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As CERTIFIED PUBLIC ACCOUNTANTS, we serve in a dual capacity. We are professional accountants and auditors, and we are professional consultants to businessmen. In this article, I want to emphasize this dual nature of public accounting as applied to our principal function—auditing. What is a good business approach to auditing? Does it present any advantages over the conventional approach? What problems are we faced with in implementing a business approach to auditing?

THE BUSINESS APPROACH TO THE AUDIT PROCESS

Understanding the Client's Business

Fundamental to any well-planned and competently performed audit is a thorough understanding of the client's business and the industry of which it is a part. The auditor needs an understanding of the business in order to determine and help resolve problems that may affect the audit. He needs an understanding of the business if he is to be helpful to the client. The requirement for understanding the client's business pervades all levels of our firm—from the junior accountant to the partner in charge—but it is obviously more critical at the top levels.

Understanding of the business is necessary in order to serve the client, and the client expects that we *will* help him. From his point of view, the help, guidance, and advice that the auditor can provide is the constructive part of the audit function and the part in which the client is interested. Any audit firm can provide him with a certificate, if one is justified. Of importance to the client is what an accountant can do for him above and beyond the regular audit.

Basically, then, the client wants management help along with performance of the audit. Now, if we were not equipped to provide such help, Touche, Ross, Bailey & Smart, and the entire accounting profession might well have a serious problem. But we do have a specialized competence in the entire accounting— not just the auditing—function. The nature of our work is such that we are required to delve into many of the confidential areas of the business. It is natural for management to want to share its problems with us. It is natural for us to help management with its problems.

To implement a business approach to auditing, what are some of the things an auditor should know about the business?

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1. *Plan of Organization* — Is the business run by one-man rule, or are duties delegated? What are the major areas of responsibility—manufacturing, selling, research, and so forth? What are the lines of authority?

2. *Products* — What are the various products? Are they consumer products or products sold to other businesses? What is the relative significance of each product to total sales? Are products standard or special items? What research and development are required in product development? Is patent protection important? Is styling important? What about product warranties or other risks associated with the products, as in the case of drug companies? How often are products changed, and how frequently are new products introduced?

3. *Sales distribution methods* — Does the company sell through its own salesmen or are jobbers and dealers used for distribution? Does the company maintain its own warehouses or use public warehouses? Who are the major customers and what is their significance in terms of total volume?

4. *Pricing policies* — How are different classes of customers treated? Who sets prices and how? Where are orders accepted? What are the criteria for accepting returns and granting allowances?

5. *Manufacturing* — Are goods purchased for stock or for specific orders? How are materials ordered for production? How are inventory levels determined? What is the philosophy of developing overhead rates—are they based on actual production levels, capacity, or something less than capacity? What procedures are used to control inventory? What sort of average leadtime is involved in production? And what are the risks involved in manufacturing? Knowledge in these areas is essential to the evaluation of inventories in the audit.

6. *Credit policies* — What is the philosophy of customer relations in handling of credits? Are special volume rebates involved? Is there a policy with respect to write-off of accounts? What are the follow-up procedures prior to write-off?

7. *Personnel policies* — What are major fringe benefit plans? What is the Union relationship?

8. *Management philosophy* — What is the business philosophy of management? Knowing this is important, because the approach to any engagement depends upon whether or not management has a conservative business approach, both to the operation of the business and to the reporting of earnings.

This is the kind of business background information we consider important when making an investigation for the acquisition of a business by a client. The auditor needs to have as much or even more current information about the client's own business if he expects to direct his audit efforts intelligently. Let us assume that we can develop this kind of general business background for each of our clients. How can we then put this information to use in the conduct of our audit?

Evaluation of risks — current events

One of the first benefits to be gained from a general understanding of the client's business is the evaluation of the major risk or problem areas which should receive concentrated attention in the course of the audit. This evaluation should be made early in the audit, so that special attention can be directed to critical areas. It hardly needs saying that the risk areas of a business are usually the risk areas of the audit.

