RELATIONSHIPS AMONG COMPONENTS OF ENGAGEMENT RISK

EVREN DILEK SENGUR *

ABSTRACT: Accounting scandals exploded at the beginning of 2000s and the collapse of Arthur Andersen highlighted the importance of implementing engagement risk management strategies in audit firms. Engagement risk refers the overall risk associated with an audit engagement and it consists of three components: client's business risk, auditor's business risk, and audit risk. The main purpose of this study is to describe each components of engagement risk and explain relations among them. Additionally, the paper points out the importance of engagement risk management throughout the audit and demonstrates engagement risk management strategies at client acceptance/continuance, planning and completion of audit.

KEY WORDS: Engagement Risk; Audit Risk; Client's Business Risk; Auditor's Business Risk; Risk Management.

JEL CLASSIFICATION: M40; M42.

1. INTRODUCTION

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users (Messier et al., 2008). Auditing process begins with the client acceptance and continuance, proceeds with the proper planning, gathering evidence and ends with reporting. Each audit engagement brings its unique risks to either auditor or audit firm. Once an auditor agrees to accept a client, the auditor inevitably exposes to an engagement risk. Engagement risk represents the overall risk associated with an audit engagement. The concept of engagement risk serves to formalize the auditor's consideration of the factors and risks affecting an engagement (Colbert et al., 1996). Engagement risk consists of three components:

* Ph.D., Istanbul University, Turkey, sengur@istanbul.edu.tr
client's business risk, auditor's business risk, and audit risk. (Colbert et al., 1996; Walo, 1995; Ethridge et al., 2007a; Johnstone, 2001; Davutyan & Kavut, 1997)

Palmrose (1997) examined more than 1,000 instances of litigation against 20 audit firms. Research based on the large sample of lawsuits against auditors found that between 30% and 40% of suits were filed on clients about to be or already in bankruptcy. Additionally, the study revealed that modified audit reports provide the auditor with some defense against litigation. Consider the audit report on the last financial statement issued before the bankruptcy or litigation (whichever came first): of bankrupt public companies with no auditor litigation, 58% had modified reports, while only 36% of bankrupt public companies with auditor litigation had modified reports. Furthermore, the outcomes of lawsuits on bankrupt public companies reinforced the defensive role of modified reports. In suits with only modified reports, auditors either paid the lowest settlements or won the highest dismissal rates. The highest auditor payments occurred when no modified reports were issued by auditors.

In conjunction with the increasing litigation against auditors and audit firms after accounting scandals exploded at the beginning of 2000s, the importance of implementing risk management practices in audit firms became much more vital (Davutyan & Kavut, 1997). Ethridge et al. (2007a, 2007b) explored whether audit firms have strengthened their client acceptance/retention procedures in the post-Enron era. They investigated whether the attitudes and procedures for evaluating engagement risk have changed substantially in the post-Enron era. The results of the survey revealed that an overwhelming majority of audit partners indicated their views regarding engagement risk have changed; however, the level of change was not overly significant.

Palmrose (1997) pointed out the outcomes of an ineffective risk management strategies and Ethridge et al. (2007a, 2007b) demonstrated that audit partners' views regarding engagement risk didn’t change significantly in the post-Enron era. Therefore, it is crucial to highlight the importance of engagement risk management strategy for audit firms. An effective risk management strategy helps auditors and audit firms to mitigate risk of litigation, financial loss and impaired reputation. Additionally, risk management process decreases the likelihood of accepting or retaining client which creates an unacceptable engagement risk for auditor or audit firm. Furthermore, risk management assists auditor to plan the audit engagement properly to obtain sufficient evidence for assertions that requires special consideration.

Engagement risk should be addressed throughout the audit, from the initial decision to accept a new client or continue serving an existing client to planning the engagement through to the ultimate issuance of the audit report (Colbert et al., 1996). The purpose of this paper is to explain the relationships among three components of engagement risk and express the importance of engagement risk management throughout the audit.

2. CLIENT ACCEPTANCE OR CONTINUANCE

Auditing standards entails auditors to execute some pre-engagement activities prior to client acceptance decision. Most of the public accounting firms establish
Relationships Among Components of Engagement Risk

policies and procedures that are used as a guideline throughout the client acceptance process. An effective implementation of such policies and procedures enable audit firms to obtain sufficient information regarding prospective client, analyze risks indigenous to prospective client and evaluation of probability of risks that an audit firm may encounter as a consequence of its relationship with a prospective client. Furthermore, application of client acceptance policies and procedures lessen the risk of executing to a client which burdens an unacceptable level of engagement risk to an audit firm.

