Engagement Risk: Perceptions And Strategies From Audit Partners

Jack R. Ethridge, (E-mail: jethridge@sfasu.edu), Stephen F. Austin State University
Treba Marsh, (E-mail: tmarsh@sfasu.edu), Stephen F. Austin State University
Bonnie Revelt, Stephen F. Austin State University

ABSTRACT

The audit function creates several important relationships among the various parties. One of the significant and potentially problematic relationships is between the audit firm and the audit client. The decision by the audit firm to accept or retain a client is crucial because of the potential risk of being associated with certain clients. The potential damage can range from financial loss and/or loss of prestige to the ultimate demise of the audit firm. Engagement risk is considered to be composed of three components: entity's business risk, audit risk, and auditor's business risk. This research questioned whether audit firms have significantly changed their views regarding engagement risk and how they evaluate and manage this risk. An analysis of the surveys revealed that 83% of the respondents believed their views regarding the importance of engagement risk have changed, but only to a moderate degree. In evaluating engagement risk, audit partners considered management integrity in general, management integrity toward fraud, and the presence of the elements of the fraud triangle to be the most important factors. Assignment of more experienced audit staff and increased substantive tests of account balances were the most frequently used mitigating strategies. Based upon these results, which were consistent with our previous study, it appears there have not been significant changes in audit partners' views regarding the importance of the client acceptance/retention decision.

INTRODUCTION

Risk is a concept that can be applied to various situations an individual faces in the ordinary course of making decisions. Auditors face various risks including the significant decision to accept/retain audit clients. This risk, identified as engagement risk, can potentially cause a loss of reputation or financial loss to an audit firm. Accordingly, evaluating engagement risk is an integral part of the audit process. Assessing engagement risk requires the exercise of due professional care and directly impacts the overall risk of an audit (Colbert, Luehlfing, and Alderman 2005). Therefore, it is important to understand an audit firm's evaluation process because of its impact on the audit. This paper investigates the current perceptions and attitudes of audit partners responsible for the client acceptance/retention decision. Furthermore, this paper assesses how the audit partners' perceptions of engagement risk have changed due to recent events, their responses to these changes and how their firms respond to these changes.

ENGAGEMENT RISK PROBLEMS

There are two main questions an audit firm should ask when evaluating engagement risk:

1. Which clients do they want to accept and/or retain?
2. What is the potential impact of associating with those clients?

The answers to these questions should be fully evaluated before performing any audit work. Johnstone and Bedard (2003) state that "client acceptance decisions are increasingly important due to continued fee pressure and litigation risk, which make it essential that audit firms carefully consider the potential benefits and costs of association with prospective clients." Are client acceptance decisions being made for the right reasons? In pre-Enron days, competition may have been the driving force of why audit firms ignored the risk associated with new clients. Firms were more concerned with the profitable outcomes than with the integrity of the client (Johnstone and Bedard 2003). Now firms should question if the costs are out weighing the benefits of accepting certain clients. After the fall of one of the largest accounting firms, Arthur Andersen, it is assumed that firms would be more concerned about their reputation than their financial standing. Audit firms need to examine all areas of their prospective clients, especially high-risk areas, in order to avoid future failures (Venuti, Holtzman, and Basile 2002).

The AICPA (1994) states that engagement risk is composed of three components: entity's business risk, auditor's audit risk, and auditor's business risk. Each component can be assessed on its own during the acceptance phase as well as during the engagement. This assessment is necessary for audit firms when analyzing engagement risk.

Entity's Business Risk

The risk that an entity will not be profitable and/or continue to survive is an entity's business risk. The entity's business risk could be due to changes in the external environment, industry and/or lack of management integrity (Colbert, Luehlfing, and Alderman 2005). Johnstone's (2001) study indicated financial trends are the most important part of the entity's business risk. Auditing firms can only assess this risk and decide whether or not to accept the risk.

Auditor's Audit Risk

The second component of engagement risk is audit risk. Audit risk is "the risk that the auditor may issue an unqualified opinion on materially misstated financial statements (AICPA 1983, AU 312.02)." There are certain factors that will impact the level of audit risk. These factors include a high volume of significant year–end transactions, financial reports not prepared in a timely manner (i.e. inherent risk) and material weaknesses in internal controls (i.e. control risk) (Colbert 1996). More experienced audit partners tend to rank management's attitude toward internal controls as the most important audit risk factor (Johnstone 2001). These factors may not be detrimental to the client, but the issuance of an unqualified opinion when not justified can be devastating to an audit firm.

