

RISKS AND CHALLENGES FACING AUDIT FIRMS

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THE PROFESSION



- The profession continues to be at a pivotal point of its **evolution**. Professionals and firms are faced with responding to new and increasing **client demands** at the same time that they try to figure out who they are, how to be more relevant and what to become. All of this is the face of ever increasing and **complex regulation**.

THE PROFESSION



- Tax and accounting professionals are overwhelmingly influenced by an unprecedented increase in regulation, a workforce shift the implications of which are not fully understood and technology, and fee pressures that are forcing them to find new and more efficient ways of working. To be successful, professionals will need to anticipate future client needs and leverage technology to add value for their clients.

IFAC SURVEY 2016



In June 2016 the International Federation of Accountants (IFAC) issued its IFAC Global SMP Survey 2015 conducted in countries with professional institutes that are members of the Federation of European Accountants (FEE). The report provided an insight into the **key trends and developments** facing small- and medium-sized practitioners (SMPs) and their small business clients.

SUMMARY



The survey identified that the **four most pressing challenges to SMPs were:**

1. keeping up with new regulations and standards (55%),
2. attracting new clients (48%),
3. differentiating from competition (43%),
4. and keeping up with new technology (41%). Other challenges were also mentioned such as experiencing **pressure to lower fees**, **managing cash flow and late payments**, and retaining existing clients.

CHALLENGES



SMPs are required to **be equally proficient in all relevant standards.** New and revised standards, including conforming amendments to other ISAs, **need to be understood and applied.** This can be particularly challenging for sole practitioners and SMPs. However, knowledge of all the standards is essential in order to apply professional judgement and determine which of the standards is applicable.

INSIGHTS



The good news is that ISAs are principle-based and do not include specific audit procedures. **They allow professional judgement** to be applied and **proportionate application** in the case of smaller audits. Some ISAs include sections with **specific reference to smaller entities entitled** 'Considerations specific to Smaller Entities'.

CHALLENGE



Although small companies are less complicated in terms of transactions, IT environment, and ownership, they still have their complexities. Very often they have few financial controls, more related party transactions, possibly complex taxation requirements and their closing entries are not accurate or complete. **Therefore, the auditor needs to have a good knowledge of the business**, financial reporting standards, other laws and regulations as well as auditing standards, if the audit is to be performed in an efficient manner.

INSIGHTS



Efficiency is key to address this risk. Auditors should have an in-depth knowledge of the ISAs to ensure that the right amount of work is performed and allocating fewer experienced professionals on the job will ensure that better professional judgment is applied on the particular job.

Specialisation by industry/sector helps the practitioner develop tailored approaches, which can be applied to a number of engagements. **Finally, the use of technology** in the audit process increases efficiency, facilitates procedures and access to documentation and evidence.

CHALLENGE



Audit fees are continuously facing a downward pressure, largely stemming from the **fact that the final product – the auditor's report – is highly standardised.**

On the other hand, ongoing compliance with the requisite standards, continuing education requirements and the fact that very often the audit process is labour intensive puts further pressure on the profitability/viability faced by SMPs.

INSIGHT



A quality audit is always expected regardless of the fees. Auditors should therefore do their utmost to exploit their expertise. Audits should be performed as efficiently as possible, reducing the amount of 'unbilled' work. This could be further supplemented by giving more value added such as a detailed management letter, which provides insights into weaknesses in the internal control with related recommendations for improvement.

CHALLENGE



The new COMPANY ACT Directive raised the audit exemption thresholds.

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Audit practices are encouraged to expand the services and offer other assurance or non-assurance services, such as agreed-upon procedures and compilations.

ISRE

IFRS 4410

SUMMARY



- RISK POSED BY CUSTOMERS
- RISK POSED BY STAFF
- RISK POSED BY NOT UPDATING WITH THE NEW REGULATIONS
- RISK POSED BY BUSINESS AND ITS LOCATION
- RISK POSED TO GOODWILL AND REPUTATION
- RISK POSED BY INFORMATION TECHNOLOGY
- RISK POSED BY FINANCIAL TRANSACTIONS
- RISK POSED BY UNEXPECTED EXIT OF PARTNERS
- RISK POSED BY THE MARKET OR ECONOMY

Risks posed by CLIENTS



- **Question:** Is the audit practice highly-dependent on a small number of major clients ? For example, you could have one client who generates 65 per cent or more of total revenue, or you could have a group five client who collectively generate over 65 per cent of total revenue. Do you have customers that take up a lot of your time but are less profitable than other customers?