Obtaining an understanding of client and its environment is one of the most important aspects of client acceptance process. Characteristics of an industry, company’s position in the industry, organizational structure of an entity, operational practices in an organization, features of manufactured product, among others, are some of the areas that an auditor should understand in the course of obtaining information about a prospective client. Companies accused of fraud, companies under Capital Market Board of Turkey or other regulatory investigation, companies that have changed auditors frequently, and companies showing recent losses (Louwers et al., 2011) should be considered as red flags of engagement risk. Additionally, auditing standards require auditors to confer with predecessor auditor with the aim of gaining information with respect to integrity of management, reasons for auditor change and the existence of any disagreement between client and predecessor auditor.

During the course of implementing client acceptance policies and procedures, an auditor should assess the possibility of risks that an auditor or audit firm may bear associated with an audit of financial statements. Engagement risk represents the overall risk associated with an audit engagement (Colbert et al., 1996) and it consists of three interrelated components: client’s business risk, auditor’s business risk and audit risk.

2.1. Client’s Business Risk

Business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s abilities to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies (ISA 315, Paragraph 4). Risk is a natural part of business activity. However, risks that are not controlled and addressed can jeopardize the operation of companies (Rittenberg et al., 2010).

Numerous external or internal factors may result in a higher assessment of client’s business risk. The overall economic climate can have a tremendous effect on the organization’s ability to operate effectively and profitably. Additionally, rapid technological change in an industry also might be an indicator of business risk for many companies. For example, Apple’s new communication products affected the business of Nokia. Moreover, competitor actions, such as discounting prices or adding new product lines, also considerably affect client’s business risk. In addition to external factors, there are also several internal factors that affect the client’s business risk. Consider items on a company’s balance sheet that are subjective and based on judgment. Because of the estimates regarding such accounts, fairness of financial reporting is affected by the competence and integrity of management and potential
incentives to misstate the financial statements. Finally, the effectiveness of entity’s internal controls can affect client’s business risk by either preventing or detecting errors or intentional misstatements (Rittenberg et al., 2010).

Some examples of conditions and events that may indicate the existence of business risks are: significant changes in the entity such as large acquisitions, reorganizations; significant changes in the industry in which the entity operates, significant new products or services, significant new lines of business, new locations, significant changes in the IT environment, operations in areas with unstable economies and high degree of complex regulation. (Messier et al., 2008):

2.2. Auditor’s Business Risk

Auditor’s business risk is the risk that the auditor is exposed to loss or injury to professional practice from litigation, adverse publicity or other events arising in connection with financial statements audited and reported on (Messier et al., 2008). In other words, auditor’s business risk is the risk that the auditor or audit firm will suffer harm because of a client relationship (Arens & Loebbecke, 1997) Even though the auditor performs the audit in accordance with generally accepted auditing standards (GAAS) and reports appropriately on the financial statements, an auditor still be sued by the client or a third party. Although the auditor may ultimately win the lawsuit, his or her professional reputation may be damaged (Messier et al., 2008). Elements of auditor’s business risk are litigation, sanctions and impaired professional reputation. Each of these elements may cause injury or loss to a professional auditing practice in a variety of ways. Litigation can involve a number of injurious costs such as attorneys' fees, court awards of damages or expensive settlements. Sanctions can curtail the practice or increase costs (e.g., a requirement for additional peer reviews). An impaired reputation can result in lost clients and injured morale of firm personnel (Brumfield et al., 1983).

Auditor's business risk is controllable, to some degree, by the auditor. The auditor can influence auditor's business risk, and thus engagement risk, through the selection of clients. Other factors bearing on auditor's business risks, such as the client being involved in lawsuits, cannot be managed by the auditor (Colbert et al., 1996). Regardless of the quality of work performed, involvement in future litigation may be inevitable when an auditor accepts or retains a client (Hall & Renner, 1991).

