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BUSINESS RISK APPROACH TO AUDITING AND COVID 19 CHALLENGES

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Abstract
The COVID-19 pandemic is an unparalleled public health emergency which has affected and still affects economies, both developed and developing. The pandemic has also had its toll on industries as well as the audit function. Considering the challenge of COVID 19 and given the nature of the audit process, this study examines the business risk approach to auditing amidst the COVID 19 challenges. In order to achieve the objective of this study, exploratory method of research design was adopted by reviewing various literatures relating to the objective in order to arrive at our conclusion. The study revealed that the COVID 19 challenges have impact on the business risk approach to auditing. The study recommends that auditors should make adequate investment in technology that is critical for effective service delivery and minimization of risk.

Introduction

The Corona virus (hereafter called Co-vid 19) has touched every aspect of life including the audit environment, especially the auditors which have posed another audit risk during the audit assignment. These following business risk can as well be faced by the clients which requires professional skepticism during the audit assignment but are not limited to: reduction in the demand for the clients products; reduction in revenue due to decrease in demand for the products and challenges encountered through the supply chain, reduction in the business market value and variation in financial market and decline in the liquidity position of the entity (Mbatuegwu, 2021).

Business risk arises due to different actions or circumstances which could lead to uncertainty that may bring the business into liquidation due to the inability to achieve their aims. Business risk can arise as a result of internal factors (this can be controlled by the entity) which include; the way the entity is structured and the various internal policies and processes and external factors (cannot be easily controlled by the entity but its effect can be minimized) in which COVID-19 can be categorized, (International standards on Auditing ISA 315). Any factor which militates against the achievement of business goals and objectives could be referred to as business risk, although, some risks can be trade-off especially through insurance.

The effectiveness of an audit exercise can be achieved through the approach which the firm adopted in carrying out the audit assignment, those approaches are fundamental factors that determine how the audit will be. Many audit firms face a lot of litigations that cost them much as well as damaged reputation due to their inability to adopt an appropriate audit approach during their audit exercise, as such the tendency of audit failure increases. An auditor needs to be painstaking when reviewing an audit engagement in order to take the right approach and strategy to handle every audit assignment thoroughly and effectively with minimal risk.

The auditor need to approach the various business risk professionally by observing the business thoroughly through the examination of all risks being faced by the clients and assess its impact in the financial statements being audited. Understanding the business risks which the client is being exposed to is very critical so as to know the impacts that those risks will have in the financial statements and as well help to identify the various going concern threat that the business might be facing at the same time. The auditor will need to come up with an appropriate audit procedures and strategies in line with the business risk identified, (Tonade and Adesanwo, 2017).

One of the assignments expected of the auditor at the planning stage of an audit exercise is to carry out an appropriate procedures relating to the risk of the audit as well as for the business in order to ascertain the risk of material misstatements in the financial statements. Although, the audit risk examination at the planning stage of the audit does not provide an audit evidence in which the audit opinion can be based but rather give a professional skepticism on the area which the auditor need to review thoroughly. During the stage of risk assessment by the auditor, there might be a need to make some inquiries with those charged with the management of the entity as well as others which could help in providing some details in identifying the risk of material misstatements which could arise as a result of the inspections, fraudulent acts and errors.

The coronavirus pandemic has changed various ways in which an entity operate both the auditor and the clients by operating remotely through the adoption of digital technology despite not being prepared for it. These has forced many audit firms if not all to adopt this new technology by digitalizing their audit procedures, which also results into the usage of virtual audit. Under the outbreak of COVID-19 pandemic, in order to improve the audit quality, there is need for the auditor to make the assessment of audit risks that could lead to the material misstatements of financial statements to be critical. As a result of the COVID-19 breakout, the probability of risk being increased is on the high side which will require the audit firms to step up their level of risk assessment due to the significant changes in businesses and economy at large which so many organizationd are struggling to cope with.

Statement of Problem

The COVID-19 pandemic is an unparalleled public health emergency which has affected and still affecting both developed and developing economies. The pandemic has also had its toll on industries as well as the audit function. According to Al-Aamaedeh and Alhosban (2021), the impact of the COVID-19 is one of the challenges being faced by the managements on how its effect can be treated and minimize in the financial statements as well as the auditor on the complexity of its audit procedure.

Considering the challenge of COVID 19 and based on the audit procedure, audit firms are faced with different obstacles during different audit exercise, in which two or more audit assignment might not have similar challenges. There so many dissimilarities in organisations in terms of impact of the pandemic on their operations, business sector, location, size, employees, governance issues, ethics issues, legal issues as well as difficulties in their operations.

