

# The Auditor's Road Map For Client Acceptance

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## ABSTRACT

*Our case study focuses on developing the student's understanding of the auditor's evaluation of prospective audit clients. A comprehensive evaluation is uniquely important since the client acceptance decision can be the chief contributor to auditor business risk (engagement risk). Even so, guidance in the area of client acceptance is general in nature and not as extensive or prescriptive as other significant auditing promulgation. This student case study provides practical evaluation criteria for client acceptance that can also be used by accounting professionals to benchmark their client acceptance evaluation process. This student case study can be used in the accounting classroom as a descriptive benchmark of the evaluation of a prospective client.*

**Keywords:** Auditor Client Acceptance, Audit Risk, Client Evaluation, Prospective Auditee, Student Case Study

## STUDENT ENGAGEMENT USING A CASE STUDY

This case can be implemented in the advanced auditing course as a take home problem or as an in-class discussion. We recommend motivating the topic of client acceptance by asking students if more revenue from a potential new audit client engagement is always a good thing. The answer is seemingly simple – ‘yes, of course more revenue is better than less revenue.’ We suggest posing the following set of questions to students:

*Put yourself in the place of an audit partner of a mid-size accounting firm who is under pressure to bring in new client work to grow the CPA practice and increase revenue. Is more business always a good thing? Why or why not? According to professional guidance, what are the evaluation criteria you need to consider before taking on a new audit client or new client work?*

Of course, the answer to these questions is not simple. Our Case Analysis and Discussion follows.

## CASE ANALYSIS AND DISCUSSION

One of the most underestimated determinants of a successful audit is the client acceptance decision. While client acceptance guidance exists, it is general in nature, and scattered across various promulgations. We provide evaluation criteria for the accounting professional that can serve as a benchmark for the client acceptance process. AU Section 315 (PCAOB 2014), *Communications Between Predecessor and Successor Auditors*, covers various important aspects of the client acceptance process when there is a change in auditors. Two key parts of AU Section 315 is successor auditor communications and considerations for the discovery of possible misstatements in financial statements reported on by a predecessor auditor.

Auditing Standard No. 9 (PCAOB 2014), *Audit Planning*, lists out preliminary engagement activities which include, “perform procedures regarding the continuance of the client relationship and the specific audit engagement.”

QC Section 10 (AICPA 2014), *A Firm's System of Quality Control*, addresses the acceptance and continuance of client relationships and specific engagements within its section on “Elements of a System of Quality Control.” Among other guidance, QC Section 10 states that (auditors) should accept engagements only when the auditor

- a. is competent to perform the engagement and has the capabilities, including time and resources, to do so;
- b. can comply with legal and 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.

QC Section 10 further states that such policies and procedures should:

- a. Require the firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.
- b. Require the firm to determine whether it is appropriate to accept the engagement if a potential conflict of interest is identified in accepting an engagement from a new or an existing client.
- c. If issues have been identified and the firm decides to accept or continue the client relationship or a specific engagement, require the firm to consider conflicts of interest and document how any issues were resolved.

### **EVALUATION OF PROSPECTIVE AUDITING CLIENTS**

Client acceptance evaluation should include General Considerations, Management Integrity, Management Commitment to GAAP, Management Internal Control Consciousness, Financial Strength of the Client, and Other Risk Factors. These factors contribute significantly to the auditor's business risk and should, taken together, inform the client acceptance decision.

#### **General Considerations**

The auditor should consider the nature of the auditee's business in order to determine whether the auditor holds an acceptable level of expertise in the client's industry or type of business. The auditor should also consider whether the client is a good fit for the auditing firm from an integrity, reputation, and industry-focus perspective. The auditor should consider the potential of disenfranchising an existing client by accepting a new client who is a major competitor of an existing client.

The auditor should consider the scope of services to be provided within the context of a financial statement audit and whether the auditor has the expertise and capacity to serve the prospective client well. For example, if tax, consulting, or other services will also be requested, can the auditor provide these services? The auditor should also consider whether the auditee is a publicly traded entity and whether the auditing firm has the capacity and expertise in providing an audit with the increased compliance requirements that come with a publically traded entity.

Independence considerations include examination of existing relationships. The auditor should inquire as to whether management, directors, or significant shareholders of the potential client are involved with existing clients of the auditor, and whether any potential conflicts can arise. The auditor should inquire of the appropriate officer of the prospective client if there are any potential independence-impairing relationships the auditor and the prospective auditing client that would preclude the auditor from performing audit or attest services. Examples of independence-impairing relationships may include:

- The auditor is providing business or accounting outsourcing services to the prospective client.
- The prospective client has made a loan to the auditor.
- The auditor is an investor in the prospective client.
- A director or manager of the prospective client is a former partner or director of the auditor.