There are several factors that have impact on auditor’s business risk. For instance, auditors should consider the likelihood of a client’s filing for bankruptcy after the audit. If a client declares bankruptcy after an audit is completed, the likelihood of a lawsuit against the audit firm is reasonably high even if the quality of the audit was good (Arens & Loebbecke, 1997). Palmrose (1988) notes that litigation against an audit firm can impair its reputation by providing a negative signal about the quality of the firm’s audit services. Previous accounting research has addressed the issue of audit litigation by identifying problem areas that should be considered when accepting a client and performing audits (Schultz & Gustason, 1978; St. Pierre & Anderson, 1984; Kellog, 1984; Palmrose, 1988). Stice (1991) developed and tested a model to predict litigation against auditors and concluded that client characteristics are empirically
related to litigation. Taken together, previous research implies that auditors should consider client characteristics when assessing litigation risk, as well as auditor’s business risk. The summary of factors which influence the level of auditor’s business risk is shown in Table 1. Additionally, in their study Pratt & Stice (1994) identified client characteristics that influence auditor’s litigation risk judgment. Their findings showed that financial condition of a client is the most important factor of assessing the litigation risk.

Table 1. Auditor’s Business Risk Factors

<table>
<thead>
<tr>
<th>Factor</th>
<th>Level of Auditor’s Business Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>The economy in which the company operates</td>
<td>Lower: Healthy</td>
</tr>
<tr>
<td>The industry in which the company operates</td>
<td>Higher: Established; stable; relatively uninfluenced by external conditions</td>
</tr>
<tr>
<td>The company’s management philosophy with regard to both operational and accounting matters</td>
<td>Lower: Conservative</td>
</tr>
<tr>
<td>The company’s control environment, including the possibility of management override</td>
<td>Lower: Strong administrative controls; control-conscious management</td>
</tr>
<tr>
<td>The company’s previous audit history</td>
<td>Lower: Unqualified opinions for previous audits; no prior disagreements with auditors; few adjustments.</td>
</tr>
<tr>
<td>Rate of turnover for top management and the board of directors</td>
<td>Lower: Low</td>
</tr>
<tr>
<td>The company’s financial position and operating performance</td>
<td>Lower: Strong</td>
</tr>
<tr>
<td>The company’s existing or potential litigation</td>
<td>Lower: Insignificant</td>
</tr>
<tr>
<td>The business reputation of the company’s management and principal owners</td>
<td>Lower: Good</td>
</tr>
<tr>
<td>The relevant experience of the company’s management and principal owners</td>
<td>Lower: High</td>
</tr>
<tr>
<td>Ownership of the company</td>
<td>Lower: Nonpublic</td>
</tr>
<tr>
<td>Client understanding of the auditor’s responsibilities</td>
<td>Lower: Clear</td>
</tr>
<tr>
<td>Conflicts of interest, regulatory problems or auditor independence problems</td>
<td>Lower: Insignificant</td>
</tr>
</tbody>
</table>


2.3. Audit Risk

Because of the nature of audit evidence and the characteristics of management fraud, an auditor can only provide reasonable assurance, as opposed to
absolute assurance, that the financial statement are free of material misstatements. This risk is referred to as audit risk. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated (Messier et al., 2008).

When the auditor decides on a lower level acceptable audit risk, it means that the auditor wants to be more certain that the financial statements are not materially misstated (Arens & Loebbecke, 1997). Conversely, a high level of audit risk means that the audit firm is willing to take a higher risk of issuing an unqualified opinion on materially misstated financial statements (Rittenberg et al., 2010).

The auditor must recognize that once a client is accepted, audit risk cannot be eliminated. However, audit risk is determined and managed by the auditor and it can be reduced by doing more work targeted to specific areas where financial reporting risk is high. The auditor should perform the audit to reduce audit risk to a sufficiently low level. By establishing a relatively low level of audit risk, the auditor minimizes the possibility that the financial statements may contain a material misstatement (Messier et al., 2008).

2.4. Risk Management at Client Acceptance or Continuance

Audit firms try to reduce their own business risks by carefully managing their audit engagements. To do so, audit firms undertake several activities before beginning any audit engagement. In general, these activities can be called risk management activities (Louwers et al., 2011). During the application of client acceptance processes, auditors should assess each components of engagement risk and a risk arises from their interaction which referred as engagement risk. Therefore, client acceptance process activities focus on understanding and managing risks taken by the audit firm (Louwers et al., 2011).

Once a client is accepted, audit firm is inevitably exposed to an engagement risk. However a low level of engagement risk is desirable and acceptable from the perspective of auditor or audit firm. In the assessment of engagement risk, auditor assesses the client’s and the auditor's business risks, and then he or she sets planned level of audit risk. While audit risk is managed by adjusting the nature, timing, and extent of audit procedures performed; auditor's business risk is controlled primarily through the client acceptance/continuance decision process. Because audit risk and auditor's business risk are controllable by the auditor (at least to some extent), while entity's business risk is not, the auditor's focus on managing engagement risk centers on audit risk and auditor's business risk (Colbert et al.,1996).

