

# BUSINESS RISK AND THE AUDIT PROCESS

## Should the risk of litigation, sanctions or an impaired reputation affect the conduct of an audit?

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Business risk is the probability that an auditor will suffer a loss or injury to his professional practice. It differs from audit risk, which is the probability that an auditor will issue an unqualified opinion on materially misstated financial statements. For example, an auditor may be sued (business risk) whether or not the audit and the financial statements comply with professional standards (audit risk).

Audit risk can influence business risk because an inappropriate opinion can be a significant factor in the events that lead to loss or injury to an auditor's professional practice. Conversely, business risk may, within limits, influence the auditor's assessment of the acceptable level of audit risk.

The concept of audit risk is directly related to the third standard of fieldwork, which requires the auditor to gather evidential matter

sufficient to support the opinion. It follows from the concept of sufficiency that a minimum level of audit work, or evidence gathering, is required on every audit conducted in accordance with generally accepted auditing standards. Although this is obvious, it must be accepted that the concept of a required minimum level of audit work is basically undefined and the concept of audit risk unmeasurable with current techniques. The auditor uses his judgment (recognizing certain specific requirements established by standard-setting bodies) to strike a balance between the amount of audit work necessary to satisfy the public, which would tend to opt for complete and accurate information (because it doesn't perceive that it directly bears the cost), and that which would satisfy client pressures for cost-effectiveness.

However, an auditor, knowing that additional work (i.e., more evidence gathering) will reduce the likelihood of an incorrect opinion, may choose to do more work than the required minimum to lessen the possibility of damage to his professional practice. In other words, an auditor may start with the maximum level of audit risk permitted under GAAS and, if he chooses, subjectively reduce that risk to a level at which he believes he has appropriately addressed the business risk inherent in the particular engagement. The realities of our current environment are such that, for this and other reasons, auditors often do more audit work than judgment would indicate necessary to satisfy GAAS. The relationship of business risk to determining the maximum level of audit risk acceptable to the auditor is the basic subject explored in this article.

### The Principal Elements of Business Risk

The discussion in this article applies to the following elements of business risk:

- ☐ Litigation.
- ☐ Sanctions imposed by public or private regulatory bodies (e.g., the Securities and Exchange Commission, the American Institute of CPAs and other professional societies).
- ☐ Impaired professional reputation, which can occur as a result of litigation, sanctions or adverse publicity.

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Each of these elements may cause injury or loss to a professional auditing practice in a variety of ways. Litigation, which can be initiated either by clients or third parties, can involve a number of injurious costs: attorneys' fees, out-of-pocket expenses, court awards of damages or expensive settlements and foregone revenues resulting from lost chargeable hours. Sanctions can curtail the practice (e.g., a prohibition from accepting any new SEC clients for a stated period) or increase costs (e.g., a requirement for additional peer reviews). An impaired reputation can damage practice development efforts, result in lost clients and injure recruiting efforts and the morale of firm personnel.

### Relationship between Business Risk and Audit Risk

Each audit should supply at least the level of audit assurance required by GAAS, and each auditor's opinion<sup>1</sup> should imply at least this level of assurance. The minimum level directly relates to the auditor's assessment of the acceptable level of audit risk, and the intensity of the audit procedures performed is a direct function of this assessment. The auditor's opinion is a "standardized" statement and must convey, each time it is issued, the message that at least the implied level of assurance is supplied.<sup>2</sup>

If there was no such minimum, a reader of the opinion would find it extremely difficult to judge the reliability of the financial statements. Therefore, even though the minimum level of assurance currently is unquantifiable, the requirement to provide it serves the interests of the users of audit reports. The policy of using subjective assessments of the level of business risk to reduce the level of audit risk implicit in GAAS is also consistent with the interests of the users of audit reports because of the increased assurance provided. Conversely, however, subjective assessments of the level of business risk can't be used to increase the auditor's assessment of acceptable audit risk to a level in excess of the maximum permitted by GAAS.