All the information received in discussions with management, the knowledge of conditions existing in the particular industry, and the knowledge of business trends generally, should be considered in our approach to the audit. For example, the auditor may learn from the president that new techniques and equipment have been developed to produce one of the company's major product lines at considerably lower cost, and that competitors have already reduced prices of these products. In this situation, the client can act in several ways. He can:

Discontinue the product;

Continue to make the product, but attempt to reduce costs by various means;

Replace the existing equipment with new equipment;

Re-locate the plant to a lower labor cost area, or obtain increased efficiency with present men and equipment.

As you can see, the financial statements will be affected in different ways, depending upon the decision made. The ultimate decision will, however, have a significant effect on the business and its financial condition. Failure to recognize this business problem in connection with the examination could be of much more significance than failure to test the clerical accuracy of inventory prices.

This kind of situation is also a test of our willingness to help the client. The auditor can either be of assistance in analyzing the alternatives with the client, or can sit back and wait for his answer. Willingness to help, per se, is not enough. In such situations, the auditor must be aggressively interested in the client's business problems and demonstrate that he can be of assistance.

As another example, the auditor may learn through professional reading programs or from other outside sources that significant price reductions are taking place in basic materials used by a client. Or, he may learn that a particular industry to which a client sells its products is depressed and experiencing many business failures.

In these instances, information about the client's business or industry affect the audit planning and audit results. The auditor might, of course, be lucky enough to discover these conditions in the normal course of his audit tests, but it would be better if he considered these matters when beginning the audit so that he wouldn't have to try to solve them the day before the report is due. Again, discussion of such matters at the start of the audit is an important way to let the client know we want to help him — and are equipped to do so.

Evaluation of risks — recurring problems

These examples have been cited to show the importance of keeping abreast of current matters affecting the client's business, thus insuring their adequate consideration in the audit. It is equally important that the auditor direct attention to problems and risk areas that are recurring in nature — again, problems which he should understand, and of which he should be aware.

Assume, for example, that a few customers represent a significant portion of the client's business. Special attention should normally be directed to the following kinds of questions:

What are the recent sales of these customers?

If the sales are contractual, what is the current status of the contract?

Are sales on a profitable basis?

What is the financial stability of the customers? How are they paying?

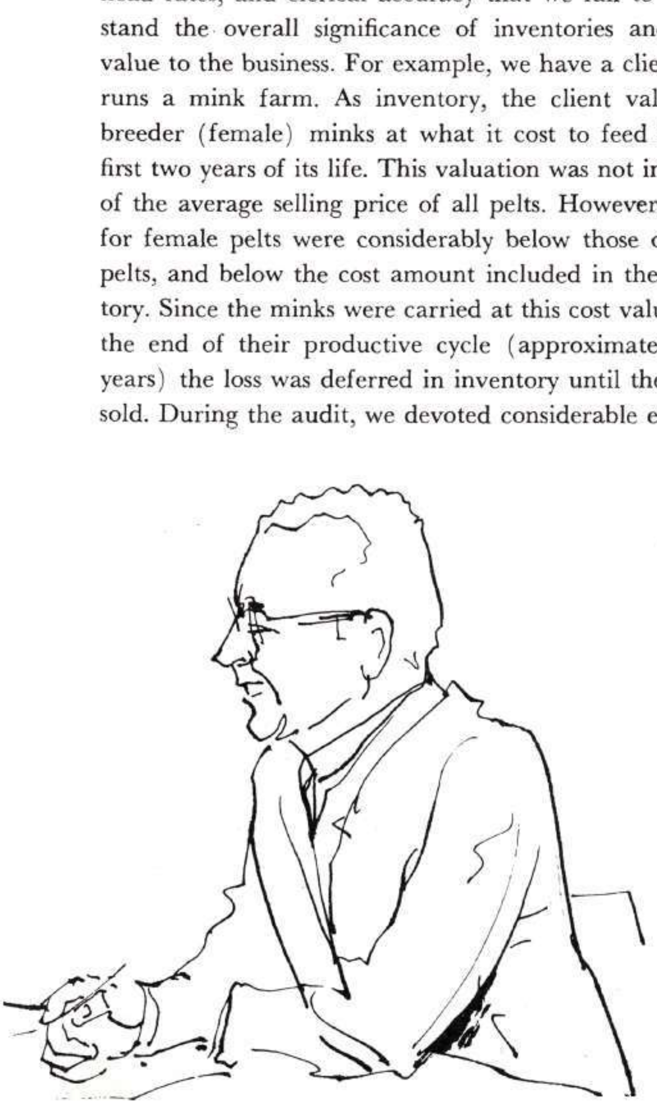
What is the status of unfilled orders?