Risks posed by clients, con'td



Risk

: If the audit firm relies on a small number of major clients , profit and cash flow may be affected in the short term (one to six months) if one of them stops yielding revenue.

Mitigating Strategies



1. Locking in major clients through long term service contracts, regularly visiting them, continuously asking them their views about the services you are offering to them,
2. spreading the risk by developing smaller, existing clients so they become larger customers,
3. seeking new, profitable clients

Mitigating Strategies - Contd



4. finding lower-cost ways of servicing the less profitable clients

Risks posed by Suppliers



- Question: Is the business highly dependent on a small number of major suppliers? For example, do you have one supplier that provides 30 per cent or more of the total product requirements, or is there a supplier whose failure to supply could stop the business?

Risk:

If the business depends on a small number of major suppliers, production, profits and cash flow could be affected one of them fails or stops dealing with the business

Mitigating Strategies



- locking in major suppliers through long-term service contracts
- seeking alternative suppliers capable of supplying similar items

QUOTE FROM RSM ON STAFF



Attracting and retaining high-performing talent who bring insights and understanding to help clients and users of financial statements make confident decisions continues to be a challenge in the accounting industry. **At RSM US LLP**, we're tackling this challenge on several fronts.

First, we are working collaboratively with other firms through the Center for Audit Quality to **raise awareness of our profession** and to help **build interest in accounting among youth**. The premise behind the combined effort is that we will all win by getting **more people to choose accounting as their profession**.

Cont'd - RSM



Second, RSM has enhanced our outreach on campus and among diverse professional organizations like, We're also building a unique scholarship program through our RSM US Foundation that will roll out this year.

Finally, we continue our focus on making RSM a great place to work. This year we are focusing on enhancing our talent development culture through new performance management, feedback and coaching processes, additional training on advisory skills and a new bonus program. We continue to give back to our communities through Birdies Fore Love, RSM Volunteer Day and our RSM US Foundation.

Cont'd - RSM



This year, we also launched a unique program for our 90th anniversary that gave nine employees \$10,000 and nine additional days of paid time-off to pursue a personal passion. It was so popular that we are looking to run the program again this year.

Cont'd - RSM



“Attracting, developing and retaining the people we need to serve our clients today and in the future is critical to the ongoing success of our firm and the profession as a whole”.

**Joe Adams, Managing partner and CEO, RSM
US**

STAFF COST



MONTHLY EXPENDITURE PER STAFF

<u>STAFF SALARY</u>	<u>25,000 GROSS</u>
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<u>OFFICE RENT</u>	<u>10,000</u>
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<u>OFFICE FURNITURE</u>	<u>1,000</u>
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<u>COMPUTER LAPTOP</u>	<u>1,200</u>
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<u>ANNUAL LEAVE</u>	<u>2,100</u>
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<u>OTHERS /ELECTRICITY./ TEA</u>	<u>1,000</u>
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TOTAL COST PER STAFF	40,300
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Question:

- Do employees see the business as a **short-term** employment option? For example, would they describe it as ‘a good place to learn for a while’ or ‘a nursery for the industry’?

Risk:

If the business is seen as a **short-term** employer, **high staff turnover** could result in **disruption to the business** and the expense of finding and training new staff who won't deliver a return to the business if they also leave after a short time

Question:

Are there employees in the business who are critical to its success?

Risk:

- If an employee is critical to the business's success, then sales and profits may suffer if the employee, RESIGNS, sets up a business in competition or goes to work for a competitor

Question:

- Do some employees largely govern or control dealings with key suppliers or clients? For example, some employees may control who your business give services too, or pricing

Risk:

- If some employees are largely autonomous when dealing with key suppliers or clients, there is a risk of fraud or collusion, or there could be significant disruption to the business if they leave.

Question:

Do staff face occupational health and safety (OH&S) risks? For example, are they working in a dirty or hazardous environment, or do they have to travel extensively?

Risk:

If staff work in an unsafe environment, the business is at risk through, the absenteeism, injury or even the death of an employee.

