The first principle of management – know

The nightmare scenario haunting many accountants today is the mega-lawsuit that can wipe out not only a partner, but also an entire firm. Things weren't always this way. A decade ago, such worries would rarely cross an accountant's mind. But in the post-Enron era, the prospect of legal claims has become a painful reality - one that is driving firms to overhaul their risk management practices and shore up their defenses against what could be a potential catastrophe.

The increasing amount of litigation against accounting firms worldwide is causing awareness of risk management to spread rapidly within the profession, with the largest firms leading the way. 'The Big Four are very concerned about risk management and doing all they can to manage their risks,' says Paul Winkelmann, partner in charge of risk and quality for Hong Kong and China at PricewaterhouseCoopers (PwC). 'The next tier firms are learning very quickly. For the very small firms, I'm not so sure it's on their radar screens to the same extent, but it should be because everyone is at risk.'

At the heart of the issue is the sudden change in attitude toward accounting firms following a raft of corporate scandals over the past few years. In the public's eye, accountants have become ensnared in the same net as corporate wrongdoers.


Paul F Winkelmann

The upshot is that accounting firms are facing many more professional risks today than they did in the past. Part of the fallout from the Enron and WorldCom disasters is that the profession is now more regulated than ever. That in itself poses challenges that didn't exist before. The US has its Public Company Accounting Oversight Board (PCAOB) courtesy of the Sarbanes-Oxley Act; Hong Kong's legislature is expected to consider the creation of an Independent Investigation Board and similar efforts are underway throughout the world.

Increasing emphasis on the paper trail

'The world has changed for us because regulators have a very focused view on their expectations of auditors. Today, regulators are carrying out file reviews and investigations where there are either complaints or evidence that a client has had a problem and with that there is a tremendous focus on documentation. The regulators' current view is that if it isn't documented in the files, then you didn't do it. That's a very important change,' Mr Winkelmann maintains.

'Previously, partners would say, "I had this discussion with my client and came to this conclusion." That's not good enough now. You need a note of that discussion and a follow-up to verify the conversation you had with your clients. Otherwise, even though you may have done a brilliant audit, you can still end up being sanctioned by regulators because your files don't document what you did.

'Secondly, more and more clients are raising funds outside their home territories which exposes the clients and their auditors to lawsuits in overseas jurisdictions. That has also significantly changed our risk profile because now you have the complexity that goes with cross-border arrangements and the potential for class action suits in the US.'

Not surprisingly, the atmosphere within the profession has turned to one of caution and conservatism. Risk management

risk your client

now plays a much more central role in the operations of accounting firms. ‘We weren’t lax about risk management before. Our own firm has had a risk management programme in place for years, but it wasn’t on the same scale as it is now. Our programme, and its breadth and depth of coverage, has expanded,’ says Richard George, a risk management partner at Deloitte Touche Tohmatsu.

Richard George

From consultation to consultation plus systems

‘In the past, the focus was perhaps more based around consultation. If an engagement team felt uncomfortable about a situation or didn’t know how to proceed, they would consult with a member of the risk team and we would come up with a plan on how to go forward. Now, on top of the consultation we’re also focused on prevention and as a result are more systems oriented. We’ve laid down more policies and established more guidelines. We’re requiring people to document what they’re proposing to do and to get prior approval.’

If a referral from a client or another firm was all it took to accept an engagement before, the process has now taken on far more rigorous dimensions. In the case of Deloitte and many other firms, potential clients are subjected to an extensive pre-acceptance screening.

‘Put simply, we want to know who we are doing business with. Who are the shareholders, directors and other principal officers of the potential client? And yes we perform checks for examples of records of legal or regulatory sanctions,’ says Mr George.

‘At the same time, when we’re considering a potential client we want to be very clear we understand the business model, what they do and how they make money. We meet with the potential client and typically visit their premises to get a feel for what they're all about. The key is understanding their business.'

Depending on the nature of the job and the client, the acceptance process can take from a matter of days to one or two weeks. The same procedures may also be activated for new engagements with existing clients.

Risk management from a medium-sized practice perspective

Mark Fong

Compared with the Big Four, small to medium-sized firms tend to employ less formalised risk management procedures. At Moores Rowland Mazars, the emphasis is on a principles-based approach. 'Whether a client is referred by a partner or comes knocking at the door, it always goes through our risk committee. Basically, we sit down and go through all the salient details,' explains Mark Fong, senior partner at the firm. Internal procedures include an overall background check; including an Internet search; a review of the client's reputation, corporate culture and internal controls as well as any risks associated with the particular industry the company is in.

At Paul Chan & Partners, the buck stops with managing partner Paul Chan, who makes the final decision on which clients to accept and which to reject. 'For a big firm, the internal system of risk control would need to be more well-defined and systematic. For a smaller firm, such as ours, it is much easier,' Mr Chan says.

Paul Chan

Potential clients must fill out a client acceptance form that asks about the ownership of the company, its line of business, how the client was referred to the firm and its relationship to any other of the firm's clients. 'Some corporate information is easily verifiable. The nature of business would come from the referral source, for instance. We don't make a site visit for each client but for large audit clients, we go to their office before we quote a fee,' he adds.

Each firm has its own list of industries or types of clients that it will either reject outright or, at the most, accept warily. 'We don't touch listed companies [because of our size] and we turn away some mainland [Chinese] companies. We concentrate on non-listed private companies in Hong Kong or in Hong Kong but with operations on the Mainland,' says Mr Chan.