There are different ways in which an audit firm can achieve best performance as relates to auditing. The possibility of not attaining the audit objective for a client can be reduced through the adoption of risk based audit by assessing the risk of material misstatements in the financial statements. This can be achieved by understanding the nature of business of the client and as well the environment in which the entity operates. The audit can make use of the strategy being referred to as top-down approach by focusing on the entity and its environment in order to identify the risks embedded in the business and the financial statements to be examined.

A new way of carrying out an audit exercise has emerged which will be referred to as digitalized auditing. Before the breakout of COVID-19, plenty of bigger auditing firms were in the process of digitalizing their audit process while the medium and smaller firms were planning to start. However, the pandemic itself forced them all to change to the new way of auditing. As such a cloud-based accounting was then put into practice immediately. With advent of covid-19, auditors will need to consider major challenges that the pandemic has brought such as challenges of remote work, changes in audit practices, technology and internal control which have possibility to impair the effective audit exercise apart from the business risk.

Regardless of the size of the audit firm, the way in which the auditors work has changed in the recent past due to the remote working system. As such there is need for regular staff training because of the fact that many of them work from home which might be difficult to adapt to the new way of conducting audit exercise from home. It has been seen that many of the firms have also started conducting the staff training remotely which include the training on the audit risk relating to COVID-19. Furthermore, most of the audit firms working remotely also conduct their regular departmental audit meetings online and also ensure that all staff is up to date by issuing periodic guidance to them. Technology advancement has really helped in achieving the objective of transitioning to remote work, which has made many firms to invest immensely on the technological tools and innovations.

Although technology capabilities of the audit staff as well as clients could pose a major obstacle to achieving the objective of remote work, some clients were able to overcome the challenge due to the professionals and their sophisticated instruments that they possessed while some were unable to. The effectiveness of the transactional data that is available with the clients will play a major role in transforming the audit process, (Nagpal and Knachel, 2021).

Theoretical Review

The theoretical foundations considered in this section are theory of inspired confidence, agency theory, stakeholder theory, the credibility theory and policeman theory.

The Theory of Inspired Confidence

Theory of inspired confidence was propounded by Limperg, a Dutch professor in the late 1920s. The theory explained the aspect of demand and supply of audit services. The objective of accountability is achieved with the preparation of financial statements; however, the need for audit service arises due to the independent demand for the examination of the financial statements in order to ascertain if there is any form of misstatement in the financial statement. Supply of audit services arises in order to satisfy the public confidence on the financial statements due to the audit and also fulfill the expectation of the stakeholders to the financial statements, as there is need for the independent examination and expert opinion on the findings by carrying out the audit functions which is due to the level of reliance being placed on the independent auditors' opinion.

If the confidence being placed on the independent auditor is lost, then the essence of the audit exercise will no longer be meaningful to the users of financial statements. The theory suggest that an auditor should comply with various professional criterias in order to maintain the independence from the firm being audited, for the purpose of satisfying the business practices and provide a credible audit opinion on the financial statements examined.

Agency theory

The agency theory was developed by Jensen and Meckling in 1976. The theory explained that the service of an auditor was to satisfy the interest of the stakeholders which are the third parties to the financial statements and also the managements. An agency relationship subsists between the agents known as the managements and the principal which are the owners of the business; in which the principal delegates the power of decision making to the agents. In most cases, there is always a conflict of interest between the agent and the principal. The principal may want to maximize share value while the agents may be interested in company growth. Hence, this theory focuses on the evaluation of the cost-benefit of the relationship between the principal and the agents.

Due to the decision made by the agents, the cost can arise, in recent times it could arise as a result of separation of ownership and controls, agency costs simply refers to the amount of money being borne by the principal for monitoring the affairs of the agents, which comprises of the bonding expense of the agent and the residual loss. As a result of maximizing the shareholders' value by incurring the beneficial agency cost, unwanted agency cost might arise due to the conflicting interest between the shareholders and the managements. Analysis of agency costs give an indication of how well an agent is discharging his responsibilities towards the principal, enabling the principal to observe and introduce controls to reduce any conflict of interest. As an organisation has many contracts, several parties, such as suppliers, employees which add value to the company for a given price, for their own personal interests; it is the agent's responsibility to optimize the contracts to maximize the value of the organization.

