

## **Executive Summary**

### **“Use of Business Risk Audit Perspectives by Non-Big 4 Audit Firms”,**

by

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### **Introduction**

In this study, we investigate the use of business risk perspectives by Non-Big 4 audit firms in Germany and the Netherlands. During the 1990s Big 4 audit firms developed and implemented Business Risk Audit methodologies (henceforth referred to as BRA) (Lemon et al. 2000). A number of studies then examined the origins, potential, and implementation issues of BRA (see special issue of *Accounting, Organizations and Society* 4/5 2007). In 2003, consideration of client’s business risks in the audit approach was formally implemented in international standards on auditing (ISA 315 and ISA 330). ISA 315 and 330 did not require auditor consideration of all business risks incorporated in BRA, but instead focused on a narrower concept: (client’s) business risks that result in a risk of material misstatement. This is the first study to investigate whether and how non-Big 4 small and medium-sized audit practices (henceforth referred to as SMPs) have implemented business risk perspectives in their audits. Moreover, our research provides insights related to the debate on the proportional application of auditing standards (e.g., European Commission 2010; European Commission 2011), which argues that auditing standards may be applied in a flexible manner that matches the complexity, costs, and risks on a particular engagement. Thus, no one audit approach is considered appropriate in all circumstances.

Research on SMPs' audit approach is important given the significant role they play with a market share above 50% in Germany and the Netherlands. SMPs regularly enjoy high autonomy in the choice of an audit approach which makes them an interesting group for the investigation of conditions and factors affecting the application of business risk perspectives. Further, they operate in a challenging audit environment, because their clients – mainly small and medium-sized entities (SME) – often do not have formalized entity-level controls for assessing business risks which limits reliance on higher entity-level evidence.

To examine a broad spectrum of client conditions, we conduct interviews with highly experienced auditors from both small and medium-sized audit firms in Germany and the Netherlands. These countries differ substantially along a number of dimensions. Since our study is on the auditing of financial reports, we focus on differences in the nature of client and user demands. While German clients of SMEs predominately prepare reports based on a government-driven accounting system with a close book-tax alignment, clients in the Netherlands have a commercially-driven accounting system with separate books for financial statements and tax statements (Nobes and Parker, 2004).

## **Research Objectives**

The main objective of our study is to gain insights into the implementation and use of business risks perspectives by SMPs in Germany and the Netherlands. We use the extent of tangible and intangible audit evidence that auditors collect as one measure for identifying the level of the application of business risk perspectives. Tangible evidence is the observation of assets, examination of documents, or analytical procedures that are directly linked to an audit assertion(s), for example inventory count observation, cut-off procedures, etc. In contrast, intangible evidence is indirectly linked to assertions and includes entity or business level evidence such as tests of entity level controls and benchmark analyses.

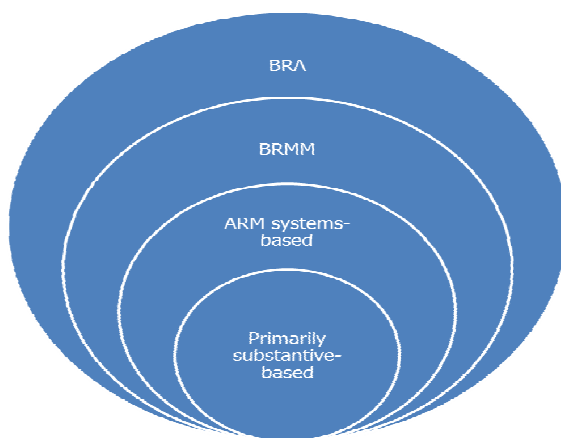
In our study we distinguish between the following two audit approaches that are based on the audit risk model (ARM) and incorporate business risk perspectives to varying degrees:

- a broad “Business Risk Auditing” approach (BRA) as implemented by most of the then international Big 5 audit firms in the 1990s; and
- a more focused “Business Risk resulting in Material Misstatements” approach (BRMM).