As a result, the auditor's investigation may show unsatisfactory conditions which could be corrected to benefit the company. In many instances, he may even be able to anticipate an unsatisfactory situation in advance.

If risk areas are carefully appraised in advance, we will have solid assurance that the important aspects of the business have received careful attention. In general, the philosophy and practice of knowing the client's business gives assurance to the firm that our audit results are indeed good audit results. The implementation of philosophy can also contribute to our practice development program.

Evaluation of inventories

Inventories are one of the most difficult areas in any audit and probably the most difficult for businessmen to understand. Inventories are also the area in which we have our greatest opportunity to exercise common sense business judgment. Failure to make a good audit in the inventory area can often be attributed to the fact that we get so involved in the details of quantities, pricing, overhead rates, and clerical accuracy that we fail to understand the overall significance of inventories and their value to the business. For example, we have a client who runs a mink farm. As inventory, the client valued its breeder (female) minks at what it cost to feed for the first two years of its life. This valuation was not in excess of the average selling price of all pelts. However, prices for female pelts were considerably below those of male pelts, and below the cost amount included in the inventory. Since the minks were carried at this cost value until the end of their productive cycle (approximately four years) the loss was deferred in inventory until they were sold. During the audit, we devoted considerable effort to establishing the correct cost value but almost failed to recognize business aspect — market value for female pelts was below cost.



In auditing inventories, knowledge of the client's business usually assists the auditor in many ways. For example:

The normal first step in auditing inventories is to establish that quantities are accurately stated. Here, a knowledge of warehouse capacity will enable the auditor to determine that total quantities are not unreasonable on their face. In the case of warehouse inventories of finished goods, a knowledge of the location of specific warehouses and sales trends of the territories served will often enable him to judge the reasonableness of the quantities of specific items. In the case of raw material inventories, a knowledge of the productive capacity of the particular plants involved will help in judging overall reasonableness. An understanding of the components of the principal products will help to judge the reasonableness of in-process inventory. These evaluations are more important than many of the normal audit tests, but nevertheless we cannot ignore the more prosaic tests which are part of the required auditing procedures.

Once quantities are established, the valuation of such quantities must be challenged. Here again, knowledge of the business is important as a supplement to examination of vendors' invoices, review of labor and burden standards, and computation of usage and turnover factors. For example, a comparison of order backlog and sales trends to finished goods and related raw material components on hand often reveals unbalanced conditions and resulting obsolescence. Similarly, a review of perpetual inventory records may reveal items with little activity requiring further investigation. A client's future plans to discontinue an entire product line or to introduce a new line can often reverse an opinion formed from traditional audit tests and study of historical data. Changes in key personnel in the sales, production, merchandising, or engineering area may be a clue to impending changes in product policies that will affect inventory valuation. A thorough understanding by the auditor of the company's policy of dealing with obsolete and slow-moving items is also necessary to determine the scope of his investigation.

Having discovered quantities of inventory that are obsolete, the auditor faces the valuation problem. In some unusual instances obsolete items should be valued at zero. Normally, however, items must be priced somewhere between cost and zero value. In such cases, valuation requires an extensive knowledge of sales and pricing policies, as well as knowledge of methods of distribution.

In some cases, it may be possible for the client to dispose of the obsolete items by offering them to regular customers at reduced prices. In other cases, this would run counter to the client's sales policy and the items would have to be sold outside of regular channels or scrapped. Knowledge of the client's business in these circumstances will help in determining a reasonable inventory valuation.

Advance planning of physical inventories and their compilation is essential, and many times will provide the auditor with opportunities to recommend improvement in the company's internal control system or in its inventory procedures. This advance planning can provide useful information which will help direct the audit effort to important areas of the inventory which need attention.

