Application of the Business Risk Audit Model: A Field Study

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SYNOPSIS: After confronting unprecedented challenges in the last decade, accounting firms have undertaken extensive effort to improve the basic financial statement audit and to expand external assurance beyond the traditional audit. The reexamination of audit methods has produced a new emphasis on assessing business and process risks in the conduct of an audit. This paper describes the fundamental changes in the audit process and examines their impact in an actual engagement. We first identify outcomes that we expect to observe in an audit based on the business risk model and then study an actual engagement to gather preliminary evidence about our expectations.

The engagement used in this study is the 1997 audit of the Czech bank Československá Obchodní Banka (ČSOB). Important observations about the new audit process included changes to the audit team structure, changes in administration and timing of the engagement, changes in the risks addressed during the audit and the evidence gathered, increased assurance to the client, and increased opportunities for value-added services. Although the generalization of results from a field study is constrained, this study identifies expectations and effects that can be examined in future larger sample studies.

The conceptual aspects of this paper benefited from discussions with Tim Bell and Jeff Arricale (KPMG). The field study portion of the paper benefited by the active involvement of the ČSOB audit teams in Prague, Czech Republic, and Bratislava, Slovak Republic. Audit team members who deserve special recognition include Mason Tokarz, František Dostálek, Barbara Lightstone, Jiří Kovář and Carol Solberg in Prague; Michele Lodi-Fe, Eugene Douglas, and Erik Barden in Bratislava. The paper also benefited from input at workshops at the Norwegian School of Economics and Business Administration, University of Florida, the University of Auckland, the University of Amsterdam, and the University of Maastricht. Grateful acknowledgment is also made to KPMG and the Fulbright Grant Commission, which provided funds for Professor Knechel's stay in the Slovak Republic while teaching at Ekonomická Univerzita.

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INTRODUCTION

Current trends in auditing are creating new challenges for the profession, leading to the development of new methods and services. Audit practice has evolved in recent years due to unprecedented market pressures including market saturation, “commodity” based pricing, pressure to reduce substantive testing, focus on value-added assurance and increasing costs from training, technology, and litigation. As a consequence, many large accounting firms concluded that the audit process needed new skills, techniques, and service deliverables. Initial efforts to redesign the audit process focused on: (1) reducing or shifting costs, and (2) increasing the value of the audit, leading to changes in staffing and recruiting, specialization by industry, reduced reliance on substantive testing, increased emphasis on qualitative and analytical evidence, and mounting investments in technology assets. Small changes in audit practice eventually became radical and pervasive, as can be seen in KPMG’s BMP audit methodology, Arthur Andersen & Co’s Business Audit and Ernst & Young’s Audit Innovation efforts, among others.

This paper discusses some of the fundamental changes in the audit process and examines their impact in an actual engagement. Instead of focusing on a narrow view of audit risk, auditors are now urged to consider a broad array of risks potentially affecting a client organization. Audit techniques based on the analysis of business and strategic risk are relatively new to the profession and firms are still wrestling with how to implement such methods. A major challenge to auditors is linking the knowledge gained about client strategy, competitive advantage, and business risk to the fairness of the financial statements. This study examines how the business risk audit model impacted an actual audit engagement. We identified outcomes that we expect to observe in engagements using business risk audit methods and tested our expectations by gathering evidence from an actual audit.

CONTROL, ASSURANCE, AND THE FINANCIAL AUDIT

Poor decisions, information breakdowns, or fraudulent activity may result when employees, management, or other stakeholders take improper or incompetent actions that adversely affect an organization. Problems can also arise from ineffective responses to strategic risks, such as a failure to identify and properly react to changes in the business environment, or misalignments between strategic objectives and business processes. Control processes within an organization attempt to alleviate these problems.

External assurance—the “audit”—can be considered a specialized form of control, and the demand for auditing or other forms of external assurance is conditional upon the business risks facing an organization and the methods available to control them. The extent to which the external auditor is viewed as a source of assurance depends on the auditor’s ability to reduce critical risks. Anecdotal evidence suggests that the traditional financial statement audit is losing value because the information associated with the auditor’s report is not timely or useful (Elliott 1994). Moreover, since owners have many different types of control available for managing risk, the external audit may satisfy regulatory requirements without augmenting organizational control.