If GAAS didn't establish a conceptual maximum audit risk, there would be the possi-



bility of little or no assurance implicit in the auditor's opinion. An auditor who perceived little or no business risk might choose to sign an opinion after having done little or no audit work. This obviously wouldn't be in the interests of report users, who should always be able to assume at least a minimum level of assurance.

Conceivably, with a maximum risk requirement under GAAS, a firm might introduce an orderly approach to business risk by recognizing, on a uniform basis, different levels of business risk for different classes of companies (e.g., smaller companies, highly regulated companies and public companies) and by assessing the acceptable level of audit risk (and, therefore, the intensity of the audit procedures to be performed) for those companies based on their relative risk classifications. As previously stated, it wouldn't be proper to use such an approach to increase audit risk above the conceptual maximum because the auditor's opinion wouldn't consistently convey at least a minimum level of assurance, nor could the implied level of assurance be evaluated by a reader.<sup>3</sup> If, in situations in which the audit

<sup>1</sup>For purposes of this article the terms *opinion* and *report* refer to the standard, unqualified auditor's report.

<sup>2</sup>The evolution of auditors' reports is discussed in Chapter 2, "Evolution of Report Categories," of Auditing Research Monograph no. 1, *The Auditor's Reporting Obligation*, by D. R. Carmichael (New York: AICPA, 1972).

<sup>3</sup>The desirability of minimum levels of assurance is consistent with a conclusion in the Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (New York: CAR, 1978, p.xiii): "All users of audited financial statements should be able to assume that the same standards apply to all audits, regardless of the size of the entity audited or the number of its shareholders." In addition, the commission rejected the contention that different groups use the assurance provided by an independent audit in different ways.



risk had been increased above the maximum permitted by GAAS and users of the report were unaware that such a policy had been adopted, they would be misled by the assumption that all similar opinions carry at least a minimum level of assurance. On the other hand, if users knew that such a policy had been adopted but not how it was being applied, they would be forced to interpret the level of assurance implicit in the phrase *in our opinion* based on their individual interpretations of the business risks associated with the types of companies being reported on.

Business risk affects the auditor's business, not the public's interest in information useful for decision making. If GAAS requirements didn't include a maximum level of acceptable audit risk, the social utility of the audit process would be subject to a new challenge. Critics could charge that a firm provided a low level of assurance to certain investors simply because there was a low risk of the firm's being sued. The perennial complaint that companies shop around for "easy" auditors would be bolstered by the acknowledgment that auditors could reduce their audit efforts without limitation based solely on their assessment of business risk. Undesirable competition among firms might grow, based on whose "clean" opinion could be obtained for the least amount of audit work and, consequently, the least cost. No such problems arise when an auditor uses assessments of business risk to increase the intensity of audit procedures above the "GAAS minimum" because a higher level of assurance than that suggested by GAAS is provided to report users.

Classifying companies by typical levels of business risk may be extremely difficult, if not impossible. The factors that indicate levels of business risk don't always do so consistently. Moreover, because the factors are interdependent, levels of business risk always depend on individual circumstances. For example, a company that has a management of questionable reputation and that is located in a small community may have significantly more business risk than it would if it was located in a large city. This is because the relative importance of a given factor (here, management's reputation) varies according to the influence of other factors (here, the location of the company). Fortunately, this difficulty shouldn't adversely affect the users of audit reports because any modifications of au-

dit procedures would be designed to reduce audit risk. An audit performed in accordance with GAAS would always have to provide at least the minimum level of assurance implicit in GAAS. Although the auditor may, for reasons of business risk, provide a higher level of assurance, he couldn't provide a lower level without violating GAAS.

### **Relationship between Business Risk and the Components of Audit Risk**

The three components of audit risk (inherent risk, control risk and detection risk) are explicitly defined and don't include elements of business risk. This can be seen from the basic audit risk equation:<sup>4</sup>

$$AR = IR \times CR \times DR$$

Where

AR = audit risk—the probability that an auditor issues an unqualified opinion on materially misstated financial statements.

IR = inherent risk—the probability that, in the absence of internal accounting controls, a material error will occur in the accounting process.

