Managing Risk in Public Accounting Firms

by H. Fenwick Huss, Fred A. Jacobs and Denise M. Patterson

Today accountants are being held to ever-increasing levels of performance and responsibility by users of financial information and by society in general. Recent legal actions allege negligence by accountants for the failure to uncover problems in savings and loan institutions, bankrupt companies and overseas conglomerates. And according to the findings of a 1990 Johnson & Higgins report, the number of these actions continues to increase.

RICHARD ELMER

Pecuniary damages in the negligence suits filed against accountants are immense. For example, an Arizona jury recently levied a $338 million judgment against a Big Six accounting firm, and a recent suit filed by the Resolution Trust Corp. seeks $400 million from another Big Six firm for alleged negligence in its audit of a failed savings institution in Texas.

These are but two of the many recent suits brought against the large accounting firms. However, many mid-sized and smaller accounting firms, as well as sole practitioners, are also finding themselves increasingly subject to litigation. The Wall Street Journal estimated that the monetary payments made by accounting firms as a result of these lawsuits are equal to "9 percent of their total revenue and 16 percent of partners' capital." In addition to these pecuniary damages (which may threaten the survival of some firms), the accountant also faces possible revocation or suspension of his or her license.

Dan A. Simunic, chairman of the accounting department at the University of British Columbia and Michael T. Stein, associate professor at the University of Calgary, suggest that one way to assess and manage business risk in

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Fred A. Jacobs is professor of accountancy at Georgia State University, H. Fenwick Huss is associate professor of accountancy at Georgia State University, and Denise M. Patterson is a doctoral candidate at Georgia State University.

an accounting firm is to continually evaluate relationships with current clients and to carefully consider the impact of potential clients on one's practice. Other types of professional services firms have also used these evaluations; for example, client evaluations have been cited by the legal profession as being important to quality control. Similarly, the importance of evaluating client relationships was addressed in a 1991 American Institute of Certified Public Accountants (AICPA) Audit Risk Alert, which urged accounting professionals to consider the impact of recent economic developments on client business practices.

Traditionally, the assessment of the client relationship by public accounting firms has been viewed as an individual event, which occurs before the acceptance of the client.

Accountants may improve their risk assessments by utilizing the variables that some Big Six accounting firms examine when determining the desirability of accepting or continuing a client relationship. These variables serve as a foundation for implementing formal policies and procedures that, when used consistently, will reduce potential business risk. This framework will be useful not only for public accounting firms, but also for other service professionals operating in an environment where risk management requires careful analysis of client relationships.

For accounting firms, the risk assessment involves analyzing current and potential clients. The Statements on Quality Control Standards, promulgated by the AICPA, require accountants to establish policies and procedures for accepting new clients or retaining current ones. These procedures include reviewing the client's financial information, holding discussions with third parties regarding the client's management, communicating with the predecessor auditor to gain information about the client, and evaluating the firm's independence and ability to serve the client. These procedures allow the accountant to contrast the economic consequences of future events against the cost of managing risk, and thus to categorize the potential risk of prospective clients as a means of establishing quality control procedures.

However, the highly competitive accounting market may have caused some accounting firms to eliminate or minimize the process of evaluating client relationships. Alternatively, the general nature of the language of the Quality Control Standards may be difficult to interpret and thus to put into operation. In any event, given the current litigation costs facing accounting firms, it is essential that they reexamine their methods of risk assessment. First, however, it is important to review the traditional risk assessment approach used in public accounting and auditing.