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1 For example, a study by Hackenbrack and Knechel (1997) using data from KPMG for the period 1992–1993 revealed several potential inefficiencies and anomalies in the audit process of the time.
2 This conclusion is consistent with the Report of the Special Committee on Assurance Services (the Elliott Committee) (see AICPA 1996).
3 Also, see the description of PricewaterhouseCooper’s methodology in Winograd et al. (2000).
4 For example, see Knechel (2001) and Bell et al. (1997).
The auditor's challenge is to maximize the value of the core audit service, while expanding the value of external assurance. Auditors should improve their acquisition of client knowledge to provide a more effective audit founded on more comprehensive and relevant audit evidence. Bell et al. (1997) argue that auditing should evolve to a strategic systems view of the organization and focus on the organization's strategies, threats, and responses to risks. Figure 1 depicts such an audit as an ongoing and iterative process of analyzing risks, measuring outcomes, updating risk assessments, and fostering continuous improvement. Logic suggests that many significant business risks have direct relationships to audit concerns. Financial statements are validated with a thorough understanding of client business risk that supports audit conclusions about financial statement assertions. The auditor's expanded knowledge can also be used to increase the scope and value of assurance provided to the client and stakeholders.

FIGURE 1
An Overview of the KPMG Audit Process: BMP*

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* Source: Bell et al. (1997, Exhibit 4, page 34).

This emphasis on understanding the client's business and related risks is gaining acceptance as auditors move away from the self-limiting focus on financial reporting and focus more on strategic risks, business processes and controls, transaction processing, and the evaluation of accounting estimates. Figure 2 illustrates the knowledge acquired in a business risk approach to the audit. Based on this structured approach to risk assessment and evaluation, the auditor reaches conclusions about residual risks that may be significant to the audit.

Although knowledge about business conditions and processes is important, the auditor must also recognize that residual business risks usually have implications for the conduct of the audit. An organization that does not adequately monitor its strategic risks or fails to respond to identified risks is more likely to have difficulty succeeding. High residual business risks may indicate weaknesses in the control environment (e.g., incentives to manipulate earnings), signal potentially high control risks for specific processes, or point to assertions that may be misstated. Residual business risks can be
analyzed for their relationship to specific financial assertions and audit objectives. The auditor then designs substantive tests to evaluate whether the assertions in question are materially misstated. Because of the extensive knowledge acquisition (evidence) used to assess business risks and their links to audit risks, only limited substantive testing may be necessary for many assertions/objectives. Additionally, high residual risks signal areas of client need that the external accountant may help improve and/or expand assurance to the client.

**RESEARCH EXPECTATIONS**

We expect to observe the following differences in the conduct of a business-risk-based audit:

- **Expectation 1—Risk Assessment:** We expect to see explicit consideration of many strategic and process risks that were not factored into prior audits. We also expect that some audit risks previously considered important to the engagement will be downgraded.
- **Expectation 2—Audit Evidence:** Due to the importance of controls and performance measures in assessing business and residual risks, we expect the audit team to make much greater use of evidence from nontraditional or nonsubstantive sources, such as analytical evidence concerning nonfinancial performance indicators.
• Expectation 3—Audit Administration: Because information about controls and performance indicators is available throughout the year, we expect more audit work to be performed prior to year-end. Thus, the audit work will be more evenly distributed throughout the year with frequent team meetings and client interaction.

• Expectation 4—Audit Team Structure: We expect to see a broader range of skills on the audit team, including various specialists and business experts (e.g., computer assurance specialists, tax specialists, and line-of-business consultants), and fewer low-experience staff auditors. Broadening the audit team requires greater coordination and information sharing among team members.

Specific expectations related to expanded assurance opportunities include:

• Expectation 5—Value-Added Assurance: As auditors’ focus on business issues and processes in areas outside of traditional accounting, we expect the audit team to provide valuable additional assurance to the client as part of the basic audit engagement. As auditors obtain evidence from controls and performance indicators, we expect high-value assurance tasks to replace low-value substantive testing. This effect should be most evident in the management letter.

• Expectation 6—Expanded Service Opportunities: As the auditor exhibits a broader range of business interests and expertise throughout the audit, we expect stakeholders to view the auditor as a source of other assurance services, leading to new service opportunities.

