# Prevention better

The HKSA's Professional Risk Management Committee (PRMC) is actively educating member firms about how to minimise the risk of professional negligence claims. Simultaneously it is lobbying government for a more equitable system of allocating liability

Once upon a time it was thought that it was virtually impossible to sue an accounting practice for negligence. Like all wishful thinking, this notion has since been challenged time and again, sometimes successfully. In the wake of the corporate scandals in the US and legislation that has emerged as a consequence, the responsibility placed on accountants has become increasingly onerous.

As a service to its members, the HKSA's PRMC is deeply involved in ongoing initiatives to make member firms more aware of the dangers of negligence claims, how to avoid them and how to fight them if they fail to avoid them.

Chairman of Deloitte Touche Tohmatsu in Hong Kong and chairman of the PRMC, Kenneth McKelvie, begins a discussion on the topic with a personal definition of professional liability in the accounting context. 'It's the risk to an accountant of a claim being made against it by a client, or others that have an interest in that client, as a result of negligence on the part of the accountant. I prefer a broader definition because, in cases such as these, financial loss is not the sole concern. Often what is more damaging is the reputational risk,' he warns.

## Media exposure

'Unfortunately, events over the last couple of years have given the media plenty of ammunition for having a go at the accountancy profession, and the big four firms in particular. They [reporters] are getting rather good at going direct to the accountants each time a corporate problem occurs,' he says. 'This is often unfair because it is usually the case that when a client company gets into trouble it is less than open about what has happened and why.' Then the first question will be 'where were the accountants when this happened?' with no thought for what the responsibility of the accountant might actually have been.

Mr McKelvie concedes, 'Sometimes there is no doubt that there is at least partial responsibility on behalf of the accountant. In most cases it is the company's management that has created the problem. Whether the accountants should have reported on it – indeed, whether they are required to report on it, is often moot.'

## Reporting requirements more onerous

There is a trend toward greater reporting requirements for accountants, and Mr McKelvie points out that there is some legislation creeping in to this effect, 'particularly within the regulated industries - banks, insurance companies and so on. This often places more responsibility on the accountant to monitor some of the day-to-day activities of a client company; something which the auditor is not normally responsible for during an ordinary audit relationship,' he explains.

Mr McKelvie is disturbed by the trend. 'Internal controls are very much the responsibility of management – establish the controls then maintain and operate them. As accountants we come in at the end of the year to see what's happened. By the time we are on the scene anything that has gone wrong is already history. But there are now new expectations of accountants. Even if they are not legislated, these expectations mean we [accountants] are much more involved in determining whether a company is properly run.'

## Sarbanes-Oxley reaches the places other legislation can't

The most striking example of litigation to come out of the Enron debacle has been the US' Sarbanes-Oxley Act. Mr McKelvie says: 'The Act places much more responsibility on management to set up and properly run governance structures such as audit committees, and take responsibility. A key feature of the legislation is that the CEO or managing director must now sign off on the financial statements to the effect that he believes they have been properly prepared.'

# than cure

'That places responsibility more clearly where it deserves to be, because they are in day-to-day contact with the activities of the company.' But the legislation also demands more from the accountant. More disturbing still is the supranational nature of the Act. Many of the listed companies in Hong Kong have some form of listing or debt instrument traded in the US.

The big four and many other firms count such Hong Kong companies and Hong Kong subsidiaries of US SEC registrants as clients. Therefore these accounting firms must register with the SEC. 'The firms should now be preparing to register with the SEC. The rules have arrived in a slightly watered down version of the original, after complaints from Britain, Japan and the European Union but we have still not discovered how the Public Company Accounting Oversight Board (PCAOB) will exercise its powers of oversight. It talks about the right to visit wherever the firms operate, and review papers and procedures.'

Although the requirement to register with the SEC has been postponed for about a year Mr McKelvie warns that when they do come into effect, the firms may have to make their working papers available to the SEC. 'Because of the more litigious environment in the US, we will be exposed to greater risk than we might have expected when operating solely here in Hong Kong.' Mr McKelvie adds: 'The risk of attack by shareholders in, or lenders to, our clients is increasing. Member firms should be responding to the threat by being more focused on the riskier areas of a company's financial statements during an audit, or indeed when doing any other type of work.'

## Alternatives under the law

Meanwhile, at the local level, the PRMC has spent a lot of the last two years examining the legal issues under the laws in Hong Kong. One tangible result of this work is a paper, which is currently with Government, that proposes changes to the liability regime governing professional services. The paper puts forward the case for replacing the current joint and several liability approach with a more equitable system such as proportionate liability. Essentially, it calls for recognition that responsibility for a plaintiff's loss should be fairly apportioned between those responsible for causing that loss. 'In other words if the management of a company was found to be 90 per cent responsible for the negligence and the accountant was 10 per cent responsible, the damages would be apportioned accordingly.'

