

## **Engaging audit clients – important factors (Lecture A809 – 11.21 minutes)**

The government is currently attempting to restore confidence in the audit profession and one of the ways in which they are attempting to do this is breaking up the dominance of the 'Big 4' and opening up the audit market to smaller firms. On the face of it, this may seem like a sensible option and one which gives challenger firms more opportunities – but it appears that there are occasions when it may not achieve what it wants to achieve.

A report by the *Financial Times* stated that lifestyle management company, *Quintessentially*, was seeking its third auditor in three years following a breakdown in relations with BDO. Accounting errors of c£7m were contained in the financial statements and the company erroneously paid £1.4m worth of unlawful dividends to its shareholders.

BDO was the successor auditor to PwC in 2019 and it was BDO who audited the 2019 financial statements which were filed in 2021. BDO resigned from the engagement following criticism by the FRC for unacceptable standards of auditing and were deemed to be growing too fast without adequate controls.

Growing too fast without adequate controls means that audit firms can become 'out of their depth'. It can result in firms taking on clients that are simply too big for them, or there are insufficient resources available in the firm to service the client adequately. When this happens, there is a significant risk that the audit work carried out will be deficient.

### **1.1 Factors to consider prior to accepting an audit engagement**

Professional bodies require certain factors to be considered prior to an audit firm accepting an audit client onto its portfolio. Independence, objectivity, management integrity and client due diligence are all typical factors which audit firms should not need reminding about.

In an environment where larger firms are 'shedding' clients in order to restructure their own audit practices, opportunities will arise for challenger firms. Challenger firms will be invited to tender for the audits of quite lucrative clients and, on the face of it, tendering for such audits may seem like a 'no-brainer'. There are five important factors that firms must consider before tendering and certainly before accepting appointment as auditor:

#### **1. Resources**

The firm must consider whether there are adequate resources available at the time the audit is likely to take place to perform the work in accordance with professional standards, legislative requirements and guidance. If there is insufficient time to conduct the work with the resources available, the quality of the audit is likely to be impacted.

At the present time, the accountancy and auditing profession is suffering from a lack of highly skilled candidates. This has been the case since the pandemic and there are still no signs of it improving. Taking on a large audit client in the hope that the firm will be able to recruit skilled and experienced auditors is a very big risk, and one which should not be

entered into unless there is certainty that additional (and suitably qualified) staff will be joining the firm.

## 2. Risks

Any risks identified with the prospective client (such as unusual transactions, a large and complex group structure, poor controls or a history of changing auditors very frequently) must be considered at the outset. These risks can increase the level of audit risk (which is the risk that the auditor expresses an incorrect opinion on the financial statements). Prior to accepting any audit client (large or small), the firm must consider the firm's overall risk profile and consider whether the client fits into that profile.

### Example – Inexperienced firm

Pastures & Co LLP are a four-partner firm based in the southwest of the country. It has 12 audit clients and last week the firm accepted appointment as auditor to Greaves Investments PLC (Greaves). Previously, Greaves was audited by a top-20 firm but the directors were unhappy with the service levels they were receiving from the firm.

Greaves has recently become a listed client and the partners are excited at the fact that this is the firm's first listed client. The audit fees for this client are very high, although they do not exceed the limit set out in the FRC's Ethical Standard.

Greaves specialises in the buying and selling of investments and has offices across the UK and overseas. The company has a material amount of derivative financial instruments on its balance sheet, all of which are measured at fair value through profit or loss in accordance with UK-adopted IFRS<sup>®</sup> 9 *Financial Instruments*. Currently no member of the audit department at Pastures & Co has any recent, practical experience of dealing with IFRS, so the audit engagement partner has agreed that three members of staff can attend a one-day IFRS update course. The firm has also subscribed to an online portal from a well-known publisher that will provide access to books on IFRS.