BACKGROUND OF THE CLIENT AND THE “OLD” AUDIT

With KPMG’s help, we selected the audit of Ceskoslovenská Obchodní Banka (a.k.a. ČSOB, or the Bank), a state-owned bank based in Prague of the Czech Republic, as the focus of our study. ČSOB was formed in 1965 to foster foreign trade in the former Communist country of Czechoslovakia and was the third largest bank in the Czech Republic at the time of the study. When Czechoslovakia split into the Czech and Slovak Republics in 1993, the Bank was restructured with its primary base of operations centered in Prague.

We believed that the 1997 audit of ČSOB was a good environment in which to test the concepts of business risk based audits for a number of reasons:

• The audit team had extensive experience with the client using traditional audit techniques prior to 1997.

• The audit team recently completed training in new audit techniques and was preparing to implement them on the audit of the Bank.

• The entire audit process was being transformed at once, making it easier to observe the impact of the changes in a single engagement.

• The operating and economic environment, although subject to a great deal of uncertainty, had not changed significantly over the past few years. Consequently, observed changes are less likely to be due to changes in conditions than to conscious actions of the auditor.\(^5\)

• The business environment did not have a history of relying on accounting firms for services other than a traditional audit. However, because there are fewer limitations

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\(^5\) An important observation in support of this conclusion was the strong feelings expressed by the audit team that changes in risk assessments were due to their improved understanding of the client, not changes in the underlying economic or business environment.
on the services an auditor can provide in the Czech Republic, this is an environment primed for an expansion of value-added services.

In this study, the researchers had approximately 85 hours of direct contact with the multinational audit team. The researchers had full and unrestricted access to the audit team and visited the engagement team six times during the audit over an eight-week period. The researchers attended six team-planning, evidence, and wrap-up meetings (22 hours); observed audit team discussions and review (16 hours); participated in direct interviews with the audit management team (25 hours) and conducted one-on-one discussions with various audit supervisors and staff working in all significant areas of the audit (14 hours). A post-audit debriefing session was conducted to discuss the experiences of the audit team and changes in future audits of the Bank (8 hours). Our findings are based on observations made during these direct contacts, and documentation related to engagement planning, evidence, and administration.

Pre-1997 audit engagements followed traditional audit approaches and issued an unqualified opinion in each year. The audit team focused on a few financial statement assertions, including valuation of loans, valuation and completeness of investments, timing of revenue recognition, regulatory compliance and disclosure, and valuation and disclosure of off-balance-sheet items. Audit evidence was mostly substantive with extensive testing of account balances, disclosures, and regulatory compliance after the close of the fiscal year. The auditor used confirmations for loans, collateral, deposits and investments, and analytical procedures for revenue recognition and evaluation of uncollectible loans. The audit team consisted predominantly of junior staff and senior auditors. Minimal input was obtained from specialists and occurred as part of the overall end-of-audit review process. Thus, previous audits were textbook applications of substantive testing with slight reliance on controls or performance data. Starting with the 1997 engagement, the audit team adopted KPMG’s new audit methodology (called BMP) for the entire audit. This represented a substantial break from prior practice and necessitated significant changes in the planning and conduct of the audit.

RESULTS: TEST OF CONCEPTS IN THE “NEW” AUDIT

Consistent with the process depicted in Figure 2, the audit team examined the strategic and process risks of the bank, the controls used to address the most critical business risks, and available performance measures. After reaching tentative conclusions about the significant residual risks, the audit team refocused their substantive tests and extended the level of assurance services delivered to the client.

Risk Assessment

Expectation 1 suggests that risk assessment will change from the traditional audit, and is based on the presumption that risks relevant to an auditor emanate from the risks to the business of not achieving its objectives. Some risks are considered less significant than in the past while others receive greater attention. ČSOB was subject to the typical economic and competitive forces of the banking sector, especially related to expansion into new markets in the face of direct competition from larger banks in the

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6 In 1996, the auditor’s report was modified to draw attention to one particular problem loan, but the overall opinion was still unqualified.

7 Some of the statements concerning ČSOB’s internal operations are, by necessity, intentionally vague in order to satisfy restraints of client confidentiality.
U.S. and Western Europe. As expected, the Bank devoted significant resources to managing financial risks—interest rate risk, market risk, credit risk, and exchange rate risk. Thus, the Bank faced challenges typical for a small international bank.

