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MANAGING RISK BEFORE ACCEPTING A PROSPECTIVE AUDIT CLIENT

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Before an entity enters into a transaction with a customer, an impression is normally formed on the prospective customer. This would include a background check and assessment of the customer's creditworthiness. In the business of providing assurance services, having in place a process to evaluate the profile of a prospective customer and compliance with professional requirement before accepting the appointment as auditor is a prerequisite. This process is very much governed by a set of rules and regulations which include the MIA By-Laws ("By-Laws"), Companies Act 1965 ("CA1965"), International Standards on Auditing ("ISAs") and International Standard on Quality Control 1 ("ISQC 1") which are discussed in the ensuing paragraphs.

1. To consider threats to compliance with fundamental principles

Section 210.1 of the By-Laws requires a professional accountant, before accepting a new appointment, to determine whether the acceptance would create any threats to compliance with the fundamental principles. The fundamental principles of the By-Laws are:

- *Integrity* – straightforward and honest in all professional and business relationships.
- *Objectivity* – do not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- *Professional competence and due care* – maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- *Confidentiality* – respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not discloses any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- *Professional behavior* – comply with relevant laws and regulations and should avoid any action that discredits the profession.

The professional accountant should evaluate and apply appropriate safeguards to eliminate or reduce the threats to an acceptable level. If this is not possible, the appointment should not be accepted.

Scenario

Connection to a client who is involved in unlawful activity, fraud or dubious financial reporting practices could pose potential threat to integrity or professional behavior. The firm should obtain sufficient knowledge and understanding about the client, its owners, management and the nature of its business activities as a safeguard to reduce the threat. If this is not possible, the auditor should not accept the appointment.

The CA1965 states specific provisions in respect of appointment of auditors in order to provide safeguards against threats to objectivity and independence. Section 9(1) of the CA1965 provides that a person is prohibited to accept appointment as auditor if he is:

- Indebted to the company or its related party (as defined in Section 6 of CA1965) in an amount exceeding RM2,500;
- An officer of the company;
- A partner, employer or employee of an officer of the company;
- A partner, or employee of an employee of an officer of the company;
- A shareholder of a corporation whose employee is an officer of the company;
- Responsible for or if he is the partner, employer or employee of a person responsible for keeping the register of members or debenture-holders of the company.

2. To assess auditor's independence

Auditor's independence is related to the fundamental principle of objectivity. Section 290 of the By-Laws provides guidance to the conceptual framework to independence for audit engagements. The onus is on the professional accountants to exhibit their independence which encompasses the following sections of the By-Laws:

Section 290. 6
Independence comprises:

- *Independence of mind* - the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- *Independence of appearance* - the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised.

Section 290.7
The conceptual framework approach shall be applied by professional accountants to:

- Identify threats to independence;
- Evaluate the significance of the threats identified; and
- Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.

When the professional accountant determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant should eliminate the circumstances or relatonship creating the threats or decline or terminate the audit engagement. Professional judgment should be used in applying this conceptual framework.

Scenario

The firm has a loan or guarantee from a prospective client that is a bank. It is considered acceptable provided the loan is made under normal lending procedures and terms, as well as the amount of the loan is immaterial to the firm and the client. However, if such amount is material, proper safeguards should be applied. For instance, a safeguard is to involve an additional professional accountant from outside the firm to review the work performed. Accordingly, the auditor may be able to accept the appointment.

ISQC 1 further states that a firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements maintain independence as required by the By-Laws. Such policies and procedures should enable the firm to:Indebted to the company or its related party (as defined in Section 6 of CA1965) in an amount exceeding RM2,500;

- Communicate its independence requirements to its personnel and, where applicable, others subject to them; and
- Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to with draw from the engagement, where withdrawal is possible under applicable law or regulation.

3. To obtain professional clearance from the existing auditor

Section 210.10A of the By-Laws requires the incoming auditor to enquire from the existing auditor any reason (with necessary details) for the change of auditor before deciding to accept the appointment. Appendix II of the By-Laws sets out detailed procedures for seeking professional clearance by the incoming auditor and actions required by the existing auditor. In the UK, there were cases where failure to respond to professional clearance request can result in the accountant to be reprimanded and fined.

4. To establish proper policies and procedures in respect of client acceptance procedures

From quality control perspective, ISQC 1 provides guidance in respect of appointment as auditor. It sets out the firm's responsibilities for its system of quality control for the engagements undertaken by the firm. In respect of client acceptance of a specific engagement, ISQC 1 states that the firm should establish policies and procedures designed to provide the firm with reasonable assurance that it will only undertake relationship or engagement 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.