This advance planning paid off for us recently in the case of a company which stored its machine repair parts in warehouses of subsidiary companies in approximately 40 locations. The inventory was completed for each subsidiary company, but because of the many parts involved, no one had considered obtaining consolidated information of the total quantities of parts on hand at all locations. We recommended that IBM techniques be used for the inventory, with the result that consolidated inventory information was available for the first time. This gave management data on the status and location of repair parts, and provided us with information on the important items in the consolidated inventory. The investigation of one item totaling $90,000 in the consolidated inventory revealed that the counts had been recorded in units, whereas the price used was for a package of three units. Management was pleased with the results of this new inventory technique, and we benefited in the audit as well.

Audit of property, plant, and equipment

In most manufacturing companies, land, buildings, and equipment constitute the largest asset on the balance sheet, yet the auditor generally spends little time evaluating the business problems of these assets. He often devotes most of his time in the audit to the routine aspects of vouching additions, checking clerical accuracy of the computation of depreciation, application of consistent depreciation rates, and recording beginning and ending balances in asset and reserve accounts. Undoubtedly, what happens is that when he has accomplished all of these tasks, the budgeted time is exhausted and he has little time for the more important aspects of the audit of properties. In order to provide this time, the client should be asked to furnish details of the additions and applicable vouchers, details of the deprecia-

tion computations, and summaries of changes in the asset and reserve accounts. If this is done by the client, all that may be necessary for the auditor to do is review the information for reasonableness and make limited tests of the supporting details.

The auditor often fails to make adequate review of internal control over properties, particularly the controls over machinery and other equipment. It is very probable that he can make recommendations for improvement of internal control of these assets, if he makes an adequate investigation. For example, the following questions should be asked and the answers evaluated:

1. Does the company maintain detailed property records? If not, why not? It may become necessary to establish such records for 1962 and subsequent years' additions because of the investment credit provisions of the Internal Revenue Code.

2. How often are property records checked by complete physical inventories of equipment? In my opinion, this should be done at least every five years.

3. Are differences disclosed by physical inventories adequately investigated?

4. What controls exist over the disposal of properties? Who authorizes disposals, determines prices, terms, and so forth?

5. Are fully depreciated assets being controlled even though removed from the accounts?

6. What controls are maintained for equipment sent out for repair or rehabilitation, and how effective is the policing job?

7. If many items are disposed of at one time, is it the practice to take a complete inventory of such items so that adequate records are established for items sold?

One of our clients recently experienced a defalcation as a result of equipment presumably sent out for repair but never returned to the plant. An officer of the company initiated the orders to send the equipment out but there was no follow-up to determine why the equipment was never returned. Property records were maintained, but it was not the practice to regularly schedule physical inventories. Had these controls been operating, it is likely that the manipulations would have been disclosed.

There are important business aspects related to properties which should be considered. Here again, background information of the business is essential. Some of the matters that should be considered are:

1. Are the useful lives of the depreciable assets reasonable? The new guideline lives and the related reserve ratio tests are a useful tool. How do overall depreciation rates compare with other companies in the industry?

2. Are records of properties adequate for insurance purposes? Who determines insurance coverage, and on what bases are values established?

3. Are machines kept in a good state of repair, or do production records indicate considerable down-time due to condition of equipment?

4. Has there been any loss in value of physical assets because of technical obsolescence, new products, discontinuance of products, or for other reasons, which has not been provided for through depreciation?

5. When the company manufactures machines for its own use, is the cost capitalized higher than the cost of the machine if purchased from another manufacturer?

It is important that properties be investigated each year from a "business" viewpoint to make certain that any loss in value of assets is provided for in the accounts. Failure to recognize such loss in value is as serious as understating the reserve required for bad debts or unrecorded liabilities, since the net worth of the business is affected. The auditor must have a thorough understanding of the business and stay close to its problems if he expects to disclose such items. The business approach to auditing not only helps use to perform our audit function well; it also helps us help our client.

Management services and the business approach to auditing

Management services is no longer a new concept or a new service with our firm. While we have a long way to go before we will develop the full potential of management services work, this added capability improves our business approach to auditing in a manner which is helpful to our clients and contribute to the growth of the firm. Let us contrast the business approach to a typical audit problem with the green eye-shade approach.