Stakeholder theory

R. Edward in 1984 detailed that Stakeholder theory posits that an organization can be successful in achieving their objectives by striving to do the right things at all time. The stakeholder theory contradicts the shareholders theory. According to shareholder theory, shareholders focus on the shareholders interest and their interest can be achieved at all times. As the shareholders primary objective is how their wealth can grow over time, shareholder theory eventually translates to a "make more profit" theory. This posits that corporate managers (officers and directors) should take into consideration the interests of each stakeholder in its governance process. This includes making efforts to reduce or mitigate the conflicts between stakeholder interests. It looks further than the traditional members of the corporation (officers, directors, and shareholders) and also focuses on the interests of any third party that has some level of dependence upon the corporation.

Credibility theory

The credibility theory was developed by Aristotle. The theory suggests that adding credibility to financial statements is an integral part of auditing, making it a fundamental service auditors provide to clients. Audited financial statements boost users' confidence in an organisation's financial records and management's stewardship; in turn, improving their decision quality such as, investment or new contracts, based on reliable information. This is because stakeholders need to have faith in the financial statements. The credibility gained by financial statements would affect decisions by stakeholders, Credit limits provided by suppliers and also helps shareholders put trust in management; reducing the 'information asymmetry' between stakeholders and management.

Policeman theory

The policeman theory asserts that the auditor is responsible for searching, discovering and preventing any fraudulent activity. However, the role of auditors is to provide reasonable assurance and an independent, true and fair view of the financial statements. Although, there has been more pressure on auditors to detect fraud after recent reporting scandals such as Enron, it can be argued that in modern societies, the users of statements want auditors to be responsible for fraud detection as they use audit reports to analyse and make decisions.

However, auditors are not responsible for finding all fraud but should improve their detection rate to instill public confidence. The primary responsibility of fraud prevention and detection rests with the management and the governance of an organisation; it is also important that more emphasis is placed on prevention of fraud. However, the auditor also has a duty of care to the end users of audit reports and should consider risks of material misstatements due to fraud when calculating audit risk.

Theoretical Framework.

The underpinning theory of the study is basically based on the inspired confidence theory which is chosen because of its relevance and suitability to the philosophy of the study. Furthermore, all auditors are expected to review any material misstatement or bias in financial reports to minimize both business and audit risk and to uphold the confidence of the public on auditor's opinion.

Empirical Review

The empirical reviews will be reviewed based on types of business risk, approach to business risk, merit and demerit of business risk approach to auditing and the implication. Kaka (2021) in an evaluation of the practical challenges auditors face in auditing financial statements of an organization in the light of COVID-19 revealed that research design was employed and secondary data sources were collected and used for his research. The paper found out that Professional associations, accounting and auditing bodies are monitoring issues and situations as they unfold that may affect the financial statements and audits reports due to the impact of COVID-19.

In a study of impact of Covid-19 social distancing outbreak on audit quality, Albitar, Gerged, Kikhia and Hussainey (2021) found that COVID-19 social distancing pose a severe impact on audit quality. In a related study, Al-Khasawneh, R. O. H. (2021) found that the Corona pandemic had a statistical effect on planning procedures, determining the level of materiality, auditing risks, and methods of collecting evidence, and affected the contents of the auditor's report in the light of the Corona pandemic.

Study by Syahputra and Saraswati (2020) in Indonesia, revealed that the effect of COVID -19 pandemic on environmental uncertainty has an impact on the quality of financial reporting. Al-Aamaedeh and Alhosban (2021) showed that the Coronavirus (Covid -19) has impact on external audit from the viewpoint of external auditors. Similarly, Jabin (2021) found a great impact of COVID-19 on the accounting profession in Bangladesh.

Adopting a Risk-Based Approach

Given the nature of the audit process, every audit assignment presents a different challenge to an audit firm, with no two audit assignments being the same. For example, no two entities are the same in terms of business sector, location, size, employees, governance issues, ethos, and complexity of operations. There is no one single approach to auditing which ensures the performance of a perfect audit.

Approach to Business Risk

The substantive procedures approach-

This is also referred to as the vouching approach or the direct verification approach. In this approach, audit resources are targeted on testing large volumes of transactions and account balances without any particular focus on specified areas of the financial statements.

The balance sheet approach

In this approach, substantive procedures are focused on balance sheet (statement of financial position) accounts, with only very limited procedures being carried out on income statement/profit and loss account items. The justification for this approach is the notion that if the relevant management assertions for all balance sheet (statement of financial position) accounts are tested and verified, then the profit/loss figure reported for the accounting period will not be materially misstated.

The systems-based approach-

This approach requires auditors to assess the effectiveness of the internal controls of an entity, and to direct substantive procedures primarily to those areas where it is considered that systems objectives will not be met. Reduced testing is carried out in those areas where it is considered systems objectives will be met.