The auditor assesses auditor's business risk and then sets audit risk (Rittenberg et al., 2010). Audit risk is established at a level so that the planned level of engagement risk will be achieved. The level of audit risk is adjusted in response to the risk factors noted during the acceptance/continuance decision process (Colbert et al., 1996).

There is a inverse relation between auditor’s business risk and audit risk (Güredin, 2007). If auditor assesses auditor’s business risk as high, auditor do not accept the client in order to avoid high level of engagement risk. If auditor’s
assessment highlights a moderate auditor’s business risk, auditor sets audit risk very low to decrease an engagement risk to an acceptable low level. Finally, if auditor determines that auditor’s business risk is low, auditor can set audit risk higher than companies with higher auditor’s business risk. However, even if the auditor assesses the auditor’s business risk as low, the auditor is not permitted to perform less extensive procedures than otherwise would be appropriate under GAAS (Rittenberg et al., 2010). In other words, an audit performed in accordance with GAAS would always have to provide at least the minimum level of assurance implicit in GAAS. (Brumfield et al., 1983). Relationship between auditor’s business risk and audit risk is summarized in Table 2.

Table 2. Relationship Between Auditor’s Business Risk and Audit Risk

<table>
<thead>
<tr>
<th>Auditor’s Business Risk</th>
<th>High</th>
<th>Moderate</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Risk</td>
<td>Don’t accept client</td>
<td>Set very low</td>
<td>Set within professional standards, but can be higher than companies with higher auditor’s business risk</td>
</tr>
<tr>
<td>Numerical Example of Audit Risk</td>
<td>None - (0,00) 0,01 0,05</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Assessment of engagement risk assists auditor in making a decision with respect to acceptance of a client. If auditor assesses engagement risk as an acceptable low level, auditor determines to accept a client. Conversely, if auditor’s assessment points out an unacceptable level of engagement risk, audit firm might be reluctant to bear such a high risk and determine not to accept a prospective client (Colbert et al., 1996; Güredin, 2007)

Johnstone (2000) developed and tested a client acceptance model. Findings of the study demonstrated that audit partners use their evaluations of client related risks and their own firm’s risk of loss to screen out undesirable clients.

3. PLANNING

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning helps the auditor to devote appropriate attention to important areas of the audit, identify and resolve potential problems on a timely basis and properly organize and manage the audit engagement so that it is performed in an effective and efficient manner. Additionally, adequate planning assists in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them (ISA 300, Paragraph 2).
3.1. Audit Risk Model

Audit risk model provides a framework for auditors to follow in planning audit procedures and evaluating audit results (Messier, Glover and Prawitt, 2008). The audit risk model is used primarily for planning purposes in deciding how much evidence to accumulate. A thorough understanding of the model is essential to effective audit planning (Arens & Loebbecke, 1997). This model expresses the general relationship of audit risk and the risks associated with the auditor’s assessments of risk of material misstatement (inherent risk and control risk) and the risks that substantive tests will fail to detect a material misstatement (detection risk) (Messier et al., 2008).

\[
\text{Audit Risk (AR)} = \text{Inherent Risk (IR)} \times \text{Control Risk (CR)} \times \text{Detection Risk (DR)}
\]

3.1.1. Components of Audit Risk Model

Audit risk is the risk that the auditor may give an unqualified opinion on materially misstated financial statements. Audit risk is influenced by inherent risk, control risk and detection risk.

Inherent Risk: Inherent risk (IR) is the likelihood that a material misstatement exists in the financial statements without the consideration of internal control (Messier et al., 2008).

Control Risk: Control risk (CR) is the risk that a material misstatement that could occur in a relevant assertion will not be prevented or detected by the entity’s internal control. That risk is a function of the effectiveness of internal control. Thus, some control risk always exists because of the inherent limitations of internal control (Messier et al., 2008).

Auditing standards refer to the combination of inherent risk and control risk as the risk of material misstatement (RMM). Inherent risk and control risk exist independently of the audit. In other words, the levels of inherent risk and control risk are functions of the entity and its environment. The auditor has little or no control over these risks (Messier et al., 2008).