All of us have been faced repeatedly, with a situation where, for example, the client takes several months to price his inventory because of the lack of adequate records. The final result is anxiously awaited because no one has any idea of the profits for the year. The final inventory listing is a gem—with prices coming from such diverse sources as cardex files, vendors' invoices, obsolete cost studies, engineers' estimates, and purchasing agents' guesses. Obsolescence is apparent, but no organized intelligent approach has been given to its evaluation. The green eye-shade auditor wrings his hands, prepares reams of schedules to test the prices, skims around the edges of obsolescence, concludes that the errors offset each other and, with some trepidation, signs the certificate. Some of the bolder ones have been known to gather their courage and notify the controller that he ought to do something to improve the pricing next year.

The auditor with the business approach deals with the pricing problem more systematically than his counterpart, and probably in less time. He goes more deeply into the obsolescence question, not only to appraise its amount but to determine what caused it and how to prevent it in the future. He views the entire situation, not just as a messy audit problem, but as a serious business problem in management information and financial control. He meets with the client's financial and operating people to discuss and explain the benefits which can be obtained from adequate cost accounting, production and inventory control, and managerial financial statements.

Obviously, none of us take the green eye-shade approach. But, on the other hand, too few of us really go all out for the business approach and actively and confidently promote our capabilities to assist management in

the installation of adequate cost and inventory controls and management information systems.

A common aim in both management services and the business approach to auditing is to serve the client. To do this, however, our conclusions and recommendations must be communicated to him. Where possible, face-to-face communication is the most effective way to explain and sell any idea. But, where personal communication is not possible or convenient, we must communicate in writing to get our ideas across to the client—the internal control letter or letter of recommendations.

Effectively used, the letter of recommendations can be one of the most useful means of communicating with and helping a client. Conversely, it can also be dangerous—especially if it reports only trite recommendations for improving control over cash.

To be sure, a businessman is interested in knowing whether the system of internal control is reasonably adequate to prevent fraud and manipulation in the accounts. But he is more interested in knowing how he can reduce costs and increase income, improve the capabilities of his personnel, upgrade the adequacy of his accounting system, and whether he has taken every tax advantage to maximize his cash flow.

If the auditor adopts the business approach to auditing, he will have plenty of useful information to put in the letter of recommendations—information in which the client will be interested, and that he does not already have. The auditor will set forth areas in which management services consulting can be of help to the client. He will point out areas of financial management in which the clients' practices can be improved—the management of credit, obligation of cash balances, purchasing practices, cash discount practices, and many others. With this kind of positive information, writing a letter of recommendations is a pleasure, rather than a chore.

DEVELOPING THE BUSINESS APPROACH

Let us now turn to the question of how the auditor can develop the business approach to auditing. How does he acquire knowledge about the business of his clients which is both desirable and necessary? Perhaps the first and best means of acquiring this knowledge begins when he first acquires the client.

New engagements

New engagements present an opportunity to implement the business approach to auditing without the need for breaking with past patterns. The opportunity for the auditor to learn as much as he can and should know about a new client's affairs is frequently passed up because of the cost involved. We should put forth our best efforts to gain a thorough knowledge of the business despite the added cost.

Management services and tax personnel should participate extensively in the initial review of a new client, since frequently they find there are additional opportunities to serve the client in these special areas. Even if additional services are not obtained in the early stages of the engagement, a favorable relationship will have developed which should serve us well in future dealings with the client. The additional cost is well worth the effort of serving the client well.

Increasing our competence

Now, how can the auditor increase and extend his competence when the client involved is an established client? The best way to keep abreast of the affairs of a client is through continuous contact during the year.

As a goal, the auditor should strive to deal at top levels of management. In all cases, he should know the president and other top officers, and should appear before the Board. He should try to make their personal acquaintance and to understand their views of problems and operations.

The practice of having the client send us copies of the monthly financial statements gives many opportunities to discuss problems or trends that are apparent from the statements. It is important that a top review of these statements be made each month so that any developing problems are brought to light. In many instances, a review and discussion of the monthly statements will result in the opportunity for further service in tax or management services.