Paragraph A18 and A19 of ISQC 1 list down matters that the incoming auditor should consider in relation to competencies, capabilities and resources to perform the audit and integrity of client respectively. Amongst the matters are:

Competencies, capabilities and resources

- Firm personnel have knowledge of relevant industries, regulation or reporting requirements. The incoming auditor can refer to the requirements of the following ISAs on specific areas:

ISAs	AREAS	AUDITOR TO....
ISA 250[1]	Understanding laws and regulations affecting the client's business.	Discuss with management on government regulations affecting the entity.
ISA 315[2]	Understanding the client and its environment which includes its nature (eg operations, ownership, governance structure etc), entity's selection and application of accounting policies and review of entity's financial performance.	Discuss with management on the organizational structure, business activities, any financial difficulties or accounting problems and existence of related parties. Other than management, the auditor can use its previous experience with the entity and its industry and reading publicly available information such as multiple years audited financial statements, analysts' comments and government statistics.
ISA 510[3]	Whether the opening balances contain misstatements that materially affect the period to be audited.	Read the most recent audited financial statements (including the predecessor auditor's report).

- The firm has sufficient personnel with the necessary competence and capabilities. The firm may need to consider the use of experts if necessary. For instance, the firm would need to use an expert when valuing certain works of art or precious stones. In this instance, the firm should consider the requirements of ISA 620 Using the Work of an Auditor's Expert which would include the competence, capabilities and objectivity of the auditor's expert.

- The firm is able to complete the engagement within the reporting deadline which includes having adequate resources to meet the set deadline. Alternatively, the firm should consider suggesting a new deadline to be agreed with the client.

[1] ISA 250 Considerations of Laws and Regulations in an Audit of Financial Statements
[2] ISA 315 Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and Its Environment
[3] ISA 510 Initial Audit Engagements – Opening Balances

Integrity of Client

- The nature of the client's operations, including its business practices.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.

For further guidance on the client acceptance, practitioners can refer to Chapter 3 and Appendix C of the Guide to Quality Control for Small- and Medium-Sized Practices, Third Edition prepared by the Small and Medium Practices Committee of the International Federation of Accountants (IFAC) which can be accessed from the Publications and Resources area of the IFAC website: http://web.ifac.org/publications.

5. To ensure adherence to the CA1965 in respect of your appointment as the incoming auditor of the company

Under CA1965, the following provisions govern the appointment of auditors by companies. The incoming auditor should ensure that the ensuing provisions have been properly adhered to by the directors of the Company in the course of the appointment of the incoming auditor:

- *Section 172(3) [Casual vacancy]* Subject to subsections (7) and (8), the directors of a company may appoint an approved company auditor to fill any casual vacancy in the office of auditor of the company, but while such a vacancy continues the surviving or continuing auditor, if any, may act.
- *Section 172(7) [Where auditor removed at general meeting]* Where an auditor of a company is removed from office in pursuance of subsection (4) at a general meeting of the company – (a) the company may, at the meeting, by a resolution passed by a majority of not less than three-fourths of such members of the company as being entitled so to do vote in person or, where proxies are allowed, by proxy forthwith appoint another person nominated at the meeting as auditor.
- *Section 172(11) [Conditions of appointment at annual general meeting]* Subject to subsection (7), a person shall not be capable of being appointed auditor of a company at an annual general meeting unless he held office as auditor of the company immediately before the meeting or notice of his nomination as auditor was given to the company by a member of the company not less than twenty-one days before the meeting.
- Section 172(12) [Notice of nomination of person as auditor] Where notice of nomination of a person as an auditor of a company is received by the company whether for appointment at an adjourned meeting under subsection (7) or at an annual general meeting, the company shall, not less than seven days before the adjourned meeting or the annual general meeting, send a copy of the notice to the person nominated, to each auditor, if any, of the company and to each person entitled to receive notice of general meetings of the company.

- ***Section 172(13) [Annual general meeting, where notice of nomination has been given]*** If, after notice of nomination of a person as an auditor of a company has been given to the company, the annual general meeting of the company is called for a date twenty-one days or less after the notice has been given, subsection (11) shall not apply in relation to the person and, if the annual general meeting is called for a date not more than seven days after the notice has been given and a copy of the notice is, at the time notice of the meeting is given, sent to each person to whom, under subsection (12), it is required to be sent, the company shall be deemed to have complied with that subsection in relation to the notice.

In the last decade, the public have questioned auditors' involvement with their audit clients especially affecting their independence and objectivity. Globally, cases like Enron, Worldcom and Xerox are some of the examples of such situation. Therefore, knowing your prospective audit client and the type of services that you can offer them is essential in managing risk before accepting the engagement.

The Malaysian Institute Of Accountants ("MIA")

MIA is a statutory body established under the Accountants Act, 1967 to regulate and develop the accountancy profession in Malaysia. As at the date of this report, MIA has close to 27,730 members. For more information please visit: www.mia.org.my

Vision

To be a globally recognised and respected business partner committed to nation building.

Mission

To develop, support and monitor quality and expertise consistent with global best practice in the accountancy profession for the interest of stakeholders.

Objectives

1. To promote & regulate professional & ethical standards
2. To develop & enhance competency through continuous education & training to meet the challenges of the global economy
3. To enhance the status of members
4. To lead R&D for the enhancement of the profession
5. To inculcate a high sense of social responsibility

The Use of the Word "Accountant"

In Malaysia, the word "accountant" is protected as provided for under the provisions of the Act which states that no one can hold himself out or practise as an accountant unless he is registered as a member of MIA.