Prior to 1997, audit planning focused on risks related to loan management, investment management, and regulatory compliance. In 1997, the time devoted to evaluating and testing risks in these areas fell by approximately 30 percent, a reduction made possible by tailoring risk assessments more precisely. For example, the audit team assessed two specific loan management risks as less significant than in past audits:

- **Policy override of the loan approval/rejection process by senior management that could undermine the quality of the loan portfolio.**
- **Unreliable transaction processing that could cause errors in customer accounts and financial records.**

The audit team de-emphasized these risks due to their better understanding of the Bank’s conditions and environment and not due to any specific change in its actual operations or environment.

In contrast, auditors found other loan management risks of greater significance than in the past:

- **Economic risks impacting loan customers such as volatility in inflation, unemployment, and exchange rates that could have a devastating impact on large segments of the economy and the Bank’s loan customers.**
- **Credit/default risk conditional on each borrower’s own financial health and situation.**
- **Collateral risk due to the vagueness and unenforceability of laws related to perfecting and collecting collateral.**
- **Loss of customers due to a very tight money supply and pressure on Bank reserves that limited the Bank’s loanable funds.**

Economic and credit risks are typical of any bank, but the latter two risks reflect unique problems of doing business in the Czech Republic.

The audit team also considered new areas of risk not given much attention in previous engagements by broadening its review of risks to include aspects of the Bank’s operations considered critical to its strategy and plans. Since the Bank’s overall strategy called for expansion into new markets, the audit team examined the product development process in detail and increased the audit time in this area from 0.0 percent to 1.2 percent of the audit budget. Similarly, the audit team concluded that long-term success of the Bank depended on its ability to retrain and rationalize its labor force and increased the time devoted to evaluating personnel management from 0.0 percent to 2.4 percent.8

Another area that the change of focus impacted was political risk, leading to a greater concern about the following risks:

- **An ongoing dispute between the Czech and Slovak governments concerning the division of banking assets when the countries separated in 1993—the Slovak government balked at servicing liabilities to the Bank that predated the fall of the communist government.**
- **Substantial ambiguity in tax regulations in both the Czech and Slovak republics that put the Bank at risk for significant tax penalties.**

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8 This engagement was considered large by firm standards and consumed in excess of 1,000 hours.
9 This dispute was identified in prior audits and was the basis for the modified audit report in 1996.
• Concern that the dispute with the Slovak government was discouraging Slovak businesses from dealing with the Bank.
• Political implications of the Czech Parliament's final authority over the disposition of the government's interest in the Bank and its assets.

Because the Bank's ability to manage these political risks would impact its long-term success and financial health, the audit team analyzed these risks in depth.

The auditor also identified two new areas of risk assessment: social risk and technology risk. Social risks to the Bank related to the country's change from communism to a market economy including:

• Mid- and lower-level employees were potentially threatened by changes management was trying to implement in order to make the Bank more competitive.
• Given the short experience with Western banking practices, many potential customers distrusted banks.
• Uncertainty surrounding the perfection and collection of collateral cut to the heart of one of the Bank's primary sources of risk: the ability to collect on loans.

The Bank's information technology was generally less developed than a comparably sized Western bank and was weakest in the areas of customer service and management reporting. However, information processing for transactions was considered to be highly reliable, in spite of extensive manual and batch processing, due to the education and training of low-level employees who handled detailed transaction processing.

The expanded view of risk adopted for the new audit approach led the audit team to revise the set of specific risks deemed significant to the audit. Identifying and evaluating business risks is only part of the challenge to the auditor, however. The auditor must also analyze the implications of the residual risks for the conduct of the audit. First, in the most extreme situation, residual risks could hint at a going-concern problem. Second, some residual risks may suggest potential weaknesses in the overall control environment and create incentives for management to undertake inappropriate actions or manipulate information in the financial statements. Third, some risks may indicate potential problems in the organization's business processes. Finally, residual risks may link directly to specific financial statement assertions indicating heightened inherent risk.

To illustrate the linkage of business risk to audit issues, Table 1 summarizes a few of the possible risks considered significant by the audit team.¹⁰ Some risks have immediate implications for the audit, such as inherent risks related to loan losses, while others suggest subtle and possibly remote problems such as going-concern issues. Concerns about the control environment may be particularly difficult for the auditor to evaluate because they arise from pressures that can have an unpredictable affect on management behavior.