It is important that the auditor take every opportunity to ask questions about the business. He should try not to appear inquisitive but in fact he should be. He should inquire into and understand business reasons behind each major transaction. For example:

What is the purpose of new financing arrangements?
Why is more stock to be sold?
Why was stock reacquired?
Why were acquisitions made?
What is the business or tax reason behind allocation of parent charges, and what is the business justification for the treatment?

At the top level of a company, the auditor should deal with problems as business problems first. He does not need to translate them to audit and tax consequences, at least at the onset. As auditors, we should encourage the president and even subordinate personnel to talk to us "off the record" so we can deal with their problems strictly on the business and moral issues involved. We will not compromise our independence by this; we will, in fact, develop a much better insight into the kind of people who run the business. Businessmen want someone to talk to about their affairs; we should encourage them to come to us first.

Staff training

If we examine the techniques used in managing our audit engagements in recent years, we find that not enough has been accomplished toward development of business concepts. The communication of audit problems between the staff assigned to an engagement and the supervisory personnel having primary responsibility for it is often characterized by the same kind of deficiencies we are so quick to note in the procedures of client companies. All too frequently, this communication consists entirely of several repetitious, semi-legible layers of memorandums covering the scope of the audit, but little, if anything, about the business itself or its problems.

In the past our audit training programs have emphasized the internal control aspects of the audit by use of illustrative good audit programs. Similar effort has not been devoted to teaching the business approach to auditing. This would be effort well spent.

In such a model business approach program, several things might well be included. The risk areas in the audit of assets and liabilities and how to deal with them could be spelled out. Current information as to special problems should be communicated as a supplement to the audit program and used on a one-time basis. In addition, it would be beneficial to have a concise summary of background information of the company prepared for inclusion in the program. This need not deal with specifics, but should cover the major areas of the business. If audit programs include this kind of information, the auditor will soon learn the significant business aspects to be considered in an audit.

The important financial ratios used by banks and the business community to evaluate credit risks and the relative success of enterprises should be of interest to us—especially a comparison to industry averages, such as those published by Dun and Bradstreet. The client's management will appreciate our ability to point out unusual relationships or trends of which they may not be aware. Yet, most of these ratios are completely ignored in our audit work papers or memos. It should be very helpful, and require relatively little time, to compute applicable ratios each year for our audit clients and record them in a trend format. Computing and recording the ratios would not, in itself, accomplish a great deal. Understanding the reasons for year to year variations between company and industry ratios would help us know more about the business and would aid in pinpointing problem areas.

Consideration should be given to preparing a statistical summary of basic operating and financial data (comparative data in either trend or graph form) to be used in connection with all audits of manufacturing and merchandising companies for submission with the draft audit report for final review. Such a summary would highlight the important business aspects and set forth significant trends of the business in compact form. Explanations of variations from the prior year could be set forth in the memorandum accompanying the data sheet. Only significant relationships should be shown, and in the case of companies with several operating units (divisions or subsidiaries), information should be shown for significant units, as well as in total. The data sheet could be carried forward from year to year if prepared in trend or graph form; otherwise, a comparative data sheet could be prepared each year.

By experimenting with the use of such statistical summary, the auditor may perhaps discover that many of the reporting and training techniques which he recommends for businesses can be applied to the internal audit reporting problem. Using the summary approach might not only save review time, but would compel the auditor to be more precise in analyzing and interpretating the significance of audit tests.

A business problem questionnaire is another device which can significantly improve the business approach to auditing. Such a questionnaire could list queries which would force us to take an overall business approach. Requiring its completion as part of an audit would both train the staff man and, on its completion, teach him more about the business.

If we were to allow present conditions to prevail we would be, by default, failing to gain the understanding we need of the important business problems of each client's audit. Perhaps more important, we are failing in the development of ourselves as professional accountants.

To summarize, we must have a thorough understanding of our client's business if we are to do an intelligent, businesslike audit which can provide the kind of service our client needs and expects. Adequate advanced planning and communication to our staff of the business problems of each client are an essential part of assuring that the important areas of the audit are covered. By developing a closer relationship with our client and an understanding of his business problems, we create opportunities to expand our tax and management services activities. Let us all follow the "business approach to auditing"—thereby becoming better auditors and better business consultants.