

## **Audits and Field Exams—What You Should Know and How to Avoid Common Deficiencies**

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According to a recent NABT survey, panel trustees rated the subject of “audits and field exams” near the top of the list of topics their assistants would like to learn about at upcoming conferences. As a result, Program representatives were invited to speak on this topic at the NABT conferences in Las Vegas and San Diego this year. In Las Vegas, panel members included Sara Kistler, then Acting Assistant Director for Review and Oversight; chapter 7 trustees Norman Hanover of Riverside, Calif., and Biff Leonard of Las Vegas; chapter 7 trustee assistants Pamela Taylor of Riverside and Libby Benson of Las Vegas; and myself.

In the Spring 2002 issue of *NABTalk*, former Region 1 United States Trustee J. Christopher Marshall and I wrote about the most common and the most serious audit and field exam deficiencies. We also differentiated between the two types of reviews and provided hints on how to prepare for each. This article expands on the prior article and provides highlights from the Las Vegas presentation.

### What is Covered in Audits and Field Exams

The trustee’s interim report (TIR) submitted to the United States Trustee is the starting point for an audit or field exam. The auditor’s or examiner’s tests and questions are based on what is recorded in this document. Both the audit and the field exam are designed to answer three main inquiries:

- Has the trustee established an appropriate system of internal controls?
- Has the trustee established an asset administration system that protects and ensures prompt administration of estate funds and assets?
- Are these systems operating effectively?

### Differences Between Audits and Field Exams

The primary differences between an audit and a field exam are the entity that performs the audit or exam and the emphasis of the inquiry. The field exam is conducted by U.S. Trustee personnel, with an emphasis on case administration and attention to internal controls. By comparison, the audits are conducted by independent auditors, with an emphasis on internal controls and attention to case administration.

For the past 15 years or so, the Department of Justice’s Office of the Inspector General (OIG) conducted the audits. As a result of a successful pilot test in 2002, independent certified public accounting firms started conducting the audits in October 2003. The audit contracts were awarded to four firms. One had prior chapter 7 audit experience, one had prior chapter 13 audit experience, and two had no previous bankruptcy experience but were well-acquainted with government audits and fraud/forensic audits.

During Fiscal Year 2004 these auditors used the same audit program as that used by the OIG, so trustees should not have experienced any significant changes in the audit process. Changes are coming, however. Since May 2004, a team of Program personnel has been re-writing the audit statement of work, with input from trustees, trustee assistants, and auditors.

### Preparing for Audits and Field Exams

The trustees and trustee assistants on the Las Vegas panel recommended reading and re-reading the *Handbook for Chapter 7 Trustees* to prepare for an audit or field exam. Chapters 8 and 9 are particularly relevant. In addition, it was noted that trustees can “test” their audit preparedness by reviewing the Internal Control and Asset Administration Questionnaires (ICQ and AAQ) posted on the Program’s web site under UST Field Examination Materials at <http://www.usdoj.gov/ust/library/chapter07/ch7lib.htm>. The correct answer for the ICQ questions is almost always “yes.” The questionnaires contain *Handbook* references so trustees can check their answers.

The Las Vegas panel made the following additional suggestions to trustees:

- Start with the philosophy that you could be audited or reviewed at any time on any case. If you try to prepare after you find out you have been scheduled for an audit, it will be all but impossible to get ready.
- Each case and its notes must stand on its own. The auditor should not have to ask you to fill in the blanks. When in doubt, document both actions and inactions.
- Make sure you have a system in place to update your Form 1's as amendments are received.
- Run the case management system’s “audit report” on a regular basis, not just before an audit.
- If there are multiple assets in a case, set up multiple file folders so asset-specific issues may be easily addressed.
- Don’t put off file maintenance. Whether you are using an electronic or a paper filing system, it is more practical and more efficient to stay on top of the maintenance on a routine basis. Those opportunities to come back and clean things up rarely happen.
- If you move, merge with other professionals, or increase or decrease staff size, re-evaluate your procedures to ensure they are consistent with the *Handbook*. Make sure you have an appropriate segregation of duties and can still answer those questions about disaster recovery plans and how backups are handled. Remember, what worked in one environment may not work in the next.
- If an estate includes property that should be insured, first ask the debtor whether the property is

insured. Request proof of insurance. If you are certain the property is not insured, contact the secured creditor to inquire whether it has insured the property. If not, and if you have no funds on hand yet to obtain insurance, see if the property can be insured while in escrow. At a minimum, have letters in your files that document your efforts to insure the property.