Mitigating Strategies



- implementing selections procedures that increase the probability of finding the right staff for the business
- putting in place confidentiality agreements and / or reasonable restraint of trade agreements signed by key staff or where appropriate all staff

Mitigating strategies - Contd



- implementing a **robust performance development** system for communication of performance expectations and goals, monitoring performance and setting remuneration. KPI,
- providing **ongoing training** for staff consistent with the needs of the business

Mitigating Strategies Cont



- allocating several people to fulfil key tasks and provide backup in the event of illness or sudden departure
- rotating employees through various functions or departments to familiarise them with other areas of the business

Mitigating Strategies - cont



- implementing suitable Occupational, Health and safety policies to minimise risks. For example, provide company vehicle for pick up and dropping if staff, insurance cover for staff
- BONUS - using equity interests, profit-sharing or other incentives to help retain key personnel and let them share the success they create for the business. But be careful how such incentives schemes are designed, as they could encourage unintended behaviour

Mitigating Strategies - Cont



- reviewing the **period of notice required of staff who resign**(Increase notice period for older staff. Once again, be careful with this as it could have unintended legal consequences.

RISKS POSED BY THE BUSINESS PREMISE AND ITS LOCATION



Question:

How dependent is the business on its current location?

RISK



Risk:

If the business depends significantly on its location to generate sales, a move to premises outside the immediate vicinity of the current location may disrupt the business by affecting clients, staff and supplier access.

RISK



- Another risk of being highly dependent on the premises is that in the event of a fire, flood or other disaster, the business may not be able to restart trading if the premises (including stock, equipment, materials and records) are destroyed.
- Another risk is the possibility that clients may move away from the location.

RISK



- **Question:**
- Is the **business growing** strongly at present, or is it relatively stable? If it is growing strongly, how long can this be expected to continue for and how big will the premises need to be in two, five or 10 years' time?

RISK



- **Risk:**
- Unless plans have been made to expand the current premises, the business may not be able to grow to its full potential and it could be overtaken by competitors

MITIGATION STRATEGIES



- identifying a **number of suitable alternative** premises which would suit clients, suppliers and staff
- where the premises suit the business's long-term needs, consider **securing a long-term lease** or right of first option when the lease expires

MITIGATION STRATEGIES



- managing the business to predict future space requirements early
- only businesses that are established, have good prospects and are growing should consider purchasing a property and then only if the property has sufficient capacity to allow for future expansion, otherwise it is preferable to rent. Renting also helps to preserve working capital for business operations

THREATS TO GOODWILL AND GOOWILL



- **Question:**
 - How exposed is the business to a threat to its reputation or goodwill? For example, what would happen if there were a **product recall**, or if the business **delivered bad client service** or advice or there was a major fraud?
 - Bad name with KRA,

RISKS



Risk:

- If there is a large-scale product recall, a fraud, or other similar event, there **would be a lot of bad publicity**. This could cause immediate distress to the business including putting it to the trouble and expense of reworking. It would probably also **cause longer-term damage** to the business's reputation.

MITIGATING STRATEGIES



- incorporating **robust review processes** and quality assurance systems to avoid a situation that may damage the business's reputation
- **investing in research and development**
- keeping up-to-date with **technological advances**
- **compulsory training and development** programs for staff

RISKS POSED BY INFORMAT TECHNOLOGY



- There are a number of issues facing the accounting profession, but the two main ones in my opinion is **adapting to constant technological changes**, and the talent pool.
- It is difficult to keep up with the pace of innovation today. More firms are moving towards cloud computing, which raises more cybersecurity issues than we have had to account for before. Also, staying up-to-date with the changes in technology and innovation in the audit field will be challenging, especially for smaller firms where upgrading can be cost prohibitive.

Antonio Argiz, Chairman and CEO, MBAF

RISKS POSED BY INFORMAT TECHNOLOGY



Question:

- To what extent does the business rely on information technology (IT)? Have you ever noticed how little work is done in an office when **'the server is down'** or power is **temporarily disconnected**? The level of risk created by using IT increases as the business becomes more reliant on it.

RISKS POSED BY INFORMATION TECHNOLOGY



Risk:

- If the business is heavily reliant on IT, the business might not be able to operate without it,
- IT service delivery: do all the software applications (including spreadsheets) work as intended? Are they all accurate?

