Audit Practice Management
Client Selection and other considerations

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Agenda

- Introduction
- Acceptance and Continuance
  - Understanding your client
  - Compliance with Ethical Requirements/Independence
- Contracting with clients

Introduction

- Risk management has a specific impact on life in an accounting firm and protects the reputation, credibility and status of the firm.
- A risk management culture emphasises at all levels the importance of managing risk as part of each staff member's daily activities.
- The goal of creating a risk management culture is to create a situation where partners and staff instinctively look for risks and consider their impacts when making effective operational decisions.
- Adopting a robust risk management framework not only protects the individual but the profession as a whole.

Introduction

- Prudent risk management requires that a firm know as much as possible about what will be involved with a new client relationship or engagement before the agreement is in place.
- Not having made a diligent risk assessment by performing timely client and engagement acceptance procedures almost guarantees that surprises will follow.

Introduction

- Various standards published by the International Auditing and Assurance Standards Board (IAASB) which address client acceptance and continuance.
- International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance, and Related Services Engagements*;
- ISA 220 - *Quality Control for an Audit of Financial Statements*
- ISA 600- *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

Acceptance and Continuance

- **ISQC 1, Para 26.** The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:
  a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so;
  b) Can comply with relevant ethical requirements; and
  c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity.

Acceptance and Continuance

- **ISQC 1, Para 28.** - The firm shall establish policies and procedures on continuing an engagement and the client relationship, addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier.
  a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and
  b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

Understanding your Client

- Access to key personnel and information enables to appropriately undertake any assessment of the client/engagement, a variety of factors need to be taken into consideration: -
  - Owners, key management and those charged with governance
  - Related parties
  - Financial & Going Concern considerations
  - Nature of operations
  - Attitude to Controls and Accounting standards
  - Previous auditors and other advisors

Understanding your Client

- Owners, key management & those charged with governance
  - ✓ Can they be clearly identified?
  - ✓ Is key management dominated by one/few individuals?
  - ✓ Does management have the relevant competence (consider experience, skill, background)
  - ✓ Attitude/tolerance to risk, management and financial performance
  - ✓ Overall integrity and reputation
- Related parties
  - ✓ Identity and reputation of related parties
  - ✓ Are there related party transactions outside the ordinary course of business?
  - ✓ Complexity of related party transactions

Understanding your Client

- Financial and going concern considerations
  - ✓ Financial statement analysis
  - ✓ Profitability margins and their consistency
  - ✓ Debt covenants/credit ratings
  - ✓ Supplier/customer concentration, Dependence on key project, contract,
  - ✓ Products/services (current and planned)
  - ✓ Industry (stability, client market presence and growth, litigation, extent of any regulatory oversight etc)
  - ✓ Regulators—status of regulatory filings —relations with regulatory authorities
  - ✓ Sensitivity of entity assets to market conditions
  - ✓ Expiration or violations of licenses or permits

Understanding your Client

- Nature of operations
  - ✓ Complexity of the entity structure
  - ✓ Past, current or impending significant litigation
  - ✓ Specialist legal or regulatory environment
- Attitude to Controls and Accounting standards
  - ✓ Ineffective internal control environment or attitude that controls are unimportant or should be circumvented
  - ✓ History of a lack of reliability of past accounting estimates by management
  - ✓ Suspect accounting policies or treatment of specific transactions
  - ✓ Ineffectiveness of management in enforcing controls
  - ✓ High management turnover

Understanding your Client

- Previous auditors and other advisors
  - ✓ Basis for appointment/Reason why previous auditor not reappointed
  - ✓ Issues raised in prior years audit report
  - ✓ Quality of work done by previous auditor
  - ✓ Have other Firms refused to provide services to this entity
  - ✓ Lawyers
  - ✓ Other advisors

Competency of the Firm

- ISQC 1, Para 26(a) focuses on the need for the Firm to ensure it is in fact competent and has the capabilities to perform the engagement.
  - ✓ Knowledge of relevant industries or subject matter;
  - ✓ Appropriate experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
  - ✓ Sufficient personnel with the necessary competence and capabilities;
  - ✓ Experts are available, if needed;
  - ✓ Ability to complete the engagement within the reporting deadline.

Compliance with Ethical Requirements

- ISQC 1, para 20 & 26(b) requires that the Firm have policies and procedures to ensure compliance with relevant ethical requirements.
- Should be guided by the key principles and tenets of the International Ethics Standards Board for Accountants' Code of Ethics (IESBA Code)
  - Integrity
  - Objectivity
  - Professional Competence and Due Care
  - Confidentiality
  - Professional Behavior

Compliance with Ethical Requirements

- Ethical threats may be created by a broad range of relationships and circumstances.
- Such threats could compromise (or could be perceived to compromise) compliance with the fundamental principles.
- Whether or not an ethical problem arises with a partner or staff member, firms should establish a process to deal with instances of non-compliance
- There are five types of ethics threats identified by the Code.
  - ✓ Self-interest
  - ✓ Self-review
  - ✓ Advocacy
  - ✓ Familiarity
  - ✓ Intimidation

Self Interest threat

- *The threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior*
- Examples of self interest threat include
  - Team member having a direct financial interest in the assurance client.
  - Dependence on fees from a client or concern about losing a significant client
  - Team member having a significant close business relationship with an assurance client.
  - A member of the audit team entering into employment negotiations with the audit client.