- Review the notes from prior audits and field exams, including each identified weakness, the response, and the changes implemented. The auditor will look at these issues first to see if the identified deficiencies were corrected.
- Your supervision of staff is part of the review, so find a system that verifies your involvement. Choose a system that fits your work patterns. If you regularly send emails containing instructions, make sure those emails are kept in your electronic or paper files. If you send hard-copy letters or documents to your staff, initial those documents prior to scanning and/or filing.
- Supervising employees is not your only supervisory responsibility. The auditors and field examiners also examine your supervision of professionals such as attorneys, special counsel, real estate brokers and auctioneers. Document these supervision efforts.
- Don't take it personally if you get an "adequate" rating; adequate in this business is a good thing.

Trustees and trustee assistants have asked the Program to prepare an "Audit Guide for Trustees" as well as a checklist that can be used to check off items as they prepare for an audit or field exam. We hope to have these documents ready by the end of 2004.

### Audit and Field Exam Timing and Scheduling

Audits and field exams are conducted on a rotating basis, approximately every four years. They are timed to occur within 120 days after the end of the interim reporting period. The auditor or examiner will contact the trustee to schedule the audit about two to four weeks before the desired starting date.

When setting a date, it is important for the trustee and his or her staff to consider their availability. The trustee's assistant must be available to the audit or exam team for the duration of the team's visit to the office, and the trustee should be available as much as possible. Avoid scheduling the first day of field work on the same day as Section 341(a) meetings, because both the trustee and trustee assistant must attend the entrance conference with the auditor or field examiner.

### What Auditors and Field Examiners Are Looking For

Audits and field exams afford the Program the opportunity to meet with the trustee and staff; to ask questions about topics as diverse as auctions, computer security, and casualty insurance; to observe and test controls over cash; and to review the documentation and records underlying the

information reported on Forms 1, 2, and 3.

The auditor or field examiner will select a sample of cases to review. The criteria used for selecting cases will vary; they might include the balance of funds on hand, the type of asset, or the absence of activity for a substantial period of time. Field examiners generally choose between five and 15 asset cases to review, while auditors review about 10 asset cases. Cases in which TFRs have been submitted, cases without funds, and no-asset cases may be included or excluded.

From these cases, the auditors and examiners select assets and transactions—receipts and disbursements—to test. They usually review activity that occurred during the interim reporting period, but they may look at prior activity, too. The Program’s goal is that the same case and the same time period will not be covered in successive audits and field exams.

The trustee will not know the sample cases, assets, or transactions prior to the start of the audit or field exam. The auditor or examiner will give the list of sample cases to the trustee on the first day of field work.

The type of documentation that auditors and field examiners expect to see will vary depending upon the asset, the asset’s possible value to the estate, and the need for something to be documented. Some decisions are obvious on their face and need no further documentation.

In addition to the customary types of documentation such as copies of incoming checks, correspondence, and invoices, the auditors and field examiners will look for activities documented in other formats, such as: notations in the computer software note and memo fields; notes to the file; notations on the petitions and schedules or Section 341(a) meeting minute sheets; notes written on correspondence; records of telephone conversations; and time records. These records may be maintained in either paper or electronic form unless a hard-copy original is required by the *Handbook*, the Bankruptcy Code or Rules, or local rules. *See Handbook 9-21 to 9-23.*

Additional information on what auditors and field examiners are looking for is contained in the “Guidelines on Supporting Documentation and Authorization for Asset Administration Decisions and Financial Transactions,” which trustees may obtain from their regional Chapter 7 Audit Coordinator or from me at [Suzanne.Hazard@usdoj.gov](mailto:Suzanne.Hazard@usdoj.gov).

### Conclusion

We hope the information provided during the San Diego and Las Vegas panel discussions, and in this article, will help trustees prepare for their next audit or field exam and allay any concerns about the audit or field exam process.