RISKS POSED BY INFORMATION TECHNOLOGY



- IT solution delivery: do you try to **integrate IT** solutions into daily work processes, so that the business runs more efficiently and predictably?
- IT benefit realisation: consider not only the cost of an application, **but also consider the cost of not implementing** that application. Some IT outlays are essential simply to keep pace with others in the industry

MITIGATING STRATEGIES



- protecting laptops and desktops
- keeping data safe by performing backups and storing those backups offsite
- using the internet safely

MITIGATING STRATEGIES



- protecting networks
- protecting servers
- securing the line of business applications
- ensuring appropriate IT support is available within an acceptable timeframe

MITIGATING STRATEGIES



- having an uninterrupted power supply unit
- conducting appropriate IT training for staff

RISK POSED BY FINANCIAL TRANSACTIONS



- Financial transactions create risks for companies.
- I ONLY PICKED LIQUIDITY RISKS, BECAUSE MOST COMPANIES HAVE YEAR END DECEMBER AND HENCE JUNE DEADLINE

Liquidity risk

Question:

Does the business have enough funds to pay its debts as they fall due?

Risk:

- If the business does not have enough funds, or is running out of money, there could be significant risks to the business and to the owner who might become personally responsible for the debts of the business. If liquidity is not improved, the chances getting a loan will be drastically reduced.

MITIGATING FACTORS



- managing cash flow on a daily, weekly and monthly basis by monitoring the flow of cash in and out of the business
- forecasting cash flow to identify any periods when it is not strong. Good forecasting will include ‘what if’ analysis; for example, ‘What if my income were to drop by 5 per cent?’
- What happens during the **traditional low season**

MITIGATING FACTORS



- seeking a committed line of credit from a financial institution. It is preferable to have two possible providers in case one does not provide credit when needed
- maintaining a strong relationship with a banker or financial institution to ensure they understand the business and are kept up-to-date with potential loan requirements

MITIGATING FACTORS



- monitoring market conditions to anticipate seasonal fluctuations in cash flows
- preparing aged debtor reports to monitor debtor collections (and regularly contacting the slow payers)

UNEXPECTED EXIT OF OWNER OR PARTNERS



- Baby Boomer retirements and the resulting succession crisis in many firms. It is fueling much of the merger mania right now. My practice has evolved to helping medium-sized firms develop their internal succession plans or, if that is not possible or it is too late, assist them with merging their practice into a larger firm.
- *Gary Adamson, President, Adamson Advisory*

UNEXPECTED EXIT OF OWNER OR PARTNERS



Question:

What would happen to the business if the owner or one of the partners died or became incapacitated? If there is no will or succession plan in place, would the business close, would it be inherited and run by someone inexperienced, or would it be sold?

UNEXPECTED EXIT OF OWNER OR PARTNERS



Risk:

- If there is no plan to deal with the death or incapacity of the business's owner or one of the partners in a partnership, the business might have to close or be sold to a competitor to avoid putting undue pressure on the remaining owners or new owners.

MITIGATING STRATEGIES



- consulting advisers who can assist in business succession, wills and estate planning
- preparing a business succession plan and a will that is consistent with the plan
- implementing appropriate insurance that provides income or a capital sum in the event of the death or incapacity of the owner or a key employee

MITIGATING STRATEGIES



- where there are two or more unrelated owners in a business, consider a buy/sell agreement and funding agreement for the eventual transfer of the business
- documenting key processes and critical information so that other people can continue to run the business

MITIGATING STRATEGIES



- training employees so that more than one person knows how to perform each task

RISKS POSED BY THE MARKET OR ECONOMY



Question:

- Is the business exposed to risks from changing tastes and trends or from the impacts of an economic downturn? For example, while the business itself may be relatively immune from an economic downturn, a downturn may impact on your customer base.
- Example after the Enron case

RISKS POSED BY THE MARKET OR ECONOMY



Risk:

- If the business is at risk from changing tastes and trends, or from an economic downturn, the viability of the business is at risk.

MITIGATING FACTORS



- researching clients trends, new requirements, new regulations so that the business can respond to change

MITIGATING FACTORS



- promoting products and services that sell **better during an economic downturn** (these can be determined by testing the market)- example internal audits, consultancy,
- using financial statements to benchmark financial and operational performance against industry averages

GENERAL MITIGATING FACTOR



- **CONSIDER THESE INSURANCE**

- Professional indemnity
- Building and contents insurance
- Business interruption or loss of profit insurance
- Public liability insurance
- Workers' compensation insurance
- Fidelity guarantee
- Machinery breakdown insurance

Questions?



Ask
Answer
Who
Why
Where
What
When
How
Apply
Question
Answers
Understand
Query
Questions