The risk-based approach: In this approach, audit resources are directed towards those areas of the financial statements that may contain misstatements (either by error or omission) as a consequence of the risks faced by the business.

Merit of business risk approach to auditing

There a lot of advantages that will be accrued to both the audit firm and the clients when a business risk approach is adapted to the audit process: Investigation of business risk enables the auditors to have a profound knowledge of the business and focus the audit on the high-risk arena. The approach tends to involve partners and senior managers much more in the planning stages of an audit. Using a system-based audit approach is impractical, expensive and uneconomic in large companies' audits where the internal control environment is strong. Audit firms wish to be in forefront of innovation to attract clients. The business risk evaluation may show up areas which the audit firm can suggest other services that can be offered to the clients.

Demerit of business risk approach to auditing

Despite the various advantages highlighted above for the business risk approach to auditing, there are some demerits that can be faced during the process: The approach increases the level of risk to the audit firm. This requires the firm to have strong quality control procedure and to document all its processes. The process requires highly qualified and competent staff both at the planning stage and during the audit itself which negates some of the efficiency gains. Audit firms must be careful to maintain their objectivity and independence. The assessment of risk will undoubtedly require a close relationship with senior management and the development of mutual trust.

The implication of business risk approach for Auditing

Auditor needs to plan the audit (ISA 300) and develop a thorough understanding of the business. The planning process still needs an assessment of audit risk, the effect on planning may include: A consideration of the control environment. Is the control environment strong, including the assessment of the internal audit function? If it is not, business risk approach may not be appropriate. The 'top down' approach to the audit, beginning with business risk and ending with the financial statements. There is still a lack of clarity in the relationship between business risk and audit risk. The ideas of inherent risk and control risk have tended to merge into the larger concept of business risk. The ideas of inherent risk and control risk can be called residual risk which has to be minimized by audit action.

An audit action carries with it detection risk. The approach is very much a high level approach and should include consideration of all matters which are critical to the business. For example, 'could the client lose the XYZ franchise and what would be the possible consequences for the company and its financial statements?' Because of the high level of understanding required of a client's business it is possible to use analytical procedures more frequently as a procedure for verification of financial statement assertions. It is an aid to the firm's acceptance and continuation procedures for clients (do we want this client?). Business failure risk is an important aspect of overall business risk. The assessment of business failure risk will assist the auditor when considering the going concern status of the clients business. The audit needs to be tailor-made and a generalized approach to audits is neither productive nor economical. Auditors need more understanding of business and to that end, the larger firms set up larger databases of information about the economy and the business world. The concept implies a continuing relationship with the client rather than a one off view with each year being separate. The auditors must be sure that the internal control is strong.

This will require the validation of assumptions. The auditor cannot escape some level of substantive testing of items comprising the statement of financial position. The amount of testing carried out will depend on the risk each item in the statement of financial position is likely. Is there a risk of litigation against the company? Does any risk threaten the going concern statistics of the company?

Discussion on Business Risk and Audit Approach

The new risk that many businesses face in recent times which the auditor have to inculcate in their audit procedure in examining the business risk of their client is the effect of the COVID-19 pandemic. Since the World Health Organisation has declared a public health emergency in early 2020, which implies that the 2020 financial statement being audited will be affected with this declaration. Auditing such a client being affected will involve some level of challenges as well as risk of material misstatements in the financial statements. Dohrer (2020) suggested four areas which are very paramount for the auditor to consider when planning the audit of business risk of the client with the effect of COVID-19.

The first area is the Internal Control aspect of the business. As a result of the emergence of the pandemic, there has been order from the various governments for stay-at-home in which many businessmen work from home, which implies that the various processes of financial reporting has now being through virtual rather than in-person. This has raised issue of breakdown in internal control of such an entity which will definitely increase the business risk of the client. In this case, thorough evaluation of the internal control should be taken into consideration in order to be sure if it has not resulted into any material misstatements in the financial statement.

The second aspect is the Fraud risk which the pandemic itself has triggered. The auditor has to bear in mind with high level of professional skepticism with the reasons for the fraud; (pressure, opportunity and rationalization) which the potential staff can rely on for committing the fraud. The last aspect is the Non-compliance with the relevant laws and regulations during the pandemic era. There are lots of relief and programs being granted to many entities for their survival which has to do with conditions for proper utilization of the funds. Some of the entities might find it difficult to comply with the conditions being set. The complexity could lead to another business risk which the auditor needs to consider during the audit process.