The current international auditing standards leave room for application of (a combination of) both approaches. In summary, the auditor is required to gain sufficient insight into the entity and its environment. (ISA 315, ISA 330)

The variations in audit approaches are depicted in Figure 1. The circles represent reliance on various types of audit evidence to test financial statement assertions. The inner circles (primarily substantive-based and ARM systems-based) focus on directly testing the audit assertions within various accounts or cycles with limited consideration of business risks. The distinction between BRMM and BRA is the degree to which business risks and entity level evidence such as entity level internal controls and entity-business-state analytical procedures are relied upon (Bell et al. 1997). While both approaches require an understanding of a clients’ business risks, BRA relies to a greater extent on entity level evidence than does BRMM.

*Figure 1 Audit approaches*



The client portfolio of SMP audit firms differs from those of Big 4 audit firms with respect to the range of clients in terms of size and complexity. Furthermore, the clients of

SMPs often have less formalized internal control systems, which in turn results in fewer opportunities for the auditor to rely on the company's internal control system, including entity-level controls. Therefore, it is an important question whether the broad BRA approach is helpful for SMPs in achieving an efficient and effective audit of smaller and medium-sized entities (SMEs). In this study we explore factors that drive the use of BRA risk perspectives such as client complexity, preparer/user demands, and investments in audit technology. Specifically, we address the following research questions:

1. How and to what degree are SMP auditors using business risk perspectives?
2. What conditions drive or hinder the use by SMP auditors of business risk perspectives?

Based on these research questions, we address the following propositions:

1. Client complexity is an important driver of the use of business risk perspectives in the audit.
2. Client expectations for smaller clients in jurisdictions with high book-tax alignment hinder the application of business risk perspectives in the audit.

## **Research Design**

We utilize a semi-structured interview approach to obtain evidence on the primary audit approach(es) of SMPs. This research method provides an opportunity to gather rich data regarding the experiences of auditors relating to the use of business risks on audit engagements. We conducted 38 interviews with highly experienced audit practitioners (mainly audit partners) working for an SMP, equally distributed across Germany and the Netherlands and equally distributed over small and medium-sized audit firms. Each interview was conducted by one or two of the research team members, and all interviews were audio-taped and transcribed. The interview questionnaire contained both close-ended and open-ended questions and made use of both qualitative and quantitative response formats. We analyzed the data making use of a pre-defined coding scheme that was further modified during coding in an iterative process. All transcribed interviews

were independently coded by two research team members. We obtained a 90% coding-agreement, indicating high inter-rater reliability.

The interview questionnaire basically consisted of three parts:

- i. Demographic questions relating to the interviewee (e.g., level of experience) and the audit firm (e.g., number of audit engagements)
- ii. Questions about the nature and impact of changes, if any, in their firm's audit approach over the past ten years. In addition to open-ended questions, this set of questions also inquired about the nature of the change with respect to business risk perspectives. We did not directly ask (or examine) whether and to what extent the auditors perceived their audits to be compliant with international auditing standards. Instead, our focus was on gaining insight into their experiences with implementing (or not implementing) business risk perspectives in their audit methodologies.
- iii. Questions about the nature and impact of changes over the past ten years in reliance on various forms of audit evidence that have been collected, including: (1) identification of business risks, (2) identification of entity-level controls, (3) use of substantive analytical procedures, and (4) use of entity-business-state analytical procedures. This set of questions was followed by questions regarding national differences in the auditor's role in terms of "income measurement" (profit & loss oriented) versus "capital maintenance" (balance sheet oriented).

We also gather and analyze statements from interviewees that support and illustrate the use of various business risk perspectives in their audit approaches.

## **Results**

### *Change to business risk perspectives*

We find that SMP auditors are divided in their opinions on the impact of business risk analysis on their audit approach. When explicitly asked about the move towards the use of business risk perspectives, we find that about 55% of the auditors consider this move to represent a material change. These auditors state that the explicit requirement to

consider business risks has had an impact on the way they conduct an audit and on the type of audit evidence they collect. The remaining 45% of the auditors consider the move towards business risk perspectives to be formal in nature. They often state that they have considered business risks before and that the only thing that has changed is that they are now required to document business risks more extensively. Therefore, they often see the change as an additional burden which makes it more challenging for them to cope with fee pressures.

