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the business

*by Duane W. Fuller
San Francisco*

EACH OF US is responsible for performing his services efficiently. I believe that by constantly rechallenging our approach to audits we can reduce the inefficiency which results from seasonal variations in auditing activities and can improve the quality of our services to clients.

As our profession has developed, the variety of services offered has constantly expanded and auditing techniques have been continuously improved. Fifty years ago we were involved principally in record keeping and checking of recorded transactions. Gradually we became active in setting standards for financial reporting, providing tax services, assisting with reports to the SEC and other governmental agencies, and advising clients regarding major business decisions. During the same period auditing techniques evolved from a detailed and mechanical checking of accounting records to today's more sophisticated method of evaluating internal controls and forming conclusions based on tests considered necessary as a result of these evaluations.

These trends (i.e., expansion of our consulting services and improvements in auditing techniques) will continue. Indeed, as a firm we seem to have little choice regarding the expansion of consulting

approach to an audit

services if we are to maintain a favorable competitive position in relation to other accounting firms which are following this pattern. Expansion of these services is the natural outgrowth of our exposure to a wide variety of business problems, the resulting increase in our general business competence, and the fact that we have available a pool of factual information regarding each client's affairs which would have to be duplicated by others if they were engaged as consultants.

Future patterns of the second trend, improvements in auditing techniques, will be influenced by several factors, the most important of which may be improvements which our clients continue to make in their information systems and the related internal controls.

I believe these improvements in information systems and internal controls, combined with our need to fill the dual role of auditors and consultants, will lead us to what I have termed "a business approach to an audit."

What Is a Business Approach to an Audit?

A business approach to an audit embraces the "continuing audit"

concept, and the idea that independent accountants should be continuously available to perform consulting services for each client.

The continuing audit concept rejects the thought that an engagement is complete when an audit report is issued. Rather, each report is regarded as only one step in a continuing process. Under this concept we would concern ourselves with having a close and constant relationship with the business activities and the information system of each client so that, based on knowledge already obtained, we could report on any financial statements prepared by the client with little or no additional testing of balances at the date of those statements. Continuous auditing presupposes a strong system of internal control and contemplates continuous testing of the client's information system, frequent communications with management, and a planned, intermittent — although not necessarily periodic — analysis and testing of various account balances.

The concept of continuous consulting activities is so related to that of continuing audits that it seems impossible for one to exist without the other. For example, the constant contact with clients required by continuing audits generates more opportunities for consulting services. Conversely, by performing more consulting services the accountant will acquire additional knowledge of his clients' business activities and information systems which is necessary to the continuing audit.

In performing these consulting services, however, each independent accountant must avoid any participation in the normal functions of management. He must not engage in the maintenance of accounting records or make business decisions for his clients.

Does a Business Approach Conform to Generally Accepted Auditing Standards?

I believe it does. Further, I believe it could result in raising the quality of our field work.

The AICPA has carefully distinguished between auditing standards and auditing procedures. Changes which might result from adoption of a business approach to audits would affect only the auditing procedures employed and would not result in the omission of any pro-

cedures considered necessary by the Institute. Many procedures which have traditionally been performed at the balance sheet date could, of course, be accomplished at interim periods under the continuing audit concept, but only in instances where, in the auditor's judgment, internal controls were such that he could place full reliance on information generated by the client's system between the dates of his tests and the dates of financial statements on which he reports.

A business approach to an audit would raise the quality of field work by minimizing the possibility of overlooking the financial implications of events occurring outside the purely accounting phases of a client's business. For example, the accountant who has a close continuing relationship with his client's business is more likely to be aware of inventory obsolescence resulting from new product development than is the accountant who forms his conclusions regarding obsolescence principally from data (such as historical usage) available to him in the accounting records. Similarly, the accountant who works closely with his client will be better informed regarding idle plant facilities, the financial condition of major debtors, and other items which might affect the client's financial condition.

How Can a Business Approach Benefit Auditors and Their Clients?

A business approach benefits auditors by reducing seasonal variations in auditing activity and by aiding in the development of management services activities. The immediate advantages of these changes to auditors (i.e., increased efficiency and an over-all growth of practice) are quite apparent, and at first the motivation for a business approach may appear completely selfish. The advantage to clients, however, should also be explored.

The continuing audit concept would benefit clients who may wish to obtain audited financial statements at dates other than the end of a fiscal year, since the cost of the additional audited statements could probably be reduced.

Similarly, the expansion of consulting activities would benefit clients. If our consulting activities become more extensive with respect

to each client we will be exposed to an increasing variety of business problems in many industries. Exposure to these problems will increase our general business competence and, as a result, will increase the value of our advisory services to all clients. In many cases we will be able to provide advice based on previous business experience in other industries which the client could not hope to find among its own employees.

Expansion of our consulting services would result in improvements in many clients' organizations which would add to their earning power and thereby strengthen their competitive positions in industry. This also benefits the auditor because, to a great extent, the strength of a public accounting firm depends on the business strength of its clients.

Finally, and extremely important to most of us, a business approach to audits would increase the average earning power in our profession. This approach would require an upgrading of personnel, in terms of both average experience and individual business acumen, because it would decrease the proportionate amount of clerical work required on most engagements. An upgrading of personnel should generally increase the value of our services to clients and, combined with the elimination of losses due to seasonal variations in activity, would substantially increase earning power within the profession.

What Steps Should Be Taken Toward Attaining a Business Approach?

A business approach to an audit is possible only if the client has a strong system of internal control and if the auditor has a thorough knowledge of each phase of the clients' operations; is aware of the clients' basic objectives; and understands the clients' business problems and the problems of the clients' industry. Many of the present practices in our firm are an aid to obtaining this type of knowledge of a client's business and some of them are included in the following paragraphs which set forth practices I believe will aid us in attaining a business approach to audits.

