**Client Acceptance Issues**

You are invited by John Bray, the president of the Cheviot Corporation, to discuss with him the possibility of your conducting an audit of the company. The corporation is a small, closely held manufacturing organization that appears to be expanding. No previous audit has been performed by independent certified public accountants. Your discussions with Bray include an analysis of the recent monthly financial statements, inspection of the accounting records, and discussion of policies with the chief accountant. He then makes the following statement:

*Before making definite arrangements for an audit, I would like to know about how long it will take and about how much it will cost. I want quality work and expect to pay a fair price, but since this is our first experience with independent auditors, I would like a full explanation as to how the cost of the audit is determined. Will you please send me a memorandum covering these points?*

Write the memorandum requested by John Bray.

Tammy Potter, a new partner with the regional CPA firm of Tower & Tower, was recently appointed to the board of directors of a local civic organization. The chairman of the board the civic organization is Lewis Edmond, who is also the owner of the real estate development firm, Tierra Corporation.

Potter was quite excited when Edmond indicated that his corporation needed an audit and he wished to discuss the matter with her. During the discussion, Potter was told that Tierra Corporation needed the audit to obtain a substantial amount of additional financing to acquire another company. Presently, Tierra Corporation is successful, profitable, and committed to growth. The audit fee for the engagement should be substantial.

Since Tierra Corporation appeared to be a good client prospect, Potter tentatively indicated that Tower & Tower wanted to do the work. Potter then mentioned that Tower & Tower’s quality control policies require an investigation of new clients and approval by the managing partner, Lee Tower.

Potter obtained the authorization of Edmond to make the necessary inquiries for the new client investigation. Edmond was found to be a highly respected member of the community. Also, Tierra Corporation was highly regarded by its banker and its attorney, and the Dun & Bradstreet report on the corporation reflected nothing negative.

As the final part of the investigation process, Potter contacted Edmond’s former tax accountant, Bill Turner. Potter was surprised to discover that Turner did not share the others’ high opinion of Edmond. Turner related that on an IRS audit 10 years ago, Edmond was questioned about the details of a large capital loss reported on the sale of a tract of land to a trust. Edmond told the IRS agent that he had lost all the supporting documentation for the transaction, and that he had no way of finding out the names of the principals of the trust. A search by an IRS auditor revealed that the land was recorded in the name of Edmond’s married daughter and that Edmond himself was listed as a trustee. The IRS disallowed the loss and Edmond was assessed a civil fraud penalty. Potter was concerned about these findings, but eventually concluded that Edmond has probably matured to a point where he would not engage in such activities.

*Required*:

1. Present arguments supporting a decision to accept Tierra Corporation as an audit client.
2. Present arguments supporting a decision not to accept Tierra Corporation as an audit client.
3. Assuming that you are Lee Tower, set forth your decision regarding acceptance of the client, identifying those arguments from part a or part b that you found most persuasive.

**ANSWERS**

Mr. John Bray

President

Cheviot Corporation

Dear Mr. Bray:

Our recent tour of Cheviot's plant was a most pleasant and interesting experience. The information obtained on this tour and during the discussion of your financial statements and accounting records has enabled us to plan the scope of an audit especially suited to your needs.

Our fees are based on the time spent on the engagement by various members of our audit staff, and will be billed at our established rates. The total time required for an initial engagement is usually somewhat greater than in repeat examinations, since the latter do not require analysis of past years' transactions. Considerable savings in the cost of the audit may be made by utilizing the services of your accounting staff to help us in certain phases of the work. We can arrange for your employees to prepare for us a number of working papers. If you approve, we shall indicate to your chief accountant the exact nature of the working papers to be prepared.

Our audit will be performed in accordance with auditing standards generally accepted in the United States and will include all procedures which we consider necessary to provide a basis for expression of our opinion on the fairness of the financial statements. The audit will include:

* + 1. Obtain an understanding of the client and its environment, including internal control
    2. Assessment of risks of material misstatement and design further audit procedures.
    3. Tests of the financial statement accounts and balances to the extent we consider necessary, based on our consideration of risks and internal control.
    4. Preparation of the federal and state income tax returns.
    5. Issuance of our auditor's report upon your financial statements.

If our investigation indicates the desirability of any changes in internal control procedures, we shall prepare a report on this subject for your consideration. However, an audit cannot be relied upon to identify all weaknesses in internal control. The purpose of our audit is to enable us to express an opinion on the fairness of the financial statements; the audit is designed to provide reasonable, but not absolute, assurance of detecting material fraud and defalcations, and we will notify you if our audit does bring them to light.

Although it is not possible to determine in advance the exact number of days required for the engagement, our estimates indicate that the total fee will be between $12,500 and $15,000. The audit will be completed and our report submitted by March 1, 20\_\_ .

We would like an opportunity during the next few days to discuss with you and your chief accountant the nature of the preliminary work to be done by your staff. We shall also be pleased to answer any further questions which you may have concerning the determination of audit fees.

Very truly yours,

Carson, Robinson and Company, CPAs

There is little guidance in authoritative pronouncements to aid auditors in making a decision whether or not to accept a client. *Statement on Quality Control Standards, No. 1* states that:

Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity. Suggesting that there should be procedures for this purpose does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to anyone but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its professional relationships.

Thus, it is clear that a CPA firm should avoid situations that involve association with management that lacks integrity. However, professional judgment must be used to evaluate the facts bearing on the integrity of management.

Auditing standards indicate that the auditors should respond to fraud risks by changing the overall approach to the audit, altering audit procedures, or performing procedures to address the risk of management override.

(a) The following are arguments that support acceptance of the client:

* We are in the auditing business. Some engagements involve more risk than others, but we can take the additional risk by designing a more thorough audit plan, for which we will bill accordingly.
* You do not grow by turning down the tough engagements. Some firm will accept this client—why not us?
* Edmond probably has matured to a point where he would not engage in questionable activities.
* Even though Edmond lied to the IRS, he would probably not lie to his auditors.
* All other information about Edmond indicates that he is a man of integrity.

1. The following are arguments against acceptance of the client:

* The fact that the audit opinion will be used to obtain substantial additional financing makes this audit a high risk engagement.
* The incident with the IRS clearly indicates that Edmond lacks sufficient integrity. We should not be associated with his corporation.
* Management fraud is difficult to detect by customary audit procedures. If Edmond does elect to misstate the financial statements, it is possible that our audit procedures would fail to detect the irregularities.
* The only way to assure that the reputation of the firm is not questioned is to avoid such high risk audit engagements.

(c) Our opinion:

We feel that the decision to accept this client depends on the degree of risk the firm is willing to accept. Since all other information indicates that Edmond is an individual of integrity, the acceptance of the client is appropriate, if the auditors recognize the high risk of the engagement and increase the extent of their auditing procedures accordingly. At the first indication of inappropriate behavior on the part of Edmond, the firm should resign from the engagement.