Self-review threat

- *The threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service*

Self-review threat

- Examples of Self-review threat include
  - A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
  - A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.
  - Team member being, or having recently been, a director or officer of the client.
  - Team member being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.

Advocacy threat

- *The threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised*
- Examples of Advocacy threat include
  - ✓ A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.
  - ✓ The firm promoting shares in an audit client.

Familiarity threat

- *The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work*
- Examples of Familiarity threat include
  - ✓ Team member having a close or immediate family member who is in a position to exert significant influence over the engagement
  - ✓ An employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
  - ✓ A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.

Intimidation threat

- *The threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.*

Intimidation threat

- Examples of Intimidation threat include
  - ✓ A firm being threatened with dismissal from a client engagement.
  - ✓ An audit client indicating that it will not award a planned nonassurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction.
  - ✓ A firm being threatened with litigation by the client.
  - ✓ Pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.

Compliance with Ethical Requirements - Independence

- Independence and objectivity are necessary preconditions for the provision of credible assurance services by professional accountants.
- All partners and staff are required to be aware of and understand the IESBA Code Section 290 and Section 291, ISQC 1.20–.25, and ISA 220.11.
- All members of the assurance team must have independence of mind and be independent in appearance of their assurance clients

Compliance with Ethical Requirements - Independence

- The firm is responsible for the development, implementation, monitoring, and enforcement of policies and procedures designed to assist all partners and staff in understanding, identifying, documenting, and managing independence threats and for the resolution of independence issues that arise prior to or during engagements.
- When threats to independence that are not at an acceptable level are identified, and the firm decides to accept or continue the assurance engagement, the decision shall be documented. The documentation should include a description of threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

Compliance with Ethical Requirements - Independence

- If threats to independence cannot be eliminated or reduced to an acceptable level by applying appropriate safeguards, the firm shall eliminate the activity, interest, or relationship that is creating the threat, or refuse to accept or continue the engagement (where withdrawal is possible).
- The firm shall obtain from all partners and staff required to be independent by relevant ethical requirements written confirmation that they understand and have complied with the firm's independence policies and procedures. The confirmation of compliance shall be obtained at least annually

Independence

- The Code (Section 290) describes specific circumstances and relationships that may create potential threats and the types of safeguards that may be appropriate to eliminate the threats (if possible) or reduce them to an acceptable level.
  - Financial Interests
  - Loans and Guarantees
  - Business Relationships
  - Family and Personal Relationships
  - Employment with an Audit Client
  - Long Association of Senior Personnel

Independence - Financial Interests

- A firm, a member of the audit team, or an immediate family member shall not have a direct financial interest or material indirect financial interest in:
  - The audit client, or
  - An entity that has a controlling interest in the audit client if the client is material to the controlling entity.

Independence - Financial Interests

- If the firm, a partner or employee of the firm, or immediate family member, receives a financial interest that would not be permitted, for example by way of an inheritance, gift or as a result of a merger:
  - If received by the firm, a member of the audit team, or immediate family member, the interest shall be disposed of **immediately**, or if the interest is indirect, a sufficient amount shall be disposed of such that the remaining interest is immaterial
  - If received by an individual who is not a member of the audit team, or immediate family member, the interest shall be disposed of **as soon as possible**, or if the interest is indirect, a sufficient amount shall be disposed of such that the remaining interest is immaterial

Independence - Loans

- Audit clients that are banks or similar institutions
  - A firm, a member of the audit team, or immediate family member, may have a loan or guarantee of a loan provided it is made under normal lending procedures, terms and conditions.
- Audit clients that are not banks or similar institutions
  - A firm, a member of the audit team, or immediate family member, may have a loan or guarantee of a loan unless it is immaterial to the firm or member of the audit team and the immediate family member, and the client.

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Independence - Loans

- A firm, a member of the audit team, or an immediate family member, shall not make or guarantee a loan to an audit client unless the loan or guarantee is immaterial to both the firm or member of the audit team and the immediate family member, and the client.

Independence – Business Relationships

- A firm shall not have a business relationship with an audit client or its management unless any financial interest is immaterial and the business relationship is insignificant to the firm and the client or its management.
- If any financial interest from a business relationship between a member of the audit team and the audit client or its management is material or the relationship is significant to that member, the individual should be removed from the audit team.
- If the business relationship is between an immediate family member of a member of the audit team and the audit client or its managements, any threat shall be evaluated and safeguards applied when necessary.