Auditor's Business Risk

Auditors face risk because they provide services to clients; thereby exposing their business to risk. Auditor's business risk is composed of all risk of associating with a potential client such as litigation cost, loss of reputation and the inability to recover audit fees. An auditor's business risk is controllable; therefore, if analyzed correctly, auditors can mitigate their own risk.

Professional standards exist to make audit firms establish procedures for mitigating risk (Johnstone 2001). According to Colbert, Luehlfing, and Alderman (2005), lawsuits and changes in the client's auditors are two of the reasons why this risk exists. Johnstone and Bedard (2003) proposed the following methodologies to manage business risk: using specialists, utilizing different billing strategies (higher fees), varying audit techniques and implementing specific monitoring policies.

OBJECTIVES AND METHODOLOGY

Results of previous research appear to indicate that audit firms were not as concerned about the level of engagement risk as they should have been. Therefore, the primary objective of this research was to investigate whether audit firms have significantly changed their approach to making client acceptance/retention decisions. To study this issue, a questionnaire was developed to determine if audit partners' attitudes about engagement risk have

changed and how the partners evaluate and manage engagement risk. To test the questionnaire, a preliminary study was conducted (Ethridge, Marsh and Canfield 2005). Based upon an analysis of the first study, the questionnaire was revised to include more details about client business type and expand the factors for entity's business risk and auditor's audit risk. In addition, strategies for mitigating risks were added or modified. The questionnaire was mailed to a national sample of potential audit partners resulting in a response rate of 19.7%. The response rate was considered adequate for the final phase of this study.

RESULTS

Table 1 provides a profile of the respondents. Ninety percent of the respondents were male with an average certification time of 23 years and an average of 25 years experience. The average age of the respondents was 49. Ninety-three percent of the respondents were either an auditing partner or managing partner and had the authority to make client acceptance/retention decisions. A profile of the audit firms is shown in Table 2. The majority of the firms were small to medium size with 98% of firms having 500 or fewer personnel and 78% having 100 or fewer professional audit staff personnel. Audit revenue, as a percentage of total revenue, was between 5 and 50 percent for approximately 75% of the firms. The predominant client base was other-for-profit (not SEC), governmental and other not-for-profit entities. Within the other-for-profit category, the types of firms varied to include transportation, consumer business, energy, healthcare, manufacturing, real estate and financial services. Therefore, we believe there was an appropriate representation of experienced and qualified audit partners who understood the issues and had the ability to address our questions of interest. In addition, the audit partners' experience appeared to represent a wide variety of business organizations.

Table 1: Respondent Demographic Profile	
Gender	Male 90% Female 10%
Age	average of 49 yrs.
Years Certified	average of 23 yrs.
Years Experience	average of 25 yrs.
Employed Positions	Managing Ptr. 14% Auditing Ptr. 79% Manager 4% Other 3%
Involved in Acceptance/ Retention Process	Yes 97 % No 3%

Table 2: Audit Firm Profile					
Size of firm	1-9	10-50	51-100	101-500	>500
	3%	48%	27%	20%	2%
% Audit Rev.	5-25%	26-50%	51-70%	71-90%	91-100%
	17%	58%	22%	3%	0%
Client Base	**SEC**	**Govt.**	**Health Orgs.**	**Other For-Profits**	**Other Not-for-Profits**
	1%	18%	2%	65%	14%

This study had three major areas of focus. The first area was to determine audit partners' perceptions regarding engagement risk, standards and procedures in place to evaluate engagement risk and the perceived riskiness of an audit firm's client base. Second, the study investigated the relative importance of the three major components of engagement risk. Finally, the study investigated various strategies being used to mitigate these risks and the strategies perceived effectiveness.

As indicated in Table 3, 83% of our respondents' perceptions of engagement risk have changed. However, the average degree of change was 3.34 on a 5-point scale from not extensive change (1) to very intensive change (5). Therefore, the change in audit partners' views would be considered to be slightly more than moderate. This finding is consistent with our preliminary study where 85% indicated a view change with a 3.29 average degree of change. As indicated in the Table 4, 90% of the respondents have standards in place to address client acceptance/retention decisions. However, the standards were considered to be only somewhat extensive.