CR = control risk—the probability that a material error that does occur isn't prevented or detected on a timely basis by the system of internal accounting control.

DR = detection risk—the probability that a material error that does occur, and isn't detected or corrected by the system of internal accounting control, isn't detected by the audit procedures performed.

Audit risk is fully expressed in this equation. Although it is possible to subdivide the components of audit risk, it isn't possible to add to them without changing the meaning of AR. If a separate and distinct component for business risk were added to the right side of the equation, AR would become the product of the risk that the auditor issues an inappro-

<sup>4</sup>The concepts in the equation are discussed in Statement on Auditing Standards no. 1, *Codification of Auditing Standards and Procedures* (New York: AICPA, 1972), sections 320A.14-.15 (see also *AICPA Professional Standards*, vol. 1 [Chicago: Commerce Clearing House], AU secs. 320A.14-.15); SAS no. 39, *Audit Sampling* (New York: AICPA, 1981), appendix, pp. 16-18 (see also *AICPA Professional Standards*, AU sec. 350.47); and the Exposure Draft, *Materiality and Audit Risk in Conducting an Audit* (New York: AICPA, December 6, 1982).



priate opinion and the risk that the auditor will suffer loss or injury to his practice. This would redefine the concept of the audit process in a revolutionary way because the concept would be incompatible with current professional standards, which nowhere give the auditor license to diminish the intensity of the minimum audit procedures necessary to establish an opinion on the financial statements based on perceived low levels of business risk. For example, nowhere in the discussion of sufficient evidential matter does authoritative literature mention the possibility of limiting the intensity of the audit procedures that would otherwise be necessary in the circumstances because of business risk considerations. Moreover, the purpose of an audit is strictly circumscribed by professional standards: "The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles."<sup>5</sup> This objective requires that at least a minimum level of assurance be provided by the auditor's opinion, and this precludes the use of business risk to reduce the intensity of the audit procedures necessary to provide that minimum level.

Although the auditor can't change the components of audit risk, audit risk itself may be set lower (more stringently) in response to business risk. In other words, the auditor may want additional protection against the risk of issuing an incorrect opinion because of perceived high levels of business risk. Setting audit risk more stringently in this way will ultimately affect detection risk. This is the most important relationship between the components of audit risk and business risk, but there is another.

Most of the factors that indicate the level of business risk are also (to varying degrees) indicators of the level of inherent risk. The existence of common factors for business and inherent risk is easily explained by the relationship between the two risks: the occurrence of material errors (more likely when inherent risk is high) can lead to inappropriate audit reports and (say, through litigation) to

loss or injury to the auditor's practice. Exhibit 1, page 65, lists the most prominent business risk factors (most of which are also indicators, to varying degrees, of the level of inherent risk).

When a single factor influences both inherent risk and business risk, the factor operates independently on each risk. The independent effects of an individual factor on inherent risk, on the one hand, and on business risk, on the other, are demonstrated by the following example. The inherent risk resulting from a company's weak financial position and operating performance is caused by the potential reaction of company management—i.e., management may try to hide the weakness by prejudicially misstating the financial statements. The business risk resulting from the same weakness is caused by potential third-party litigation—i.e., the company's financial ill health may lead to financial losses by investors, who then initiate legal actions claiming the financial statements were negligently audited. The effect of the factor on the behavior of investors (business risk) is clearly independent of and separable from the effect of the factor on the behavior of management (inherent risk). Each of the two behavior patterns could occur in the absence of the other even though triggered by the presence of a single factor.

The fact that several individual factors affect the level of both business risk and inherent risk has a very important consequence. At a given level of audit risk, when the level of inherent risk is assessed and this assessment is used in determining detection risk (and, therefore, the nature, timing or extent of audit procedures), the level of detection risk will, by virtue of the existence of the common factors, coincidentally reflect some measure of business risk. Therefore, an auditor will do more audit work to support his opinion for engagements with more business risk because such engagements would also have more inherent risk.