The vast majority of auditors consider the change to be driven by regulatory changes in auditing standards and stricter oversight (AFM in the Netherlands and APAK in Germany). Some SMP auditors believe that the change was driven by the then Big 5 audit firms in an effort to cope with fee pressure and to develop new business opportunities.

Few of the SMP participants believe that the change towards business risk perspectives has resulted in significant improvements in audit efficiency and/or audit effectiveness in the audits of small and less complex SMEs. An explanation for this finding is that SMP auditors often act also as business advisors for their clients and frequently visit clients during the year for a variety of assurance-related services. In this role, they develop a good understanding of the clients' business. Moreover, the less complex audit environment makes it possible to achieve an effective audit that is more efficient by focusing on tangible audit evidence.

From an auditing standard perspective, these results provide support for the importance of international standards that have explicitly recognized proportional application to small and less complex audit environments. Nonetheless, SMP auditors appear to still struggle in their interpretation (and implementation) of SME considerations in auditing standards. It is interesting to note that none of the interviewees referred to the "SME guidance" that was developed by the IAASB in 2007 (and updated in 2010). The proposed regulation of the European Commission (November 2011) suggests that national professional audit bodies should take further efforts to facilitate the proportional application of auditing standards that fits the national context.

The findings also indicate that the reasons why SMP auditors implement business risk perspectives in their audit approaches differ from those of the Big 4 audit firms (Lemon et al., 2000). SMP auditors mention external factors (regulation, i.e. ISA 315/330 and an increased level of supervision of the audit market) as a primary reason of implementing business risk perspectives in the audit approach, where Big 4 audit firms use intrinsically motivations (improvement of audit effectiveness and audit efficiency). We attribute this difference to variation in the size and complexity of the client portfolios of SMPs and Big 4 audit firms.

### *Changes in audit evidence*

SMP auditors were asked to indicate their experiences with regard to changes over the past decade in the type of audit evidence that they collect. We observed that many auditors struggled to identify significant changes. Their replies show the following distribution:

- 47% of the auditors mentioned the greater importance of the internal control system as an information source they rely on;
- 32% of the auditors perceived IT-system related audit evidence has become more important.

Participants also report that the collection of more systems-related evidence helped them to reduce the amount of detailed evidence. Only a few auditors consider the collection of business risk-related evidence, such as information on the developments in the industry, as a major change. Some auditors mentioned that they make greater use of interview- and observation-type evidence than previously, which may be caused by making use more use of intangible audit evidence.

In our study we have identified various elements of a BRA audit approach (in addition to or as part of application of the audit risk model):

- Assessment of business risks;
- Substantive analytical procedures;

- Entity-business state analytical procedures (e.g., benchmarking);
- Assessment of entity-level controls.

SMP auditors assess business risks in almost all financial statement audits (85%) and feel comfortable about relying on such information. The observed high proportion reflects the requirements in ISA 315 to consider business risks. The high level of comfort suggests that auditors have confidence in their knowledge of their clients' business.

A substantially lower number of SMP auditors (44%) apply substantive analytical procedures. The auditor conducts this type of substantive procedure to a financial statements account or cycle, which implies a controls reliance approach. That is, many substantive analytical procedures rely on a fluctuation analysis of account balances or ratios, which utilize unaudited, internal data. When controls are weak, the accuracy of such data is suspect. This finding of a low reliance on substantive analytical procedures may be explained by the SME audit environment, where generally internal controls are less formalized or even less present as compared to the audit environment of larger, more complex companies.

Entity-business-state analytical procedures are applied in only about 25% of all SMP audits. According to the participants, there are two reasons for this low proportion. First, industry data is missing or unavailable for the client. Second, the business model of the client is unique which makes it impossible to identify relevant industry benchmarks.

Finally, we found that SMP auditors rely on entity-level controls in approximately 40% of all audits. The following relevant factors for the level of reliance were mentioned (see also ISA 315.A49/A50):

- An owner-manager can exercise significant influence on the effectiveness of entity-level controls. For instance, the owner/manager may personally supervise business operations on a daily basis and oversee bank accounts. Some auditors told us that they consider the perceived credibility of the owner manager, while other auditors reported that this setting makes it almost impossible to rely on entity-level controls.



- Generally, the entity-level controls within a smaller entity are less formalized as compared to the control environment of larger entities. While some auditors have procedures in place to document and to rely on informal entity-level controls such as management by walking around and undocumented staff meetings; other auditors considered informal controls of limited value in preventing or detecting financial statement misstatements.

### *Country differences*

Our study examines whether SMP auditors in the Netherlands and Germany differ in their level of reliance on higher level audit evidence and whether this also differs across small and medium-sized audit firms. In our study German SMP auditors report that their audit clients focus to a greater on achieving tax objectives in the preparation of financial statements than Dutch clients, while Dutch SMP auditors report that their audit clients focus more on financial objectives. This finding supports the traditional classification of Germany as a country with high book-tax alignment and of the Netherlands as a country with a focus on income measurement. Such differences impact the expectations of preparers and users on auditors whose primary function is to provide assurance on the reasonableness of financial disclosures in meeting their decision needs.

We found that German auditors from small practices are the least likely to see the benefits from applying business risk perspectives. The findings offer some support that the audit environment (i.e., auditor expectations) affects the extent to which business risk perspectives is a useful tool to meet audit objectives. This result enriches our understanding of the applicability of BRA procedures in small versus medium-sized entities, but also in Germany versus the Netherlands. Particularly, small audit firms with relatively small audit clients in Germany are skeptical about BRA-type procedures, thus, supporting the proportional application of international auditing standards

### *The role of investments in audit technology*

Lastly, our study reports results on the differences between small and medium-sized audit firms with respect to their level of investments in audit technology such as staff training, industry-specific databases, development of audit guidance, and the level of structure in the audit approach. The role of investments in training is corroborated by a large number of auditors naming the lack of experience as a factor hindering the application of business risk perspectives. SMPs have a difficult time in determining how to efficiently achieve a high level of confidence in business risk assessments in the early years of an engagement. Industry specialization seems to be an important factor that helps to achieve sufficient comfort with business risk assessment, but which might be difficult to achieve for small audit firms with a relatively broad portfolio of clients.

### **Implications for standard setters**

Our study identifies factors and conditions that influence the effectiveness and efficiency of the application of business risk perspectives by SMP auditors. These factors are the complexity of the audit environment, audit expectations, and audit technology investments.

We find that many SMP auditors find it challenging to scale the use of business risk perspectives to the client environment and to achieve a proportional application of auditing standards. Some auditors believe that current auditing standards do not provide sufficient guidance to apply business risk perspectives in smaller and less complex audits. They see possibilities to reduce the level of documentation for smaller clients, and they feel under pressure from oversight bodies. Surprisingly, none of the SMP auditors specifically identify the existing IAASB guidance of the application of auditing standards to SME audit environments as a potential source for achieving proportionality. Therefore, standard setters might consider putting greater effort into communicating the availability of such guidance and in ensuring the guidance is user-friendly (e.g., readable and not too detailed or lengthy). Further, clearer guidance may be needed on the required level of audit documentation and the specific identification of circumstances where less documentation is appropriate. In addition, auditor training in proportional application of

guidance may be of help in realizing the full opportunities that proportional application offers for SME audit engagements. In this respect, we also note that the European Commission asks its member states to ensure a proportional application of auditing standards in the recently issued proposed regulation (November 2011). The focus of our study has not been to assess the level of application of auditing standards. In this respect, our results do not provide an indication whether or not the international auditing standards are being applied. The participants in our study report, however, that they struggle with the level of required documentation which - in turn - is dependent of the interpretation of supervisory bodies and auditors. In summary, SMP auditors express concern that supervisory bodies (AFM and APAK) might take a more strict view on what the ISA requirements may imply in terms of the appropriate and sufficiency of audit documentation. In general, SMP auditors do not expect a separate set of auditing standards for an SME audit environment.

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