Detection Risk: Detection risk (DR) is the risk that the auditor will not detect a misstatement that exists in a relevant assertion. Detection risk is determined by the effectiveness of the audit procedure and how well the audit procedure is applied by the auditor. Thus, detection risk cannot be reduced to zero because the auditor seldom examines 100 per cent of the account balance or class of transactions. (Messier et al., 2008). Detection risk is controlled by the auditor. The auditor’s determination of detection risk influences the nature, amount, and timing of audit procedures to ensure that the audit achieves no more than the desired audit risk (Rittenberg et al., 2010).

Three steps are involved in the auditor’s use of the audit risk model (Messier, et al., 2008):

1. Setting a planned level of audit risk
2. Assessing the risk of material misstatement.
3. Solving the audit risk equation for the appropriate level of detection risk.
3.1.2. Relationship Among Components of Audit Risk Model

Inherent risk and control risk are functions of a client and they cannot be controlled by auditor. On the other hand, audit risk and detection risk are risks that the auditor faces, and that the auditor can manage (Rittenberg et al., 2010). Detection risk has an inverse relationship to inherent risk and control risk. A high level of inherent or control risk means that the company is more likely to have misstatements. If the client’s internal controls are inadequate, or management is motivated to misstate the account balance, or if the natures of the transactions are inherently difficult, then the risk of material misstatement is quite high. Consequently, the auditor will do more work in testing the account balances. Audit risk is held constant, but the high levels of inherent and control risk demand that the auditor’s detection risk be small in order to control audit risk at the predetermined level (Rittenberg et al., 2010).

3.2. Risk Management at Planning

After deciding to accept a client, the auditor plans the engagement by continuing to consider engagement risk and its three components. The auditor should be alert throughout the engagement for the existence of factors that may indicate that one of the three component risks, and thus engagement risk is at a higher level than originally believed. The auditor may be able to adjust the nature, timing, and extent of audit procedures such that audit risk is lowered and the achieved engagement risk is acceptable (Colbert et al., 1996).

Once a client has been accepted, in addition to audit risk, an auditor also subjects to business risk in his or her professional practice. Therefore, the auditor also exposed to risks that are not embraced in the audit risk model. The audit risk model primarily addresses the risks associated with issuing unqualified audit opinions on financial statements that contain material misstatements. Auditor’s business risk, on the other hand, is present even when auditors comply with GAAS and render appropriate audit opinions. For example, a client with a weak internal control system experiencing financial difficulty introduces two kinds of risks; the risk of a material misstatement and the risk of financial failure. The audit risk model reflects only the first; business risk encompasses both (Houston et al., 1999).

In previous research Walo (1995) concluded that public versus private ownership resulted in a significant effect on audit scope. This finding supports to the fact that auditors do impound auditor’s business risk assessments into their scope judgments. The results imply that the risk considered in planning decisions may be broader than audit risk and involve overall engagement risk (Walo, 1995).

As noted before, auditor’s assessment of auditor’s business risk impacts the level of planned audit risk and there is an inverse relation between auditor’s business risk and audit risk (Güredin, 2007). If an auditor assesses auditor’s business risk relatively high, to maintain engagement risk at a constant low level, the auditor should decrease audit risk through increasing audit scope (Walo, 1995). A company with high auditor’s business risk, and thus low audit risk, requires a more experienced audit staff and direct tests of account balances performed at year end. In contrast, a company with
low auditor’s business risk, and thus higher acceptable levels of audit risk, requires less
direct tests of account balances at year end and could rely more on substantive
analytical procedures (Rittenberg et al., 2010).

Houston et al (1999) conducted a research to identify conditions under which
the audit risk model does, and does not describe audit planning (investment and
pricing) decisions. They concluded that when the likelihood of an error is high, the
audit risk model dominates business risk in the explanation of the audit investment,
conversely when the likelihood of an irregularity is high, auditor’s business risk
dominates audit risk model in the explanation of the audit investment. They claimed
that the ability of the audit risk model to describe auditor behavior depend upon the
nature of the risks present in the audit. In the presence of errors; the audit risk model
adequately describes audit planning decisions, however in the presence of irregularities
it does not.

4. RELATIONSHIPS AMONG COMPONENTS OF ENGAGEMENT RISK

Client’s business risk is a broader concept than the risk of material
misstatement. However, most business risks have the potential to affect the financial
statements either immediately or in the long run (Messier et al., 2008). Auditor should
assess client’s business risk. Although client’s business risk is not controllable by
auditor, the auditor considers its assessment in controlling the engagement risk
(Colbert et al., 1996).