Table 3: Perceptions Of Engagement Risk					
Engagement Risk Views Changed	Yes: 83%	No: 17%			
Degree of Changes	**Slight (1)**	**(2)**	**Moderate (3)**	**(4)**	**Major (5)**
	2	13	48	34	9
Average Response	3.34				

Table 4: Existence & Extent Of Engagement Risk Procedures					
Existence of Firm Specific ER Procedures	Yes 90%	No 10%			
Extensiveness ofProcedures	**Not (1)**	**(2)**	**Somewhat 3)**	**(4)**	**Very (5)**
	3	13	44	39	8
Average Response	3.34				

The degree of audit partners' view changes and the extensiveness of the procedures were somewhat surprising given our belief that attitudes about engagement risk would have changed since the reporting of numerous accounting scandals. A possible explanation for this outcome could be derived by investigating how audit firms evaluate and analyze their clients. As indicated in Table 5, only 64% of audit firms classified their client by risk categories (low to moderate to high). Of those audit firms who classified by levels of risks, the firms rated approximately 92% of their clients as low to moderate risk. Is there a correlation between the perceived risk level of your clients and the extensiveness of standards? One could reasonably assume the answer to be yes. Accordingly, one could be satisfied that the audit firms have in place the appropriate level of procedures to match the potential risk of their clients. However, there are approximately one-third of the audit firms who did not indicate they were classifying clients by risk; therefore, the extensiveness of the audit firm's procedures may not be appropriate for the level of client risk actually present. In a related issue, 27% of the respondents indicated they have reevaluated and changed the risk classification of their client base. A couple of observations may be made. First, we hope, this small change in the number of audit firms reevaluating their clients was due to rigorous processes already in place by the audit firms. Second, it is hopeful that audit firms are recognizing their clients may be riskier than first perceived and are not taking on more risky clients without considering the potential consequences.

Table 5: Perceptions Of Audit Firm's Client Risk Base			
1. Classify client as Low, Moderate, High	Yes 64% No 36%		
2. If yes to 1, % classified as:	**Low**	**Moderate**	**High**
	58	34	8
3. % Classification Changed since late 90s:	Yes 27% No 73%		
4. If yes to 3, changed to:	Less Risk 29% More Risk 71%		

The final area of the research project investigated how audit firms evaluate engagement risk and what strategies they use to mitigate these risks. As indicated previously, engagement risk has three components: entity's business risk, auditor's audit risk, and auditor's business risk. Specific factors were identified for each major

component and the respondents were asked to rate the relative importance of the factor on a five-point scale from very unimportant (1) to very important (5).

As indicated in Table 6, auditor's business risk was rated the most important overall factor followed by audit risk and entity's business risk. This was the same ranking as in our previous study. However, the perceived importance of each major component was slightly lower than the earlier project. The ranking of auditor's business risk as the most important was not too unexpected since the primary responsibility of the audit partner is to understand how their association with a client will impact their firm. However, as will be discussed in more detail later, the entity's business risk factors appeared to play a major role in evaluating engagement risk. In addition, the results were different from Johnstone (2001) where audit risk was ranked the most important component of engagement risk.

An analysis of the individual factors of each major component was conducted to determine their significance to the evaluation process. The highest rated factors were found within the audit risk component of engagement risk. As suggested from our previous research, client management integrity was broken into two types: client management integrity (general) and client management integrity (toward fraud). The results reveal audit partners considered management integrity (both categories) to be the most important factors for evaluating engagement risk. This appears to be consistent with the fact that management integrity plays an integral part in establishing the control environment for an organization. The organization's control environment has a direct impact on inherent risk and control risk. Therefore, this appears to be in line with the Johnstone and Bedard's (2003) study in which experienced partners tended to rank management's attitude toward internal controls as an important audit risk factor. Furthermore, within the audit risk component, client's corporate governance structure was ranked last, followed closely by client's control environment and internal control structure. The last two factors were added as results of our preliminary study. This appears to be somewhat inconsistent due to each factor's impact on inherent and/or control risks. However, management integrity directly influences these factors. If the auditor is satisfied with management's overall integrity, it could be assumed that these factors were in place with the appropriate levels of effectiveness.