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¹⁰ The issues raised in Table 1 are meant to be illustrative and do not necessarily reflect actual conditions.
## Nature of Risk

<table>
<thead>
<tr>
<th>Nature of Risk</th>
<th>Audit Implications of Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political Risk: Collectibility of loans backed by the Slovak government.</td>
<td>Inherent Risk: Valuation of loan loss reserves and related disclosures.</td>
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<tr>
<td></td>
<td>Control Environment: The uncertainty surrounding these loans limits investment opportunities for the bank. The auditor should consider if management is compensating for these problems in inappropriate ways.</td>
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<td></td>
<td>Other: Wording of audit report may need to reflect “Emphasis of a Matter” with an explanatory paragraph (as was done in 1996).</td>
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<tr>
<td></td>
<td>Control Environment: Given social attitudes, the auditor should consider if interactions with tax regulators are appropriate.</td>
</tr>
<tr>
<td>Political Risk: Potential loss of business due to attitudes of the Slovak government.</td>
<td>Going Concern: Is the bank viable in the Slovak Republic? If not, are there issues related to asset valuation, disposals, and disclosures?</td>
</tr>
<tr>
<td></td>
<td>Control Environment: The auditor should consider how management is responding to this situation and consider the potential for questionable activity related to this problem.</td>
</tr>
<tr>
<td>Social Risk: Employee attitudes about change and job performance.</td>
<td>Control Risk: The competence and attitudes of employees affects the performance of all business processes and could indicate low-quality performance in key areas, including information processing.</td>
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<tr>
<td></td>
<td>Inherent Risk: The auditor should examine the Bank's approach to moving, terminating, hiring, and retraining employees and determine if there are any issues related to the valuation, classification, and allocation of related costs.</td>
</tr>
<tr>
<td>Social Risk: Slow growth due to suspicion from prospective customers.</td>
<td>Going Concern: Do the challenges of customer acceptance of existing and new services raise questions about the Bank’s strategic plan and ultimate viability?</td>
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<tr>
<td></td>
<td>Control Environment: Are the marketing and customer acquisition practices appropriate?</td>
</tr>
<tr>
<td>Social Risk: Ineffective control of loan losses due to uncertainty about legal system.</td>
<td>Inherent Risk: Valuation of loan loss reserves and related disclosures.</td>
</tr>
</tbody>
</table>

* The audit implications are for illustration only and may not apply directly to the Bank.
Audit Evidence

Our second expectation addresses the nature of the evidence acquired during the audit. The workpapers of the audit reflect a significant shift from substantive test evidence to evidence concerning risks, controls, and performance measures. An important effect of the new audit approach is the audit team’s documentation of strategic risks, processes, and performance indicators as primary sources of evidence. Information about how the Bank mitigated business risks helps to establish and justify inherent and control risks related to the financial statements. The shift in approach allowed the audit team to obtain evidence about the reliability of routine transactions in nontraditional ways. The team relied much less on evidence from the documentation of individual transactions than in the past, finding that consistency of interviews with multiple process participants, available performance measurements, and assessments of management’s handling of exceptions supported the conclusion that the processing of most routine transactions was reliable.¹¹

Reliance on key processes related to routine transactions like deposits and loan repayments led to a significant decrease in substantive testing at the end of the year. Substantive testing could focus on specific attributes of complex transactions like derivatives and accounting estimates of valuation allowances. The testing of potentially uncollectible loans was indicative of this change in perspective. Prior audits reviewed numerous loan files, testing for completeness of paperwork, consistency with bank loan policies, proper authorizations and approvals, existence and valuation of collateral, etc. Now, by linking business risks to specific audit risks, the audit team decided to focus on the realizability of a few large loans particularly sensitive to the Bank’s economic and political risks. Compliance attributes were not considered to be a source of significant risk. Due to the problem of perfecting collateral in the Czech Republic, the audit team decided not to confirm or appraise collateral since it was not a significant source of risk reduction to the Bank.

The audit team noted that the new model’s expanded knowledge acquisition and risk assessment provided far more evidence for the auditor about risks and potential financial statement misstatements than was obtained from previous heavy reliance on substantive tests. Senior members of the audit team stated that they had a much better appreciation of the Bank’s risks and that the quality and completeness of the evidence supporting their final conclusions was superior to that obtained in the past. In short, the overall conclusion was that the team performed a more effective audit.¹²

Audit Administration

Our third expectation is that the allocation of engagement time would shift, and possibly decline in total. Total time devoted to the basic audit of ČSOB decreased by 9.5 percent. The three audit managers on the engagement projected 20 percent fewer hours in future years due to the new audit approach and better scheduling. The audit team

¹¹ One of the arguments advanced for a business risk approach to the audit is that it provides a better basis for assessing the environmental pressures and conditions that might lead to financial statement fraud. This possible benefit must be weighed against the potential reduction in fraud detection that could accompany reduced transaction testing.