Client’s business risk affects the auditor’s business risk. With an increase in
client's business risk, auditor's business risk increases (Rittenberg et al., 2010). Assume
the auditor determines that the client’s industry is undergoing significant technological
changes which affect both the client and the client’s customers. This change may affect
the obsolescence of the client’s inventory, collectability of accounts receivable, and
perhaps even the ability of the client’s business to continue (Arens & Loebbecke,
1997). If client declares bankruptcy or suffers extremely large losses, it is more likely
that an audit firm will be sued (Rittenberg et al., 2010). According to Johnstone
(2000), audit partners’ evaluations of client related risks affect their evaluations of their
firm’s risk of loss on the engagement.

Client’s business risk also affects the audit risk. A high level of risk of
material misstatement increases the likelihood of error of fraud in transactions or
financial statements. In order to provide reasonable assurance regarding the fairness of
financial statements, auditors set audit risk lower for companies with a high level of
client’s business risk.

Auditor’s business risk influences the audit risk. The auditor sets the desired
audit risk based on the assessment of auditor’s business risk (Rittenberg et al., 2010).
For companies with a high level of auditor's business risk, the auditor should decrease
audit risk through increasing audit scope to maintain engagement risk at a constant
level (Walo, 1995).

Audit risk can influence auditor’s 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 (Brumfield et al., 1983). Thus, decreasing the level of audit risk
enables to lessen the auditor’s business risk (Güredin, 2007). As the level of audit risk decreases, auditor’s business risk also diminishes (Arens & Loebbecke, 1997; Bozkurt, 1999). Relationships among components of engagement risk are depicted in Figure 1.

Figure 1. Relationships Among Components of Engagement Risk

At the completion of the audit, if auditor assesses the actual or achieved level of audit risk as being less than or equal to the planned level of audit risk, an unmodified opinion can be issued. If the assessment of the achieved level of audit risk is greater than the planned level, the auditor should either conduct additional audit work or modify the audit opinion (Messier et al., 2008). More importantly, at the completion of the engagement, the auditor again considers engagement risk and its component risks. The achieved levels of entity's business risk, audit risk, and auditor's business risk are combined to yield achieved engagement risk. The auditor ascertains if the achieved engagement risk is at an acceptable level (Colbert et al., 1996).

5. CONCLUSION

Previous accounting scandals and the collapse of Arthur Andersen denote the fact that implementing risk management strategies during the course of audit engagement is crucial for auditors or audit firms. An effective risk management processes can be achieved by assessing and managing each components of engagement risk throughout the audit engagement.

At the stage of the client acceptance and continuance, an auditor should assess the client’s business risk and auditor’s business with the aim of identifying potential risks that an audit firm may encounter. Based on the assessment of those risks, an auditor should set audit risk at a low level which in turn produces an acceptable low engagement risk for audit firm. If an auditor assesses engagement risk at an unacceptable high level, audit firms does not accept the client because high engagement risk elevates the risk of litigation, sanction or financial loss.

At the planning stage auditors utilize audit risk model to determine the nature, timing, and extent of the audit procedures. However, once a client is accepted, in addition to audit risk an auditor is also subject to auditor’s business risk which is not incorporated in audit risk model. During the process of applying audit risk model, auditor’s consideration of auditor’s business risk facilitates setting an acceptable low level of audit risk, in turn achieving acceptable low level of engagement risk. In order to conserve low level of engagement risk, it is appropriate for auditors to assign lower
audit risk and perform more extensive audit procedures for clients with relatively higher level of auditor’s business risk.

At the completion of audit engagement, in order to ascertain the achieved level of engagement risk it is essential to assess each components of engagement risk. Risk management at the completion stage, ensures to express an appropriate audit opinion and prevents to burden an unacceptable engagement risk to auditor or audit firm.

In conclusion, establishing, implementing and developing risk management strategy in audit firm is vital for survival of a company. Auditors should have knowledge about each components of engagement risk, understand the relation among them and have sufficient competence to manage each of the risks. Effective engagement risk management can be accomplished by assessing the engagement risk from the beginning to the termination of the audit engagement with the aim of retaining engagement risk at an acceptable low level. Otherwise, exposing to a high level of engagement risk may cause litigation, sanction, financial loss, impairment of reputation and even bankruptcy of audit firms.

REFERENCES: