additional engagement for services known as agreed-upon procedures. It's a separate engagement to perform specific monitoring driven by what is happening at the co-op. So far we've identified four areas for additional focus to be covered under the agreed-upon-procedures engagement: fixed assets, cost of goods sold, sales, and human resources. In this engagement, a few accounts are randomly selected within the chosen area and are checked for accuracy and adequate internal controls. If the results of the random investigations are good, the agreed-upon procedures are done. If an irregularity appears, the auditor might dig deeper but will certainly make recommendations for changes. Keep in mind that your general manager might have good reasons for doing something a particular way and might not agree with a recommendation, in which case the GM must adequately defend his or her position so that the board can make an informed decision.

For any given year, circumstances drive the selection of areas for agreed-upon procedures engagement. We started with fixed assets because we had just completed a major store expansion. Last year the area was human resources because we were between years of management's own external monitoring. And this year we'll ask our auditors to review cost of goods sold. As there was a chance we were going with a new POS system, it didn't make sense to select sales because procedures would potentially change and render the engagement moot.

The discussion to determine each year's area of engagement occurs between the board's finance committee and an independent accountant; the committee then submits its recommendation for board approval. (As the auditor's work is part of the board's external monitoring, it isn't management's job to make the choice.) We are now in our third year using this approach for external monitoring, and we are pleased with the results. The cycle of particular focus into specific areas has provided prudent oversight and useful recommendations, along with cost efficiency. The system may not be for everyone, but it has served us well so far.

Under the umbrella of cooperative principles and values, co-ops are primed to enjoy a positive and trusting relationship between boards and managers. The role of external monitoring is not to "catch" management doing something wrong. It's a function of trust and verification. An independent accountant contributes his or her professional expertise to help the board fulfill its duty of care and diligence. Along the way, positive outcomes can surface, to the benefit of both board and management, and can ultimately strengthen the co-op as a whole. Since most co-op board members aren't highly proficient with finances yet are still accountable for the performance of the co-op, independent external monitoring is worth your consideration, and it certainly offers the potential for a better night's sleep.

Try This: What If?

Take 15 minutes at each board meeting (or one board meeting per quarter) and have a "what if" discussion. For instance:

- *What if our co-op was given $500,000? What would we do with that windfall?*
- *What if it became apparent that our sales were declining at a slow but regular rate?*
- *What changes in consumer shopping have we observed in our store since October 2008 (the start of the current recession)? How do those changes match national trends? What should we be planning for the co-op's future if patterns hold or don't change?*
- *What would we be doing today if we knew we would have to relocate in three years?*
- *What would we be doing today if we knew a new competitor was going to open within a mile of the co-op in the next year?*