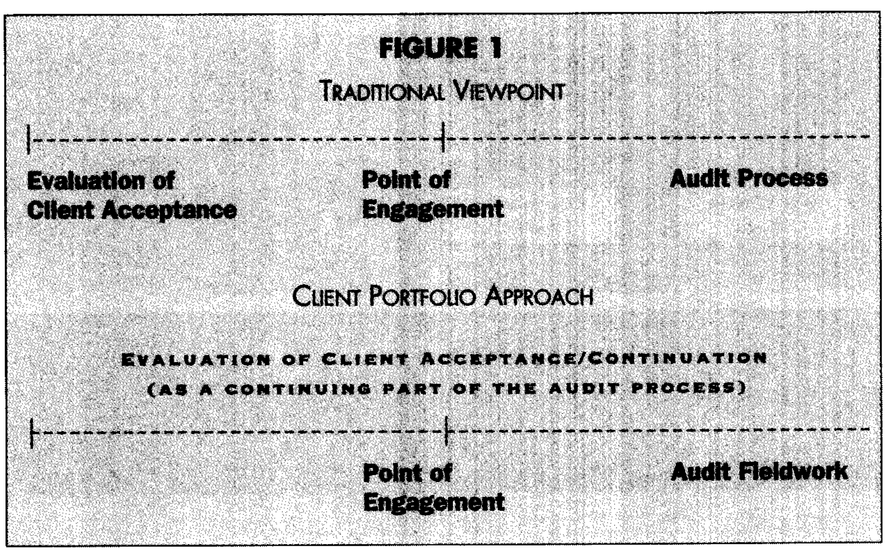
TRADITIONAL RISK ASSESSMENT

Traditionally, the assessment of the client relationship by public accounting firms has been viewed as an individual event, which occurs before the acceptance of the client. Prior to the engagement, the accounting firm identifies the service needs of the potential client, reviews its ability to provide such services and decides to accept or reject the client. Then, only after deciding to accept the client, does the accounting firm conduct its risk assessment. This assessment involves making inquiries about the operations of the client's business, which are often directed to the former auditor, firm attorneys, primary banking associates and perhaps major lenders, customers and suppliers.

Additionally, the accountant computes financial ratios that identify potential strengths and weaknesses of the client company in relation to its industry and also with its major competitors. These financial data, combined with the results of client inquiries, are used to determine the extent of testing necessary during the audit process. Therefore, the traditional view of the audit process does indeed incorporate risk assessment, but only after acceptance of the client.

Statement on Auditing Standards (SAS) No. 47 (AICPA, 1983) presents a model of audit risk that includes inherent, control and detection risks. Inherent risk is defined as the probability that a material error will occur when internal accounting controls are absent. To reduce inherent risk, accountants perform a variety of investigative inquiries into the overall operation of a company. However, these inquiries are traditionally made after the client has been engaged. Nevertheless, some accounting firms make such inquiries prior to the client's engagement. These firms' actions indicate that client acceptance and the audit process are not compensatory models; in other words, if the client acceptance/continuation decisions are made poorly, then the audit process may not be enhanced enough to compensate for the former error.

Control risk, which is the probability that a material error will not be prevented or detected by the system of internal controls on a timely basis, may be reduced as the accounting firm makes itself more knowledgeable about the client's system of internal controls. Potential weaknesses can be identified and resolved earlier. The accountant is then faced with determining a level of detection risk. Detection risk reflects the probability that a material error that is not prevented or detected by the system of internal controls will also not be detected by the audit procedures performed. When combined with the inherent and control risks, detection risk provides for an acceptable level of risk within the firm's total client portfolio.



This traditional model of audit risk (inherent, control and detection risks) is captured in the more recent investigation of the client acceptance/continuation decision process.

This traditional view of client acceptance contrasts with the view offered by Mr. Simunic and Mr. Stein. They identify each client as a member of the firm's total client base, or "portfolio." Potential clients present the accounting firm with a risk decision, which ultimately impacts the total client portfolio. Therefore, the firm must evaluate the acceptance of the potential client, as well as the continuation of all existing clients, in light of the entire client portfolio and the desired level of aggregate risk. Client acceptance and continuation decisions then necessarily occur over an extended period of time prior to the audit process and continue after the audit process has been completed. This view is more in keeping with the definition of risk management. Figure 1 contrasts the traditional view with the portfolio view of total audit risk/return.

Big Six Firms that are highly selective in their client acceptance/continuation decisions examine certain other risk factors. These decision variables and potential sources of information as they relate to the client's business risk, audit risk, and the auditor's business risk are summarized in Figure 2 on page 57.

CLIENT'S BUSINESS RISK

The first step in examining the risk variables associated with a particular client involves analyzing the client's business risk. The client's business risk reflects the client's potential for survival and profitability. The evaluation of the client's business risk encompasses the overall business environment in which the potential client operates, including the management environment and the client's financial stability. An assessment of the business environment focuses on the status of the general economy, the regional economy, if relevant, and the industry in which the client operates. Past economic effects provide an initial point of reference. However, expected trends in the economic health of a geographic region are also an important consideration. This information can generally be obtained from economic forecasts provided by colleges and universities, financial institutions, and business journals and newspapers.

The current and expected future status of the client's company and its industry includes overall production and profitability statistics and the impact of operations on the social and ecological environments. An evaluation of the company's "fit" in the business environment focuses on its market share, perceived quality of products and services and name recognition. Principal customers and suppliers are also identified. The accountant can obtain this information initially from the prospective client through methods such as direct contact with company personnel, sales brochures and corporate documents. However, substantive information can be obtained from industry-issued publications and other publications that provide a more objective evaluation of past activities and expected trends within the industry. Examples of these publications include Value Line and Standard & Poor's.

The evaluation of the client's business environment also considers variables relating the client's company to the industry as a whole.

