

Auditor's business risk and audit regulation – in the light of research

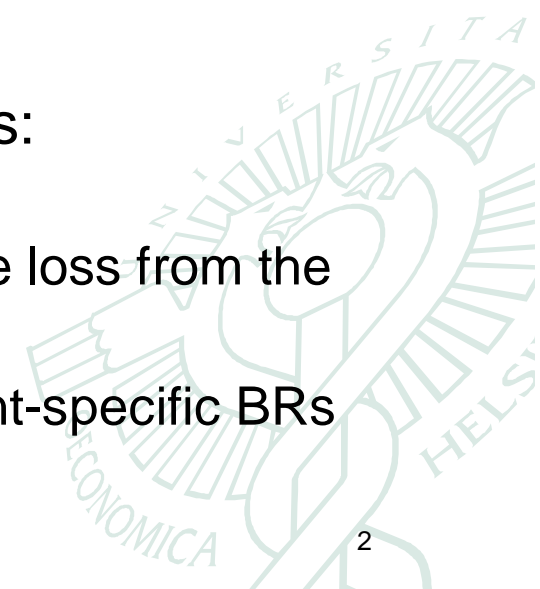
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Auditor's business risk (BR)

- How should it be priced?

- Definition of BR:
 - risk that the auditor suffers a loss from accepting to audit the client (-> BRs are client-specific)
- BRs can be fatal
 - (e.g. bankruptcy of Laventhol&Horwath, 1990)
- Two components of client-specific costs:
(Simunic, 1980; Simunic& Stein, 1996):
 - Resource costs + expected value of the loss from the audit
 - > hourly billing rates should reflect client-specific BRs



Findings on BRs - How auditors react to BRs?

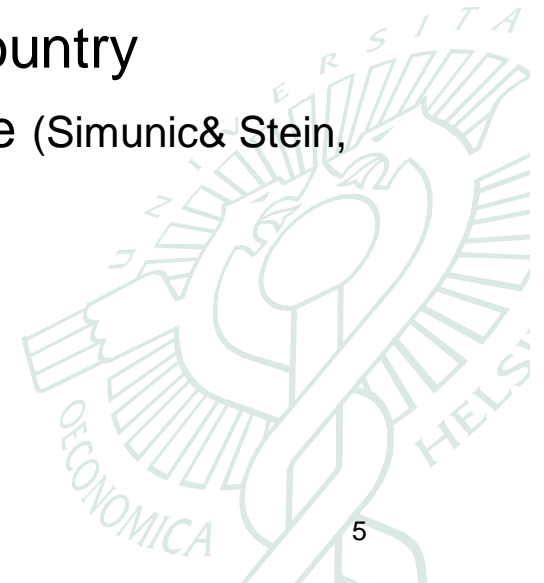
- Client attributes related to BRs
(e.g. Lys & Watts, 1994; Pratt & Stice, 1994; Hellier-Monroe-Woodliff, 1996)
 - Outsider's reliance on financial statements (listed firms)
 - Likelihood of financial distress
 - client management behaviour
 - Risks related to client operations
- In experiments fees are risk-adjusted...
(e.g. Pratt & Stice, 1994; Houston- Peters-Pratt, 1999; Johnstone & Bedard, 2001)
- ... but actual fees are not. Auditor's do react to BR but by increasing effort, not by adjusting billing rate
(Wallace, 1989; Simunic & Stein, 1996; Bell-Landsman-Shackelford, 2001; Niemi, 2002)

Possible obstacles for risk adjusted billing rates:

- Difficult to measure - > price accurately
- Difficult to anticipate changes in client's financial condition
- Client fee pressure against increases in billing rates:
 - Your performance has decreased so we need to raise our billing rate
- 'vagueness' and unanticipated changes in liability & negligence regime (Moizer & Hansford-Smith, 1998)

Regulation and BRs in auditing

- Regulation has an impact on audit costs through
 - Liability regime => litigation pressures
 - Disclosure (financial statement) requirements => risk exposure
 - Significant differences between countries (Taylor & Simon, 1999)
- Differential effect also within a single country
 - Change in audit costs -> auditor change (Simunic & Stein, 1996)



BRs and economic crisis - Why audits fail?

- *'Why do audits fail? Evidence from Lincoln Savings and Loan'* (Erickson-Mayhew-Felix, 2000):
 - Increasing transaction based auditing work would likely not helped the auditors to realize that the results were 'too good to be true' but understanding the prevailing economic trends in the client's industry
- Standards on professional judgements
 - challenging but essential to develop stds that help auditors in professional decision making
 - Regulation on guidance has less differential impact on audit costs than that e.g. on liability/negligence regime