¹² Obviously, the stated impressions of the audit team must be weighed carefully since they could simply reflect the impact of newness rather than actual quality improvement. It is not possible to empirically demonstrate that the audit process was more effective, only a large sample study of similar engagements will reveal whether the changes to the audit process have resulted in a net reduction of audit risk across a pool of clients.
held more than ten biweekly planning and review meetings attended by all available team members, including specialists. Information sharing at these meetings kept the entire team abreast of significant audit circumstances, risk assessments, and current developments, especially audit seniors and staff who are normally only exposed to narrowly focused areas of the audit. The information sharing facilitated coordination of risk assessment where key processes and activities were linked to other areas of the engagement. Specific examples of changes to the scheduling and planning of the audit included:

- The audit team devoted significant time to understanding the consequences of management's strategies and how they related to business risks and audit risks, and designed audit procedures accordingly. Much of this work was performed six to eight months prior to year-end and updated over the course of the year.
- The timing of procedures shifted with much more work completed prior to year-end. Much of the interim work involved examination of internal control and performance measures. Control evaluation and testing necessitated that the audit team talk to people far removed from the accounting department.
- The audit team justified reducing or eliminating substantive testing in areas judged to have low or no residual risk.
- The audit team relied more heavily on specialists, particularly information risk management, in the review and evaluation of core processes and related information processing.

The improved communication among the audit team also led to greater interaction of audit team members with tax specialists early in the engagement that revealed significant tax-reporting problems arising from identified political risks. Early involvement of the information system specialists helped identify problems with internally developed software impacting the preparation of the financial statements. The new approach enabled early identification of problems and the involvement of the entire team allowed a proactive response.

Audit Team Structure

Expectation 4 predicts that the contributions of different team members change as more experienced personnel and specialists become involved. However, the observed changes were not as significant as expected. In 1996, 41.9 percent of engagement hours were charged by staff auditors; in 1997, the comparable rate was 39.9 percent when more experienced personnel were involved with the audit. The hours charged to the engagement by specialists increased from 4.2 percent of total engagement hours to 6.3 percent. This increase relates to the conduct of the basic audit, not to new or extended services. Moreover, specialists set their own agenda to facilitate the audit process, rather than being assigned tasks during the review process. Additional changes in the audit team are expected for future audits.

Value-Added Assurance

We expected the in-depth knowledge of the client obtained during the conduct of the basic audit to result in the provision of valuable additional information and assurance as

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13 It is easy to underestimate the problems associated with communication frictions within an audit team. Knowledge held by individuals does not always become team knowledge, causing a potential loss in efficiency and effectiveness. To the best of our knowledge, intra-team information frictions have not been studied in an audit context.
a by-product of the audit, not as separate services. In 1997, 14.5 percent of total engagement time was devoted to assurance activities not directly related to verifying the financial statements, up from 7.3 percent in 1996.

First, the audit team developed a complete model of the entity and its competitive environment useful for analyzing strategic and process risks. The model was included in the auditor's reporting package and described in detail in meetings with management and directors to assist them to validate their own risk analysis. Second, the audit team provided feedback to the Bank concerning the effectiveness and efficiency of specific processes not previously examined in depth by the external auditor, such as new product development and personnel management. Finally, the standard management letter was expanded significantly, increasing from a small report to a large document in excess of 20 pages. Informal feedback indicated that the Bank was very pleased to receive this increased level of information from the audit team.

Expanded Client Service Opportunities

Although the value of new audit methods is not dependent on the expansion of fee-added services, we did expect opportunities to arise for assurance services outside the financial statement audit. The audit team believes the Bank developed a fresh perspective about the range of services available from the audit firm. Specifically, the Bank requested proposals on two engagements involving strategic planning for: (1) the Bank as a whole and (2) services related to electronic transactions. In addition, due to the impending privatization, the firm was asked to participate at a high level in preparing the Bank for soliciting offers and evaluating potential investors beyond what is expected for basic due diligence services.