High risk industry sectors

PwC's Mr Winkelmann lists clients involved in the gaming industry and gold and jewellery companies as high risk. 'With gambling, it depends on if the owners are acceptable. Internet gambling is something we would not touch except in very limited circumstances because most Internet gambling, if it's cross-border, is illegal. With gold and jewellery companies, it's often hard to value their inventory,' he notes.

Ernst & Young's quality and risk management partner Andrew Wu singled out the gaming industry as problematic as well as Internet companies and domestically owned Mainland Chinese companies. 'With domestic Chinese companies, it's difficult to check on the background of the companies,' he says.

Deloitte's Mr George says, 'We would be sensitive to any business activity that our professional association with would expose our reputation to harm.' Initial public offerings, given their reporting responsibilities, are another category that entails risk.

For a big firm, the internal system of risk control would need to be more well-defined and systematic

After weighing the pros and cons of each client, firms then calculate their fees based on a risk-reward ratio. 'There are some clients for which no fee can compensate for the risk that we are bearing. So when we set our fees, we are mindful of the fact that we are bearing a level of risk in some cases. Inevitably that is part of the matrix we look at,' Mr George says.

Ernst & Young has taken the risk management step of actively culling clients from its portfolio, resigning from engagements with more than 60 listed companies since the beginning of 2003. 'We're much more cautious. For some clients where we think the risk is more than normal, we ask for an increase in fees or we just resign,' says Mr Wu.

Increased fees

Fees in general at accounting firms are creeping up after having been frozen for several years during Hong Kong's economic downturn. In today's risk averse climate, it's not uncommon for a firm to decide to part company with a client who balks at the current rates or asks for a fee reduction. 'We are increasing our fees by 10 per cent across the board this year which reflects the standard we need to maintain our quality,' declares PwC's Mr Winkelmann. 'We will not compromise the quality of the work that we do. If a client comes along and doesn't pay us sufficient fees to do the work we need to do from a quality point of view, we will finish our work, but unless we can change that equation, [we will end the relationship].'

Needless to say, the overall tightening of client acceptance has led to increased client rejection rates at firms. Medium-sized firms are finding themselves wrestling with the question of what to do when clients rejected by the Big Four come knocking at their own door. Decisions do not come easily. 'As professional accountants, risk is something associated with every job. The higher the risk, the more resources we have to expend to manage and reduce the risk, and that's where the risk/reward factor comes into play,' says Moores Rowland Mazars' Mr Fong. He says his firm has seen an increase in potential client enquiries over the past 18 months, some coming from larger firms. 'But if the risk is too high and if the Big Four reject a client, we would probably do the same,' he asserts.

Compliance

Compliance issues represent another major area of risk management that firms must address. Compliance covers a wide range of categories, from regulatory compliance to ethical compliance to compliance with accounting standards and internal risk management procedures.


Andrew Wu

Firms such as PwC, Ernst & Young and Deloitte have either already created compliance posts at their firms or are in the process of doing so. In some cases, independence and conflict of interest issues can overlap with regulatory requirements. 'It's getting so complicated, particularly regarding multi-national companies, and the things that we can and cannot do in China and Hong Kong. For our SEC [Securities and Exchange Commission] clients, we need to know whether a company is our audit client or not. ABC company, for example, may have a completely different name in Hong Kong and if we provide services to them and it turns out that it's a subsidiary of an SEC client, then we're in trouble,' observes Ernst & Young's Mr Wu. (Sarbanes-Oxley requires foreign accounting firms to register with the PCAOB if they perform audits on US companies which are under the jurisdiction of the SEC. The US law prohibits firms which are auditing a client from providing a host of other services which could compromise their independence.)

For small to medium-sized practitioners such as Moores Rowland Mazars, the burden of compliance is especially heavy. 'There is so much more work,' says Mr Fong. 'There are so many new accounting standards and disclosure requirements. Every regulatory authority is coming up with additional requirements.' He hopes that some relief for firms like his may come in the form of Small GAAP, which is due out next year and would simplify many accounting requirements. 'Small GAAP would help smaller practitioners who may not necessarily have the internal critical mass to deal with international accounting standards,' he adds.

One of the most important ways of managing risk is the quality of the work that we do

Mr Fong feels that the growing complexity of an accountant's job is itself becoming a risk factor. He believes that more investment in human resources is needed. 'One of the most important ways of managing risk is the quality of the work that we do. We have to have proper staff, they have to be properly trained and instructed. The work has to be properly reviewed. They have to have in-house training. That's the part that we need to spend more on,' he argues.

PwC's Mr Winkelmann agrees. 'We need to move ahead with the times. There was nothing wrong with the training we had in the past. It was good and it was adequate. We just need different training. Training now needs to be directed at compliance, making sure we comply with the policies of the firm, complying with auditing standards as they evolve, making sure we help clients comply with accounting standards and complying with the expectations of regulators,' he says.

At the same time, he sees the firm's risk management and quality assurance procedures producing concrete, positive effects of their own. 'By re-examining our audit methodology and applying a quality aspect to it, I think our partners are much more comfortable about signing their opinions. We're also giving better guidance to our clients on improvements they need to make as they grow and I think we're communicating better with our clients.'

In the end, the essence of risk management boils down to quality control. 'We see a profession that is trying to identify all the threats that are out there and trying to respond,' says Deloitte's Mr George. 'The consequence of the new reality is that we can never be relaxed again because many of those risks are pervasive. The new reality is one of constant vigilance.'