There are a number of issues with this appointment which may render it inappropriate for Pastures & Co:

1. The new client has only recently become listed, and the firm has no previous experience of dealing with clients listed on a stock market. This is significantly high-risk as not only is the client listed, but there are also questions to be asked as to why such an entity has chosen a smaller firm, when it has previously been audited by a top-20 firm. It also appears that the tendering process was flawed because the directors should not have appointed a firm lacking the requisite experience and expertise (i.e. a firm with no experience of listed clients or IFRS).
2. While the audit fees for this particular client do not breach the limit set out in the FRC's Ethical Standard, it may be construed that the fee income from this client was the main motivator into the firm accepting appointment as auditor to the client.
3. The principal activity of Greaves is the buying and selling of investments and operates both in the UK and overseas. Such a structure is likely to be complex which is an inherent risk in itself. Pastures & Co LLP are unlikely to be able to adequately service this client in light of its complex structure. There may also be fundamental misunderstandings in how overseas branches operate as they may be subject to their own national laws and regulations, which could impact the financial statements.
4. Greaves applies UK-adopted IFRS as its financial reporting framework and IFRS 9 is a highly complex

standard. No members of the audit department have any recent or practical experience of dealing with IFRS and so the audit firm is unfamiliar with the financial reporting framework that will be applied by the client. This means the auditors will be unable to identify any material errors or incorrect accounting treatments as they are not familiar with them (i.e. an increase in detection risk).

5. Attending a one-day update course and enabling staff access to books on IFRS will not be enough to enable the firm to justify acting for this particular client. The audit is highly likely to be deficient and, as Greaves is a listed entity, it is likely to be subject to scrutiny by the FRC. As Pastures & Co have not previously acted for public interest entities, they will have no experience of an FRC audit inspection, which is likely to find significant failings given the problems already noted. This could result in significant fines being levied by the regulator.

This example highlights the fact that the audit firm has taken this client on because of its status as a listed entity and the fact that the audit fees are very high for this firm. These are wholly inappropriate reasons to act for such a client, and the audit engagement partner should have declined to tender for this engagement at the outset. Acting for such a client is likely to create a whole host of problems for the firm, particularly when it comes to the audit file being reviewed by either their professional body or the regulator.

Risk assessment and judging audit clients against the firm's risk profile is a valuable exercise. It can protect the firm against problems further down the line and means that the firm will only accept clients that fall within acceptable risk limits.

### **3. Fees**

The audit firm should consider the acceptability of the fee. The fee must always be commensurate with the level of risk attached to the client. As noted in 2 above, the level of risk must always be within the firm's risk limits.

Disproportionately low fees can be viewed as 'low-balling' (which is where an audit firm will set a fee deliberately low in order to secure the audit). The risk here is that the firm carries out inadequate audit procedures in order to ensure that the time spent on the audit does not exceed the agreed fee.

Fees must also be considered in light of the FRC Ethical Standard. Fees from public interest entities or listed entities cannot regularly exceed 10% of the annual fee income of the firm. Fees from a client that is not a public interest entity or is non-listed cannot regularly exceed 15% of the annual fee income of the firm.

In addition, the audit firm should also consider the creditworthiness of the audit client as any non-payment of fees may create a self-interest threat.

### **4. Professional competence**

This is linked to 2 above. The firm must ensure that it only accepts engagements if the firm has the necessary skill and experience to perform the work competently. For example, it would be reckless for an audit firm to accept appointment as auditor to a pension scheme if it has no experience in auditing pension schemes.

Relying on appointing suitably experienced personnel is a reckless strategy as the firm may not be able to find such people.

## **5. Timetable**

The timetable for the audit work must be carefully considered. If the firm has several audits being undertaken at a specific time in the year, it may not be appropriate to take on another client which needs an audit at that time of the year also as it may not have the available resources. For example, academy schools all have the same year end (31 August). If the firm has several academy audits between September and December, the audit engagement partner must carefully consider whether there are sufficient resources available if a potential audit client wants the audit carrying out at the same time.

Time-pressure on the part of the audit firm is not the only consideration. There may also be statutory or regulatory reporting deadlines. Again, where an audit firm acts for a number of academy schools, the audited financial statements must be signed off and submitted to the Education and Skills Funding Agency by 31 December each year. The audit firm must carefully consider any reporting deadlines a prospective client may be subject to and whether the firm can do their work in good time to meet those deadlines.