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Financial statement error: client's business risk assessment and auditor's substantive test

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Abstract

This paper examines the impact of the assessment of business risk on the auditor's choice of audit procedure. Business risk ultimately translates into the risk of financial statement error. In order to test the hypothesis that auditors change audit procedures in response to business risk, researcher provided each subject with a statement of risk, and a statement of risk with an additional environmental issues that will enhance business risk. Respondents were provided with the audit procedures for each risk. The results would indicate whether auditor's assessment of relevant audit procedures is affected by business risk.

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1. Introduction

Business risk is generally defined as the risk that an entity's business objective will not be attained as a result of the external and internal factors, pressures and forces brought to bear on the entity and ultimately, the risk associated with the entity's survival and profitability. Business risk ultimately translates into the risk of financial statement error. Therefore, an approach which focuses on understanding a business, its environment and business processes provides the best means by which an auditor will recognize risks with management fraud and business failure, and thus reduce the room for any dysfunctional behavior by auditors. Prior research has considered the impact of account-specific audit risk on evidential audit planning. There are some evidences that auditors adjust evidential planning for inherent and control risks. This study embarks on the following objectives:

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1) To investigate the influence of business risk on the auditor's planned audit procedures; and
2) To examine the impact of the assessment of business risk on the auditor's choice of audit procedures.

2. Literature Review

In an effort to improve the effectiveness of the audit by better understanding of the client business risk, audit firm need to reengineer their audit methodologies to focus the auditor's attention on the business risks in the organization whose financial statements are being audited. The audit methodology has been associated with changes in the scope of the audit planning and risk assessment process and in the related evidence gathering procedures. Thus, the proposed study is aimed to examine the influence of business risk on the auditor's identification of significant financial statement assertions and planned audit procedures. This is to be done by having further examination on the influence of business risk on the auditor's assessment of the likelihood of a material error in the financial statements.

In a survey made by KPMG in 2009 on financial statement fraud, the result shows that only 8% (out of 31% fraudulent financial statement cases) were detected by external auditors. As auditors plays an important role to provide reliable opinion especially in the cases of fraudulent financial statement, a strong and effective audit framework needs to be established. To do this, a detailed preparation by the auditor that encompasses comprehensive audit procedures and thorough risk assessment is essential in order to enable them to detect fraud. This task however could be very time consuming as upon any abnormalities found, additional audit testing is required in order to collect audit evidence. This translates to additional extensive audit procedure that would attract more cost to the auditor and subsequently, a higher audit fee.

The shift from a financial statement risk approach to a business risk approach is predicated on auditors changing audit procedures with respect to identified business risks. However, given the prior evidence regarding a weak linkage between account-specific risk factors and audit program plans (Mock and Wright, 1993 and 1999), the maintained hypothesis that auditors change plans in response to business risk needs to be empirically validated. While prior research has focused on risks associated with receivables, payables and similar accounts, this study focuses on the risks associated with the achievement of business objectives that are generally classified as business risk.

Prior literature suggests that the holistic perspective that auditors acquired in making business risk assessments influences their judgments by altering the auditor's tolerance for changes in accounts that are inconsistent with information about client operations. This suggests that auditors utilizing a business risk audit methodology may lead auditor to view business risk as an indication of possible misstatement in the financial statements. Reference corroborated and extended the archival study by considering additional audit risk factors and expanding the study to include a sample of engagements and to include audits in a more recent time period. The results of both studies indicate lack of strong relationship between account-specific client risks and audit program.

This study examines the impact of the assessment of business risk on the auditor's choice of audit procedure. Business risk is generally defined as the risk that an entity's business objective will not be attained as a result of the external and internal factors, pressures, and forces brought to bear on the entity and ultimately, the risk associated with the entity's survival and profitability (Bell, Marrs, Solomon and Thomas, 1997). Business risks arise from conditions and forces within the organization's internal environment, industry forces and macro-environmental forces. An understanding of business risk widens the focus of the auditor, from audit risk, defined with reference to financial statement error, to business risk, defined as the risk that an entity will fail to meet its objectives (Higson, 1997). Business risk ultimately translates into the risk of financial statement error. Therefore, an approach which focuses on understanding a business, its environment and business processes provides the best means by which an auditor will recognize risks associated with management fraud and business failure (Erickson, Mayhew and Felix, 2000).

The shift from a financial statement risk approach to a business risk approach is predicted on auditors changing audit procedures with respect to identified business risks. However, given the prior evidence regarding a weak linkage between account-specific risk factors and audit program plans, the maintained hypothesis that auditors change plans in response to business risks needs to be empirically validated. While prior research has focused on risks associated with receivables, payables and similar accounts, this study focuses on the risks associated with achievements of business objectives that are generally classified as business risk. Therefore, the hypothesis of this study is listed as:

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