Management environment variables, however, measure the impact of the corporation's ownership, management and employees on its operations. In regard to assessing the client's management environment, the accountant should determine if one or more persons holds controlling shareholder interest or has significant potential for control of management. Such influences can have an important impact on management's actions and should be identified early in the evaluation process. To obtain this information, the accountant should review stockholder records and hold discussions with management.

The rates of turnover of the client's top management and the board of directors are used as indicators of the company's management philosophy and objectives. A high turnover rate could indicate an aggressive management style that emphasizes short-term results. However, a low turnover rate may be indicative of a conservative management style, or perhaps an even more progressive style. The conservative style might be represented by managers who have held their positions for a long period of time and have maintained "tried and true" operations.

Alternatively, progressive managers may be allowed ample time to implement operational changes that encourage long-term survival and growth of the company. Information relative to the rate of management turnover can be obtained from board minutes, corporate policies and procedures – including management compensation schemes – and public documents such as proxy statements. Holding direct discussions with current management, predecessor auditors and business colleagues can provide additional insight into management's philosophy and the reasons for management turnover.

After developing a basic understanding of the client's business and corporate environments, the accountant should then analyze the client's financial statements in light of its overall business operations. Besides providing a snapshot of the client's financial stability, this analysis will also determine the client's standing within its industry.

The analysis focuses on not only the more common financial ratios – such as current ratio, accounts receivable, inventory turnover, return on investment and debt to equity ratio – but also on that information specific to the company's industry such as an analysis of loan reserves, warranty accruals, income tax provisions and segment reporting. "Unexplainable" deviations between the company's financial data and that of its industry are discussed with knowledgeable management personnel. The accountant should then carefully review areas of weakness to determine what impact, if

FIGURE 2

RISK VARIABLES FOR CLIENT ACCEPTANCE/CONTINUATION

Type of Risk	Decision Variables	Sources of Information
Client's Business Risk	Business Environment	Economic forecasts Trade publications Value-Line, Standard & Poor's Corporate goals and objectives Sales brochures Client inquiry Corporate records
	Management Environment	Client inquiry Corporate records Inquiry of current auditor
	Financial Stability	Financial statements Client inquiry Trade publications
Audit Risk	Audit Environment	Client inquiry Financial statements SEC filings
	Reasons for Switching	Client inquiry Inquiry of current auditor
	Management Integrity	Client inquiry Background investigations
	Independence	Personnel records Discussions with firm personnel Policy & procedure statements
	Special Situations	Background investigations Financial statements SEC filings Client inquiry
Auditor's Business Risk	Professional Associations	Client inquiry Corporate records
	Fee Realization	Financial statements Inquiry of current auditor
	Risk/Return	Partner discussions

any, these weaknesses may have on the potential client relationship.

Audit Risk

After addressing the client's business risk, the accountant should then examine audit risk. An evaluation of this risk helps the accountant identify how best to provide quality services. Audit risk refers to the problems that may result from the accountant's professional relationship with the client company. These risks include the risk that a material misstatement will result from control weaknesses, the risk of intentional suppression of information by the client, and the risk that the audit procedures will fail to detect misstatements, thus resulting in an inappropriate opinion being rendered on the client's financial statements.

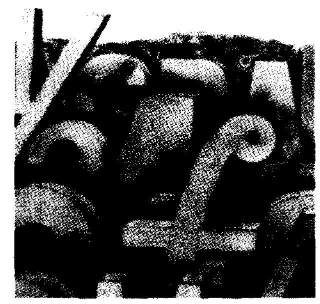
The characteristics and integrity of the client'ssignificant management personnel and principal owners can be evaluated in terms of their effects on company operations.

In order to identify audit risks, the accountant should evaluate closely management's understanding of the accountant's responsibilities and prior audit history, the reasons for changing accounting firms, management's integrity, the technical ability of the accounting firm to serve the client, the accounting firm's "independence" and any other special circumstances.

Through discussions with management, the accountant should clearly understand the potential client's expectations and the way it uses financial information. By gaining an understanding of the company's accounting methods and practices, the accountant can help identify potential problem areas. Reasons for changing accounting firms may be identified through a review of the auditor's report, annual report, or interim Securities and Exchange Commission (SEC) filings, or discussions with corporate management and the current audit firm.

The characteristics and integrity of significant management personnel and principal owners can be evaluated in terms of their effects on overall company operations. The accountant can assess management's integrity and character through personal discussions with management, other corporate personnel and business associates. Background investigations, obtained from agencies such as Dun & Bradstreet and Pinkerton, provide information on an individual's past and current business ownership, credit and payment history, involvement in litigation (as either defendant or plaintiff) and past business experience. This information offers some evidence of the business reputation and the relevant experience of management and the company's principal owners.