The HKSA's submission to Government was passed on to the Standing Committee on Company Law Reform (SCCLR) which has studied it and considered it in the light of similar proposals being looked at in other jurisdictions. The SCCLR has summarised the various views on reform of accountants' liability in its Consultation Paper that was issued in June this year. That Consultation Paper suggests looking at the issue in a wider context, calling for more comments and views from the public, before making any proposals. The consultation period will end on 30 September 2003 and Mr McKelvie calls on members of all professions to look at the relevant section and provide their views.

'At this stage it is difficult to assess what the ultimate recommendation will be and how the Government will

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respond, but what I will say is that, if Hong Kong wants a capital market that is internationally recognised as strong, we must have good regulatory and governance processes. Part of those processes is a reliable independent review of what companies are reporting in their financial statements.'

Under the current liability regime and with the demise of Enron and Anderson still vivid in the minds of most professional accountants, Mr McKelvie notes that accounting firms are looking very hard at the type of clients they are prepared to work for. While this shows a healthy awareness of risk factors, taken too far, perfectly respectable companies that happen to work in industries with a naturally high risk profile may find it difficult to come to market. 'After all, all business is risky but some businesses are riskier than others. In the past we [accountants] felt that we could manage the risk of reporting on such businesses. Now we begin to wonder.'

Mr McKelvie believes there is a real possibility that companies in such industries may therefore be audited by accounting firms that may not have access to the same depth and range of experience and expertise that the larger firms have. 'Is this a desirable situation for a world class capital market? This is the question we should be asking ourselves?' he says.

Mr McKelvie concedes that the proposal to Government for proportionate liability is a request for a form of protection through the law. 'However, I'm convinced this will not adversely affect the quality of work that professional accountants do. What it should do is encourage companies and audit firms to work more closely together even where the company might be viewed as more risky than others,' he says. 'There is nothing wrong with risky business coming to the market, as long as the investing public is made fully aware of the nature and extent of the risk through independent reports on that business.'

## Effective risk management

Every self-respecting audit firm must be constantly vigilant to avoid the risk of a claim for negligence, but in fact very few claims ever reach the courts. Claims in Hong Kong are rare compared to Europe, the US or Australia, but the costs of getting a frivolous or vexatious claim simply struck out can be enormous. Therefore, another initiative conducted by the PRMC is to help practices understand and minimise the risk.

'In attempting to reduce the risk of a claim for negligence the obvious starting point is quality work. If you get it right every time, even if you are challenged, the chances are you can defeat the challenge. But we are all human and humans make mistakes from time to time. In that case one has to resort to actively managing the risk exposure,' says Mr McKelvie. 'Through a series of seminars and written articles which we have offered to member firms we have attempted to help members understand the processes which should be adhered to when vetting potential clients.'

Key questions should include but not be limited to:

- Who are the owners behind the company?
- Who else might you be exposed to?
- Is the company financially sound?
- Are there additional risks arising from the geographical locations of its business?
- What other risk factors might exist (financial, regulatory, business environment etc)?

Members should also ensure that proper engagement terms are understood and agreed up front. 'Beyond the establishment of an engagement, the agreement must be closely managed,' he says. 'It is sometimes the case that, subsequent to arranging an engagement agreement, the client company might say –almost casually – "Oh, while you are here perhaps you could look at this, add this, report on this," and so on and so forth. Suddenly you are performing a whole lot of work you were not originally engaged to do. Apart from the fact that you might not get paid for this additional work, there is a real risk that you may innocently be exposing your firm to more risk than it is prepared to bear.'

## Last resort

Even after making efforts to manage the risk, things can still go wrong. The last resort is the firm's professional indemnity insurance policy. It is perhaps ironic that just at the time more professional firms in Asia are waking up to the need for professional indemnity cover, the cost of cover is more expensive than it has ever been and there is far less insurance cover available in any market. Insurers have had to settle huge claims lodged against the larger firms in recent years and are no longer willing to provide lower limits of cover that they were prepared to do in the past. This has meant that international firms are self insured at lower limits of cover with only higher levels, which effectively amount to catastrophe cover, sourced through the few remaining insurers underwriting this business, primarily in the London market.

Firms other than the big four in Hong Kong can avail themselves of the HKSA Professional Indemnity Insurance Master Policy, which provides a broad range of cover at a very competitive price.

## Food for thought

To finish this account of the Society's efforts with regard to professional liability, Mr McKelvie puts forward a thought provoking reason for why the audit of Hong Kong public companies may actually be less risky than in many other parts of the world.

'Some 90 per cent of Hong Kong's public companies are the traditional family-owned entity, where only a small proportion of the shares are in the hands of the public. This structure has come under attack from corporate governance activists for a number of valid reasons. However, I believe that at least one level it has an advantage,' he claims.

'If a family owns 75 per cent of a company, how will it run that company? Will it manage the company with only the next half-year results in mind, or for the long-term benefit of the family shareholders? The answer is obvious and that means the minority shareholders will benefit also. I would say that by avoiding the sort of short-termism promoted in other jurisdictions, we have managements that are far more focused on the long-term development of their businesses, which, in itself, is an effective deterrent to the deliberate distortion of financial statements,' Mr McKelvie concludes.