Independence – Family and Personal Relationships

- Threats to independence are created when a member of the audit team has an immediate family member who is an employee in a position to exert significant influence over the client, in particular the overall financial position, financial performance or cash flows, the preparation of the accounting records of the financial statements
- The significance of the threats shall be evaluated and safeguards applied when necessary.

Long Association of Senior Personnel

- Using the same senior personnel on an audit engagement over a long period of time creates threats to independence, which should be evaluated and safeguards applied when necessary.
- In the case of audit clients that are public interest entities, key audit partners shall rotate after seven years and shall not be a member of the engagement team or a key audit partner for the client for two years.

Contracting with Clients

Contracting with Clients

- ISA 210 requires that an auditor accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed through:
  - Establishing whether the preconditions for an audit are present; and
  - Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Contracting with Clients

- In order to establish whether the preconditions for an audit are present, the auditor shall:
  - Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable;
  - Obtain the agreement of management that it acknowledges and understands its responsibility (Preparation of FS, FS free from misstatement, Access to information and individuals etc)
- If the preconditions are not present, unless required by law or regulation the auditor shall not accept the proposed audit engagement

Contracting with Clients

- The agreed terms shall be recorded in an audit engagement letter
  - The objective and scope of the audit of the financial statements;
  - The responsibilities of the auditor;
  - The responsibilities of management;
  - Identification of the applicable financial reporting framework for the preparation of the financial statements; and
  - Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Contracting with Clients

- *"It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter* ***before the commencement of the audit*** *to help avoid misunderstandings with respect to the audit."* ISA 210, para A22
- The practioner should therefore be able to demonstrate that management's agreement with the terms in the engagement letter was at an appropriate time before any significant work had taken place.
- On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement

Contracting with Clients

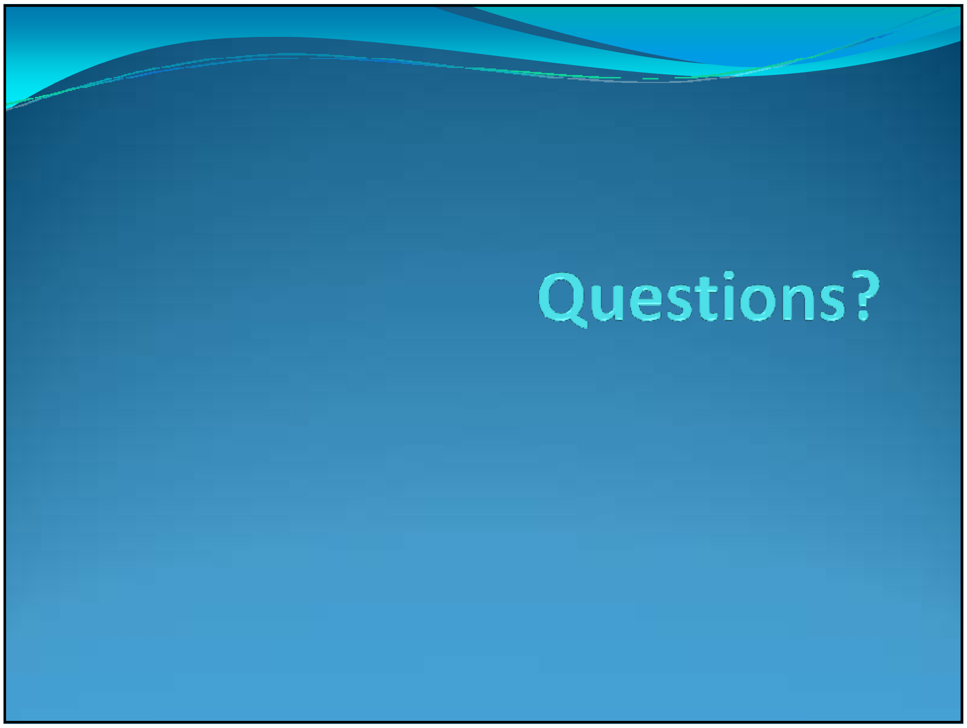
- For recurring engagement, if certain factors have changed then the auditor should consider revising the terms or reminding the parties of the existing terms of the engagement. For example:
  - Any indication that the entity misunderstands the objective and scope of the audit.
  - Any revised or special terms of the audit engagement.
  - A recent change of senior management.
  - A significant change in ownership.
  - A significant change in nature or size of the entity's business.
  - A change in legal or regulatory requirements.
  - A change in the financial reporting framework adopted in the preparation of the financial statements.
  - A change in other reporting requirements.

Contracting with Clients

- May also want to consider including other relevant information, for example
  - Termination provisions
  - Dispute resolution
  - Fee and billing arrangements

Conclusion

- Foster a strong risk management culture within your practice
- Know your clients – Gather sufficient information to make an informed assessment
- Lack of commitment to optimal quality can lead to difficult auditor-client relationships and damage to the firm's and the profession's reputation


Questions?