In order to maintain a constructive client relationship, the accountant must be able to serve the client adequately. The accountant's personnel must therefore have the appropriate technical skills, knowledge and work experience that enable them to sufficiently meet the needs of the client. After accepting a new client, the accounting firm may consult with experts from other offices to obtain supervisory guidance during the engagement. Alternatively, these experts may be transferred into the service office to become a part of the client service team.



The audit firm must also ensure that it is "independent" from the client. In other words, there should be no conflicts of interest between the accountant and the client. An example of the lack of independence includes providing audit services to a client for whom the accounting firm or its personnel appears to assume a management role. To determine the potential for such conflicts of interest, significant firm personnel such as partners, senior managers and other managers can be polled to determine each individual's relationship with the potential client or their knowledge of any potential conflicts of interest.

Other special situations are also considered. For example, the accountant should attempt to determine whether the client is involved in activities such as offshore funding, gambling operations, multinational operations or common control among business entities. The accountant will then examine the effects of these factors on the overall audit environment. Such information is obtained from investigative agencies, a review of audited financial statements and other public filings, and through an inquiry of knowledgeable management personnel.

Auditor's Business Risk

The potential for litigation and the other risks resulting from the association with the client constitutes the auditor's business risk. These risk factors arise from the client's associations with other professionals, the accountant's ability to realize fees and the risk to return ratio.

Besides the services provided by the accountant, a company receives professional services from a number of other firms. For example, the client may receive advice and services from bankers, legal counsel, investment bankers and underwriters. Because the accountant's relationship with the client company will bring the firm into direct contact with other professional service companies, the accountant should consider the reputation of these firms. This is because accountants' performances are judged not only by the services rendered, but also by the company they keep.

The acceptance of a favorable client can result in returns such as the fees realized, the firm's reputation gained through the client association, the visibility within the client's industry, and the potential for future clients.

The identification of these professional firms occurs through discussions with client personnel and a thorough review of their corporate documents. The reputation of these firms can be determined through discussions with other business associates or with members of professional organizations.

The ability of the accountant to realize a fair fee is also important and needs to be considered. The accountant can determine the potential for fee realization by reviewing the client's financial stability and forecasted results. Additionally, querying the current audit firm may identify the ability of the firm to realize a fair return for services provided. Accounting firms should also evaluate the risk associated with acceptance of the client and the return realized.

The risk to return ratio can be determined by looking at the pros and cons of accepting or continuing the client relationship. On the con side, accepting an adverse client can result in problems such as litigation, the loss of reputation among colleagues and the business community and the loss of existing clients. The accountant should therefore determine if the client's industry or operations are susceptible to litigation. The likelihood that such litigation could occur and the potential for the auditor's liability with respect to such litigation must be considered.

Perceived conflicts between client interests also need to be resolved. For example, the potential acquisition of a client may be perceived as a "conflict of interest" by an existing client. The accounting firm must assess its ability to serve both clients in a professional manner. The relationship between the auditor and the potential client and its impact on the overall reputation of the firm must also be carefully considered.

Conversely, the acceptance of a favorable client can result in returns such as the fees realized, the reputation gained through the client association, the visibility within the client's industry and the community in general, and the potential for gaining future clients. These potential risks and returns should be carefully evaluated by the accounting firm's personnel. This evaluation should be made at least at the service office level and, if possible, at a group or regional level.

When assessing its business risk, the accountant should take the combined results of the client business and audit risk assessments into consideration. Finally, throughout the client acceptance/continuation evaluation process, the accountant should keep in mind that although each area of risk is individually important, the areas are interrelated. Negative evaluations in one area may be reinforced or refuted by results in other areas. The decision to accept, reject or continue with a client should therefore be determined on the assessment of risk as a whole.

Performing risk assessments of the client's business risk, audit risk and auditor's business risk is generally well-documented. This documentation consists of copies of financial statements, SEC filings, business and investigative reports, and internal memos. The factors considered and the required documentation and approval are communicated to all members of the firm through formal policy and procedure statements.

The client acceptance/continuation analysis and decision-making process is a key component of measuring the potential for risk occurrence against the cost of managing risk and has an impact on the auditor's entire client portfolio. This evaluation process continues throughout the length of the firm's association with the client.

As the cost of occurrence exceeds the cost of risk prevention for individual clients, the accounting firm may no longer consider certain clients "acceptable" to the client portfolio. These clients may then be terminated. This approach to the client acceptance/continuation process should assist in minimizing business risk while providing quality services to all clients. RM