These interrelationships don't, of course, apply to factors that indicate only the level of business risk (i.e., those that don't also indicate the level of inherent risk). These factors have no place in the model of audit risk because they in no way pertain to the detection of material financial statement error. Consider, for example, the business risk aspects of "ownership of the company." (Any inherent risk aspects, such as the increased risk that an

<sup>5</sup>SAS no. 1, sec. 110.01. See also *AICPA Professional Standards*, AU sec. 110.01.



## Exhibit 1

### Business risk factors\*

| <i>Factor</i>  | <i>Level of business risk</i>   |   |
|--|---|---|
|  | <i>Lower</i>  | <i>Higher</i>   |
| The economy in which the company operates.   | Healthy.  | Depressed; stagnant.  |
| The industry in which the company operates.  | Established; stable; relatively uninfluenced by external conditions.                                  | Relatively new; unstable; greatly influenced by external conditions.  |
| The company's management philosophy with regard to both operational and accounting matters.        | Conservative.   | Aggressive.   |
| The company's control environment, including the possibility of management override.               | Strong administrative controls; control-conscious management; low possibility of management override. | Weak administrative controls; management isn't control conscious; high possibility of management override.                          |
| The company's previous audit history.  | Unqualified opinions for previous audits; no prior disagreements with auditors; few adjustments.      | No prior audit history; qualified or adverse opinions for previous audits; prior disagreements with auditors; numerous adjustments. |
| Rate of turnover for top management and the board of directors.                                    | Low.  | High.   |
| The company's financial position and operating performance.  | Strong.   | Weak.   |
| The company's existing or potential litigation.  | Insignificant.  | Significant.  |
| The business reputation of the company's management and principal owners.                          | Good.   | Poor.   |
| The relevant experience of the company's management and principal owners.                          | High.   | Low.  |
| Ownership of the company.  | Nonpublic.  | Public.   |
| Client understanding of the auditor's responsibilities.†   | Clear.  | Unclear.  |
| Conflicts of interest, regulatory problems or auditor independence problems.                       | Insignificant.  | Significant.  |
| The location of the company.   | Large city.   | Small community.  |
| The level of business acuity or sophistication within the community in which the company operates. | Low.  | High.   |

\*Because the terms used in this exhibit are general, the risk levels indicated may be subject to individual interpretation. In addition, many of the listed factors may also indicate the level of inherent or control risk.

†Misunderstanding the auditor's responsibilities could lead a client to sue or fire the auditor.



owner-manager would understate assets to minimize taxes, would have been considered in assessing inherent risk.) The identification of this factor is based on the proposition that business risk is generally lower for a private company than for a public company because litigation and adverse publicity are less likely. The public company's greater exposure to litigation and adverse publicity is independent of whether there is an error in the financial statements. This is because, as previously stated, litigation can occur when the audit and the

**“... under no circumstances should an assessment of low business risk lead an auditor to do less work than that suggested by the GAAS minimum.”**

financial statements comply with professional standards—in other words, when the auditor has done what is necessary to detect material financial statement error and therefore to issue an appropriate opinion. Even if the auditor could do a perfect audit, reducing audit risk to zero, business risk arising solely because the auditee is a public company wouldn't be eliminated.

#### **Relationship of Review Procedures to Audit Risk**

One of the responses to audit risk is to perform review procedures in order to reduce the risk of an incorrect opinion, i.e., to reduce audit risk by reducing the achieved level of detection risk. However, it should be recognized that reviews by themselves don't reduce the achieved level of detection risk. Although it must be assumed that a review procedure that uncovers an inadequately performed audit procedure will lead to a follow-up procedure, it should be clear that it is the follow-up procedure, not the review alone, that reduces the achieved level of detection risk.

Audit procedures (as contrasted with review procedures) are designed to reduce detection risk to a predetermined level, and, as

has been pointed out, the achieved level of detection risk contributes to achieving a desired level of audit risk. Review procedures, on the other hand, are designed to ensure that the audit procedures achieve their intended purpose. Unaccompanied by follow-up, review procedures are, in effect, quality control procedures. They can identify when audit procedures can't achieve their desired purpose (review of planned procedures) or haven't achieved their desired purpose (review of completed procedures), but they don't by themselves reduce the achieved level of detection risk. If an ineffectively planned or performed audit procedure (which could allow detection risk to exceed the desired level) is identified, the achieved level of detection risk isn't reduced by the identification. It can be reduced only by effectively performing another audit procedure or by correctly reperforming the original audit procedure.

