A Comparison of Risk-Based and Traditional Auditing and their Effect on the Quality of Audit Reports

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ABSTRACT: The purpose of the present research was to compare risk-based and traditional auditing and their effect on the quality of audit reports. The sample consisted of 80 senior managers, supervisors, and auditors of Iran’s Audit Organization. A questionnaire rated on the 5-point Likert scale was used to assess the participants’ view on 4 subscales: validity, quality, reliability, and closeness to reality. The results of t-test showed that risk-based auditing creates significantly more valid and more reliable audit reports than traditional auditing. Also it was shown that risk-based auditing is not closer to reality than traditional auditing. It can thus be concluded that risk-based auditing can gain the trust and confidence of the users of audit reports.

Keywords: Risk-based auditing, traditional auditing, quality of reports

INTRODUCTION

Until three decades ago, auditors tried to reduce audit risk through extensive content tests, but development of organizations and the increasing volume of their activities made difficulties for auditors. However, advancement of information technology and the sciences of mathematics and statistics allowed auditors to predict and determine audit risk and its components (inherent risk, control risk, and detection risk) (Arjmandi, 2001). The auditor assesses the inherent risk and control risk and then solves the audit risk by assigning detection risk. By determining detection risk, auditors can identify the appropriate nature, timing, and extent of substantive testing for covering audit risk. This procedure identifies the accounts that have higher audit risk and require further investigation. Despite these advancements, current auditing procedures have shortcomings and auditors are searching for new, more reliable methods with faster and more accurate results (Moradi&Pourhosseini, 2009; Khodada4, 1996).

Risk-based auditing is a new approach to the practice whose aim is to improve the quality and effectiveness of audits, since determining the appropriate nature, timing, and extent of substantive testing allows for higher quality audits at shorter time. Substantive testing is limited where there is internal control reliance and extensive where there is no internal control reliance (Forsati, 2002).

Risk-based auditing is the process of identifying and reporting the risk of significant distortions in financial statements. This approach not only increases the value of the product (financial statements), but also makes auditing more profitable. In other words, risk-based auditing satisfies both the managers and the auditors (Smith, 2006; Harrington, 2004). In this approach, the auditor first examines the accounting and internal control systems (through written narratives, questionnaires, and flowcharts, and by performing a walk-through test), and then estimates inherent and control risks. Initial estimates of inherent and control risks help the auditor in determining the reliability of the internal control system. If the internal control system is effective, the auditor performs the tests of control. The results can adjust and finalize the initial estimates of inherent and control risks (Moradi&Pourhosseini, 2009).

The new methodology allows auditors to control risk at an acceptable level, thus achieving a high level of reliability while reducing time and cost of auditing. Given the importance of this new auditing approach, it is imperative to examine and compare it with the traditional auditing approach (Kratchman et al., 2008; Blay et al., 2008).
In general, audit procedures have tremendously changed over that last decade, and there has been a shift from traditional auditing to risk-based auditing. This approach determines organizational risks, allowing for optimal use of rare audit resources, higher agreement between internal audits and management goals, facilitation of organizational development, and reduction of potential risks. Considering the increasing importance of risk-based auditing in organizations, the purpose of the present research is to study the views of experts regarding traditional and risk-based auditing.

**Methodology**

The sample of the research consisted of 80 senior managers, supervisors, and auditors of Iran’s Audit Organization. A questionnaire was developed and used to examine the views of the participants regarding risk-based and traditional audit approaches. It included four components—i.e. validity, quality, reliability, and closeness to reality—and was rated on the 5-point Likert scale. Reliability of the questionnaire was calculated to be 89% using Cronbach’s alpha, and its validity was confirmed by the experts. Descriptive statistics and Student’s t-test were used for data analysis at the 0.05 significance level using SPSS 19 software.

**RESULTS**

Figures 1, 2, and 3 respectively show the frequency chart of education, audit experience, and job of the participants.
The results of t-test showed that risk-based auditing produces significantly more valid audit reports than traditional auditing \((t(44) = 4.16; p < 0.05)\). Moreover, risk-based approach produces significantly higher quality reports than the traditional approach \((t(44) = 1.90; p < 0.05)\). Risk-based auditing also significantly increases the reliability of audit reports compared to traditional auditing \((t(44) = 2.89; p < 0.05)\). Finally, the results indicated that risk-based audit reports are not closer to reality than traditional reports \((t(44) = -0.391; p = 0.630)\).

**DISCUSSION AND CONCLUSION**

The results of the present research showed that risk-based auditing can increase the validity and reliability of audit reports. If necessary standards are met, this approach can also increase the quality of the reports. However, there was no significant difference between risk-based and traditional auditing approaches in closeness to reality.

Considering the present findings and the results reported by previous studies, it is clear than risk-based auditing considerably increases the confidence of users of financial statements, reduces potential errors and distortions, reduces the costs of auditing, and increases the validity and reliability of audit reports. Therefore, it is recommended that audit firms use this approach in their audit practice.

Generally, risk-based auditing focuses on audit risks, i.e. inherent risk, control risk, and detection risk. Inherent risk is the risk involved in the nature of business or transaction. Control risk refers to the risk that a misstatement could occur but may not be detected and corrected or prevented by entity’s internal control mechanism. Detection risk is the probability that the audit procedures may fail to detect existence of a material error or fraud.

Risk-based auditing takes a step further than traditional auditing and not only focuses on audit risks, but also highlights business risk. That is because business risk can affect the profitability and even survival of a firm. This increases pressure on management to misstate financial results and result in decreased resources devoted to accounting for transactions. Thus, client business risk increases the propensity for misstatements from fraud and/or error and also increases the auditor’s business risk, e.g., as proxied by engagement profitability and potential litigation (Bedard, 2002).

Another explanation for the differences between traditional and risk-based auditing is that traditional auditing is like a game of chess where the players sit across the table and look at the game (client’s business) from their own perspective. However, in risk-based auditing, the auditor and the client are both at one side, and in this situation the client (management) has a partner.

Consider a contracting company. In traditional auditing, auditors make decisions primarily based on importance which is, in this case, a portion of the operations of the contractor. Since in this type of accounting the focus is on recording the entries of financial statements, internal controls of the company are not effectively evaluated. In the end, the auditor proves that which the company already knows, i.e. what profits and losses the

Figure 3: Job of the participants.
company has made. Then, the company receives an invoice from the auditor and this process is repeated next year.

Due to the poor internal control of some Iranian firms, the above approach may prove to be effective. It must be noted, however, that a poorly controlled environment has considerable risks that must be the focus of attention of the management. In this situation, risk-based auditing identifies the weaknesses and helps the management to take proper measures in reinforcing the internal controls. Further research is required to examine how the lack of specific standards in risk-based auditing or the lack of auditing software has hindered its development in Iran.

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