First, we should re-examine our present practice with respect to programs of examination, letters of recommendation, and cooperation with management services personnel and the tax staff.

- Are our programs really tailor-made to fit all the requirements of each engagement or are portions of the programs “boiler-plate” repetitions of mechanical auditing procedures to which we have given universal application?
- Are our letters of recommendation the result of careful and detailed consideration of a client’s basic problems, or are they lists of minor internal control weaknesses compiled by relatively inexperienced personnel who performed mechanical tests of the accounting records?
- Have we asked management services personnel to review management reports of each client and have we consulted these specialists regarding areas in which each client’s performance appears weaker than that of its principal competitors?
- Have we kept the tax staff advised of all significant changes in each client’s operations and accounting procedures?

Second, we should budget as much time as practical during periods of low staff utilization for investigation of areas where internal controls are presently strong enough (or could be made strong enough) to permit us to:

1. Perform audit tests traditionally completed at the balance sheet date during other periods; and/or
2. Perform certain audit tests at less frequent intervals than considered necessary under the annual concept of auditing.

Third, in conjunction with our tests of each client’s accounting controls, we should consider using a check list of special services commonly needed by clients as a reminder of points which may have been overlooked during the preparation of letters of recommendations. My own office is presently using such a list and, in addition, annual written reports are submitted to the management services staff explaining each client’s principal problems and enclosing copies of each client’s management reports and chart of accounts. A nucleus for such a checklist is contained in the AICPA *Economics of Accounting Practice Bulletin No. 13*, “Planning a Practice for Growth.”

Fourth, we should increase, within our firm, the flow of information relating to consulting activities we have performed so that, by drawing on the experience of others, we may each increase our individual business competence.

Fifth, we must encourage clients to seek our advice more frequently. The initiative must be taken by the auditor, since some clients regard an audit as an annual event, necessary only because of SEC or other external requirements, and are either not aware of all the services we offer, or are reluctant to engage consultants because of increases in professional fees. Our initial efforts to expand services to clients sometimes require expenditure of time and thought with no certainty that we will be compensated for it. However, even if we do not receive direct benefits, intelligent efforts of this type should yield indirect rewards by improving client relationships and/or increasing the efficiency of audit procedures.

- In addition to taking steps noted above, each of us should realize that an approach to a task is really a state of mind. If we are to have the state of mind necessary for a business approach to audits we must be constantly conscious of the continuing audit concept and must strive to increase our knowledge of each client's business and of the problems and trends in each industry with which we have contact. We must obtain answers to such questions as:

1. How do the client's operations (and operating results) compare with those of the most successful competitors?
2. What are the client's business objectives regarding use of funded debt vs. equity capital, expansion through new product lines or by producing components presently purchased, and similar matters?
3. What are the client's specific operating problems and what are the general problems of the client's industry?
4. What weaknesses exist in the client's organization?
 - a. Is authority and responsibility delegated in a logical manner?
 - b. Is there a plan for training personnel to fill future vacancies in key positions?
5. Have business successes and failures been attributed properly to persons responsible?
6. Are operating reports logically designed, intelligently used, and promptly available to management?
7. Is the client's distribution system efficient?

8. Is capital employed efficiently?
 - a. Is there idle plant capacity?
 - b. Is inventory managed properly?
 - c. Is surplus cash properly invested?
 - d. Is the handling of trade creditors such that optimum financing is obtained from this source?

9. What recent changes have occurred in the business?
 - a. Major suppliers and customers?
 - b. New product lines or discontinuance of old?
 - c. New markets or marketing policies?
 - d. Changes in production methods or distribution systems?

We cannot function effectively as auditors or financial consultants without these answers.

Summary

A business approach to audits is one which combines the continuing audit concept with the idea that auditors should also be engaged in extensive consulting activities.

Adoption of a business approach to our work is necessary if we are to enhance our present reputation as expert businessmen and if we are to maintain our competitive position within the profession.

The principal advantages which auditors gain from a business approach are:

1. A reduction of seasonal fluctuations in auditing activity;
2. An expansion of their practices by developing more consulting engagements;
3. An improvement in the quality of field work;
4. A broadening of their own personal business experience; and
5. An increase in the average earning power of those in the profession.

Clients also benefit from a business approach through lower costs of interim audits; through acquiring a financial consultant who is constantly alert for malfunctions within their organization; through improvements in the quality of consulting services available to them; and

through increases in earning power which can result from the intelligent use of these services. A business approach utilizes more fully the factual information relating to a company which is gathered during an examination of its financial statements.

In order to attain the state of mind necessary for a business approach to audits we should:

1. Budget time specifically for efforts directed toward conversion to the continuing audit concept;
2. Re-examine our present practices regarding programs, letters of recommendations, and cooperation with management services and tax department specialists;
3. Encourage clients to seek a close continuing relationship with the firm by showing them the advantages they can obtain;
4. Increase, within our firm, the flow of information regarding experience gained from consulting activities; and
5. Consider use of a checklist during each audit as a reminder of possible services which we could provide to the client in question.

Many of the ideas presented in this article are not new. During the past decade they have been widely discussed within the profession and have appeared from time to time in periodicals.⁽¹⁾

Perhaps the most important thought presented here is the need for each of us to emphasize, in his own approach to audit assignments, the need to know his client better.

⁽¹⁾ e.g., see Tietjen, A. Carl, "A Suggested Change in Examination Approach," *Journal of Accountancy*, April 1956, and "Changes in Public Accounting," *Journal of Accountancy*, May 1958.



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