If an audit procedure is properly performed, a review that identifies proper performance has absolutely no impact on the achieved level of detection risk. This is because the impact of an audit procedure on the achieved level of detection risk is independent of any review. If performed correctly, the audit procedure would accomplish its purpose whether reviewed or not. If, on the other hand, an audit procedure is performed incorrectly (e.g., several sample items were treated as correct when they were actually incorrect), the desired level of detection risk isn't achieved. The review procedures may identify the incorrectly performed audit procedure and lead to a remedy. This remedy—reperformance of the audit procedure—can reduce detection risk to its originally desired level.

The distinctions between audit procedures and review procedures become clearer when viewed in light of the nature of audit evidence and documentation. Audit procedures provide evidence weighing for or against the validity of financial statement assertions; they are directed toward uncovering financial statement error. Review procedures, on the other hand, provide evidence weighing for or against the adequacy of the audit procedures performed; they are directed toward uncovering auditor error. Review memorandums and initials on lead schedules, detailed working papers and other memorandums document the performance of the review, its results and the reviewer's conclusions, but they don't in them-



selves indicate whether financial statement assertions are worthy of an unqualified opinion.

### **Addressing Business Risk**

The major conclusion from the preceding arguments is that a perceived high level of business risk may be recognized as a factor that could lead an auditor to do more audit work than would normally appear necessary to satisfy GAAS, but under no circumstances should an assessment of low business risk lead an auditor to do less work than that suggested by the GAAS minimum. In addition, there are several other courses of action a firm might consider to address business risk. Obviously, the perceived level of business risk should influence a firm's evaluation of prospective clients. A firm might also consider relative assessments of business risk in evaluating liability insurance coverage and determining billing rates.

As stated earlier, a workable model of business risk applicable to all circumstances encountered by a firm would be extremely difficult to develop because the factors which influence the level of business risk interact and function uniquely in particular circumstances. However, it might be possible to educate a firm's personnel regarding the concept of business risk and how to use the factors that indicate relative levels of business risk so that they could evaluate the level associated with a potential client. Notwithstanding other considerations, prospective clients with perceived low levels of business risk could be accepted and audited at the GAAS minimum.

Prospective clients with perceived high levels of business risk could be either refused or accepted. If they are accepted, the amount of audit work performed could be increased to respond to the high level of business risk. Once the level of business risk is assessed as too high, the auditor could resign from the engagement.

If a firm performed some sort of business risk assessment for each client (or category of clients), such assessments might be used to evaluate the business risk for a firm's practice as a whole. The firmwide assessment could be factored into the determination of appropriate liability insurance coverage.

Billing rates for clients could be adjusted based on the assessed level of business risk (i.e., higher rates for clients with greater business risk). Because adjusting the rate structure in this manner could affect a firm's competitive position, the trade-off between the potential gain from adjusting rates and the potential loss from a diminished competitive position would have to be considered.

In conclusion, it should be understood that varying the intensity of audit procedures within the bounds of the GAAS minimum as a response to business risk is permissible and may be desirable. However, using business risk considerations to rationalize less audit work than would otherwise be appropriate under GAAS would violate professional standards with ultimate damaging consequences to both the firm and the profession. ■

### **Auditing's role in society**

I predict [schools] will move to a beginning auditing course that is more general. It will stress the fundamentals, independent of any special emphasis on financial or nonfinancial applications. It will be scheduled sufficiently late in a student's career to take advantage of an expanded background in liberal arts and sciences. I would expect that the introduction to the course would spell out the essence of auditing and its role and performance in society, all in a general setting. The importance of accountability would also be stressed. The necessary preconditions to performing an audit would be discussed.

From "Educating the Next Generation of Auditors"

by Frederick L. Neumann

Price Waterhouse Professor of Auditing  
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