#### **Management Integrity**

The auditor should obtain background checks that include a search for civil and criminal litigation, bankruptcies, tax liens, SEC violations, media reports and any needed additional research on principal management personnel. In

most cases, background checks for management personnel may be limited to those individuals from whom the auditor would obtain management representations. These usually include the chief executive officer, the chief financial officer, and the chief accounting officer. If the background checks reveal litigation, criminal proceedings, SEC violations, or other significant matters, the auditor should follow up on each matter of potential significance and document the matter(s) along with assessed significance of the matters(s) and conclusions.

The auditor should make inquiries of attorneys, bankers, and others. The auditor should contact outside legal counsel, primary bank officer and any other additional sources deemed significant to make inquiries to obtain their impressions of the entity and its management.

AU Section 315 (PCAOB 2014) addresses discussions with predecessor auditors. If there is (or will be) a predecessor auditor, the auditor should request management's agreement to contact the predecessor auditor. If permission is declined, further investigation is needed. If the predecessor firm had any reportable conditions or disagreements with management over any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, regardless of whether any such disagreements were satisfactorily resolved, an evaluation should be made as to whether any of these matters or circumstances raised questions regarding the integrity of management.

It is useful to know the predecessor auditor's understanding of the reason for the change in auditors. If the predecessor auditor's response provided is inconsistent with the successor auditor's understanding based on discussions with the prospective client, the inconsistency should be evaluated as a possible circumstance that raises questions regarding the integrity of management. The successor auditor should also inquire as to whether the predecessor auditor had any communications with audit committee regarding fraud, illegal acts, or matter related to internal control. The successor auditor should also question the possibility of any opinion shopping. Finally, the successor auditor should attempt to obtain access to prior year working papers.

Based on inquiries listed above, the auditor should determine the existence of any matters that cause reservation about the integrity of client management and if so, the effect on the auditor's business risk and the client acceptance decision.

### **Management Commitment to GAAP**

The auditor's review for any questionable accounting policies will help determine management's commitment to GAAP. The auditor should read the prospective client's financial statements for the past several years looking for any questionable policies, practices, or transactions. The auditor should inquire of management regarding these matters. If the auditor believes the prospective client should adopt different accounting policies or practices, the auditor should propose these changes to the prospective client. It is meaningful for the auditor to note whether the prospective client is willing to adopt such other policies or practices, if any.

The auditor should inquire whether any significant transactions, related party transactions or significant accounting estimates have occurred during the current or prior year and should review these transactions for appropriateness. Significant accounting estimates provide meaningful information to management's commitment to GAAP since these estimates are subject to a high degree of judgment and hold the potential to circumvent the intent of GAAP.

### **Management Internal Control Consciousness**

Kizirian et al (AJPT 2005) illustrates how management with high integrity will operate under high control consciousness. Their study creates a management integrity metric using management's attitude toward reporting, controls, and the external audit, as well as their reputation in the business community.

The client acceptance process should include an inquiry to find any reportable conditions or material weaknesses in internal accounting controls that lead to the production of the financial statements. The auditor should inquire of management as well as the predecessor auditor about any prior reportable conditions or material weaknesses relating

to the potential client's internal control over financial reporting (both the internal control system in place, and its operations).

The auditor should consider the background and experience of the potential client's accounting personnel. Of particular importance is that personnel skilled and experienced in accounting (as opposed to some other business function) are in charge of accounting operations (SAS 99, AICPA 2002). The auditor should also inquire whether there has been any recent turnover in key accounting personnel and, if turnover has occurred, inquire as to the reasons for any such changes.

### **Financial Strength of the Client**

The auditor should read and analyze the prospective client and industry financial statements to assess the possibility of business failure. Significant doubt of going concern increases audit risk as it is correlated with a larger probability of fraudulent financial reporting (Blay et al 2007). Business failure increases the risk that the client will be unable to pay for audit services.

### **Other Risk Factors**

Certain other risk factors require consideration and evaluation:

Is this the prospective client a start up? If yes, the competency of management and senior accounting personnel should be more closely evaluated. Will the prospective client be imposing certain restrictions on the scope of services or access to evidence? If yes, this could indicate a possible increase in audit risk. Who will be relying on the audited financial statements? The greater the scope of investors and stakeholders relying on the audit report, the greater the audit risk. Publically held clients hold more audit risk than closely held private clients. Potential clients intending to use the audit report for an initial or subsequent public offering hold relatively greater audit risk and significant regulatory requirements.

## **CONCLUSION**

We provide a case study as a means of learning practical considerations for the client acceptance evaluation. It can be argued that the client acceptance process may inherently be as important to the auditor as a successful GAAS audit. Yet, guidance in the area of client acceptance is seemingly dispersed. We illustrate key factors that inform auditor's business risk and, taken together, inform the client acceptance decision. The practical criteria we provide can be used both in practice and in the auditing classroom to illustrate key facets of the client acceptance process.

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