Kutum (2010) carried out a study titled ‘the application of business risk audit methodology within Non-Big-4 firms’. The study emanated through the recent changes being adopted by audit firms in their audit approach which is referred to as business risk approach. The business risk audit approach was being influenced through the administrators of the larger audit firms as well as its recommendation through the auditing standards. The study concentrated on the non-Big-4 audit firms in three developed countries: United States, the United Kingdom and Canada. Semi structure interviews and a questionnaire survey was adopted to ascertain the reason for the adoption of business risk approach by the non-Big-4 firms as well as the merit and demerit of applying this approach in auditing process in the three countries under review. It was found from the study that the non-Big-4 firms in the three countries utilize business risk approach in their audit process in order to comply with the standards in the three countries as well as comply with the requirement of the industry.

The advantages in adopting the approach is in line with the previous studies which are making the audit exercise effective and also help in the area of managing risk. The major challenges uncovered were the cost of implementation to both the audit firm and their clients. It was recommended that there should be a modification to the standards regarding the adoption of the business risk approach by the non-Big-4 firms considering its cost and complexity.

Naibei, Oima and Ojera (2014) examined a moderating effect of business risk on the audit fee model among small audit firms using Kenya from the Western region as a case study. The study adopted a cross-sectional survey research design with 48 audit firms as population. Questionnaires were used to gather information from the firms using saturated sampling technique. It was found that there is an existence of moderating effect of business risk audit fee relationship which comprises of the audit duration and the size of the clients. It was concluded that the major factors that determine the audit fee are; size of the clients business, complexity of the clients business which could be as a result of the number of branches and subsidiaries they have as well as the audit size of the audit firm, all these further triggers the business risks which is the variable being moderated in the study.

The study recommended that the audit firm should always carry out a thorough assessment of the business risk of their client prior to the engagement of the audit exercise which could further enhance the audit fee as more resources will be employed to the more risky areas of the business in which appropriate fee will be charged for such activity.

Nguyen and Le (2020) conducted a study using Vietnam as a case study on the adoption of risk based audit approach in the independent audit firms. They made use of the combination of primary and secondary data collection method for two years 2018 and 2019. It was found from the interview conducted that all audit firms in Vietnam were aware of the benefits of adopting risk based audit approach. The Big-4 firms made use of the risk based audit approach more often than the non-Big-4 firms in Vietnam. The reason to the differences in the adoption of the approach by the Big-4 and the non-Big-4 was due to some of the features of the clients which could be accounted for as relevant rules and regulations, fees being charged for the exercise, the auditor’s experience and technical know-how. The study further analysed the data collected using appropriate statistical tools and the results show that there are six factors that trigger the adopting of risk based audit approach by audit firms and it includes: risk that the clients are exposed to, the fees being charged for the audit, auditor’s motivation, the ability of the auditor to carry out the risk assessment and the development of technology. It was concluded that the auditor's ability to examine the clients risk and the technological development are the main factors that contributed to the adoption of the risk based audit approach positively.

Arori and Ibrahim (2017) carried out a study with the objective of identifying the various factors affecting the strategy of conducting the business risk audit approach and also to ascertain the impact of such approach on the audit quality. The research also intends to know if the audit quality is independent of the business risk audit strategy or not. The researchers designed a questionnaire which was sent to four audit firms being used by commercial banks in Jordan as sample. Relevant statistical tools were adopted through the SPSS program to analyse the data collected. It was found that there is high level of adoption of risk based audit approach in the auditing of commercial banks in Jordan. It was also found that external auditors examining the Jordanian commercial banks has the understanding of the principle of business risk audit and its quality on audit.

Conclusion and Recommendation

Conclusion

In conclusion, as the auditor is required to focus on the entity and its environment when making risk assessments, auditors need to identify other risks and factors such as covid-19 towards adopting best approach for audit service delivery. Auditors are to identify the key day-to-day risks faced by a business, to consider the impact these risks could have on the financial statements, and then to plan their audit procedures accordingly.

Recommendation

Companies should recognize that audit plans are not set in stone. In a normal environment, auditors would reassess audit risks if there were company changes during the year. In this environment, many of the changes are driven by COVID-19, but companies recognize that things happen that must be evaluated and then worked through with the auditors. Auditors are to expect the unexpected because new issues will continue to arise, including fourth-quarter events, and they may result in business changes and changes to the risk assessment and audit approach. Auditor should have investments in technology which is critical for effective service delivery and minimization of risk.

There is no one-size-fits-all solution, an auditor should recognize that every client's system is a bit different. Auditors should take a different approach to up-skill, and harness technology that are bespoke for each client. Auditors need to know their clients thoroughly. To assess risk, auditors must understand the client's industry, operations, and capital structure. There must be a heightened awareness of clients' daily operating environments, business models, and how revenues are generated."

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