Table 6: Importance Of Components of Engagement Risk

ER Components:	**Mean Response**
Entity's Business Risk:	
Client Financial Solvency	4.18
Client Risk Appetite – Tolerance for Risk	3.92
Client Specific Risk	4.10
Industry Specific Risk	3.82
Presence of Elements of Fraud Triangle	4.17
Client Earnings Manipulation Risk	4.13
Mean CBR	**4.06**
Audit Risk:	
Client Management Integrity – General	4.66
Client Management Integrity – Toward Fraud	4.46
Client Corporate Governance Structure	3.62
Client Internal Control Structure	3.68
Client Control Environment	3.77
Client Audit History	4.14
Mean AR	**4.09**
Auditor's Business Risk:	
Effect of Firm's Reputation	4.22
Effect on Firm Solvency	4.22
Client Reputation	4.20
Mean ABR	**4.21**

Four entity's business risk factors were rated four or higher by the respondents. They were financial solvency, presence of elements of the fraud triangle, earnings manipulation and client specific risks. Financial solvency and potential earnings manipulation may have a direct impact on the ability of the organization to continue as a going concern. Going concern issues should always raise a red flag for an auditor. In addition, concerns about earnings manipulation should be a top priority because of potential problems associated with revenue recognition. Since emphasis on fraud is prevalent in the current environment, it is not unexpected that searching for elements of fraud should be of extreme importance to the auditor.

Finally, all three factors of auditor's business risk were rated four or higher. As indicated earlier, the importance of auditor's business risk is of great concern to the audit partners because it impacts the firm's image and financial health. However, it is the factors of the other two components that determine the riskiness of the client and how the audit firm is ultimately affected.

Audit standards require firms to have procedures in place to evaluate potential clients. As indicated earlier, 90% of the respondents have procedures in place to evaluate the acceptance/retention decision. Once a decision to accept/retain a client has been made, the next step should focus on what strategies are used by an audit firm to handle or mitigate any potential risks associated with the client.

Specifically, the respondents were first asked if the strategies listed in Table 7 were used to mitigate the risk of being associated with a client. If the procedures were used, the respondents were asked to rank the strategy on a five-point scale from being very ineffective (1) to very effective (5). The results indicated the assignment of a more experienced audit staff and increased substantive testing of account balances were the most used strategy (98%) with a more experienced audit staff being consider the most effective of all the strategies listed. The second most frequently used strategy was a change in the predictability of audit procedures. However, this procedure was rated less effective. The results indicated a specialist was not frequently used; however when used, the strategy was considered fairly effective. Communication with the client's previous auditor was used by 75%, implying that auditors seek the reason(s) why the client changed auditors. The relative effectiveness of this strategy appears to be marginal. Increased test of controls was used by 75% of the respondents with questionable effectiveness. Finally, about two-thirds of the respondents used increased fee structure or fee collections as a strategy with limited effectiveness.

Table 7: Specific Engagement Risk Strategies And Effectiveness Evaluation

	% of Respondents Using This Strategy	Very Ineffective (1)	Ineffective (2)	Neutral (3)	Effective (4)	Very Effective (5)	Average
Use of a Specialist	36		1	8	23	8	3.95
Increased Fee Structure	65		3	29	37	2	3.54
Indemnification or Hold-Harmless Agreement	38		8	19	13	2	3.21
Assignment of More Experienced Audit Staff	98			4	82	24	4.18
Increased Test of Controls	75		1	10	24	4	3.79
Increased Substantive Test of Account Balances	98		1	4	34	12	4.12
Change Predictability of Audit Procedures	77			15	20	5	3.75
Aggressiveness in collection of fees due	66		4	41	23	4	3.38
Extensive communication w/previous audit firm	75	2	7	36	35	5	3.40

SUMMARY AND CONCLUSIONS

The client acceptance/retention decision is an important part of the audit process because accepting the wrong client can be costly to an audit firm. Accordingly, this study was interested in determining the view of audit partners who were primarily involved in and responsible for this process. The study investigated whether the attitudes and procedures for evaluating engagement risk have changed substantially in the post-Enron era. The study assumed there would be an increased awareness of the importance of this process. An overwhelming majority of audit partners indicated their views regarding engagement risk have changed; however, the level of change was not overly significant. It was interesting to note that auditors understand the significance of their clients' management's integrity and its impact on the organization and the audit process. We hope audit partners understand the importance of evaluating engagement risk and that any change in the environment would have little impact on this process.

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