SUMMARY AND FUTURE RESEARCH

New approaches to audits offer the promise of better assurance and reduced risks to multiple stakeholders. However, the touted superiority of new approaches and the purported weaknesses of traditional methods need to be evaluated with a critical eye and without undue consideration of subjective and self-serving assessments. The new audit methods being developed and implemented by most large accounting firms are designed specifically to improve the use of high-level competitive and strategic information during the audit. A presumption underlying these developments is that this global or holistic view of a client will lead to more effective audits. On the other hand, to the extent that traditional substantive testing is decreased or eliminated, an auditor runs the risk of overlooking errors that might have been detected under those approaches. In the end, whether auditors are performing a better audit or not can only be evaluated with research, over an extended period of time. There is some understanding of the limitations of traditional methods due to previous research; a similar level of experience and insight must be attained before we can similarly assess the new audit methods.

As a first step in this process, this paper presents an overview of new audit approaches that focus on strategic and business risks. We observed a number of important outcomes from using the new audit process that are summarized in Table 2. In one sense, the outcome of the audit of ČSOB for 1997 was essentially the same as prior years, in that the Bank received an unqualified audit report. However, to focus solely on the audit report is to miss the significance of the many changes and improvements due to the new approach used by the audit team.
### TABLE 2
Comparison of New and Old Audit Approaches: A Field Study

<table>
<thead>
<tr>
<th>Engagement Attribute</th>
<th>Traditional Audit Approach</th>
<th>&quot;New&quot; Audit Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Assessment</strong></td>
<td>Audit risk assessments tended to focus on the audit objectives associated with asset valuations (e.g., loans, investments). Other significant risks were related to compliance with regulations (e.g., capital adequacy).</td>
<td><strong>Strategic Risks:</strong> Risk assessment considered specific risks of the organization and linked those risks to process risks. Political risks were deemed most important, followed by economic risks.</td>
</tr>
<tr>
<td><strong>Audit Evidence</strong></td>
<td>Prior audits relied primarily on traditional sources of substantive evidence including tests of transactions and account details.</td>
<td><strong>Process Risks:</strong> Increased attention was devoted to risks associated with New Product Development and Human Resource Management. Less risk focus was devoted to Credit and Investment Management.</td>
</tr>
<tr>
<td><strong>Audit Administration</strong></td>
<td>Audit team met infrequently and most work was performed after year-end.</td>
<td><strong>Pervasive Changes:</strong> Much more time and effort was devoted to interviewing people involved in key process activities. Much less time was devoted to substantive testing of accounts that were not deemed to be at risk. Performance indicators were used as evidence of risk conditions where feasible.</td>
</tr>
<tr>
<td><strong>Audit Team Structure</strong></td>
<td>Audit workload dominated by staff and seniors. Specialists were used infrequently and only for narrow issues identified by the audit team.</td>
<td><strong>Specific Changes to Loan Audits:</strong> Loan file reviews focused on collectibility. Confirmations were significantly reduced. Collateral confirmation and valuation were omitted.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Focused on understanding client strategies and consequences for financial statements. Increased use of interim work. Deleted low risk audit work. Improved communication among audit team (biweekly meetings) and with client.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Increased use of manager and partner time. Increased use of specialists who were involved in regular team meetings and set their own agenda. Early identification of two significant audit issues (software development, tax exposures)</td>
</tr>
</tbody>
</table>

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TABLE 2 (Continued)

<table>
<thead>
<tr>
<th>Engagement Attribute</th>
<th>Traditional Audit Approach</th>
<th>&quot;New&quot; Audit Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value-Added Services</td>
<td>Few services provided beyond the basic audit report and minimal management letter.</td>
<td>Delivered business model and business risk analysis. Delivered expanded management letter. Provided feedback on processes not previously examined by the external auditor.</td>
</tr>
<tr>
<td>Expanded Client Service Opportunities</td>
<td>Virtually no additional assurance or consulting services requested by client.</td>
<td>Firm asked to bid on two strategic-planning projects. Firm asked to be involved at a high level in the preparations for privatization.</td>
</tr>
</tbody>
</table>

This study has a number of limitations that should be considered when interpreting the overall results. First, the subject of the case study was not randomly selected. Second, as is true for all small-sample studies, the ability to generalize to a broader population is limited. Third, unique circumstances at the client and/or within the Czech Republic may further limit the implications to be drawn from our observations. In a similar vein, some changes in the audit process could have been caused by changes in the Bank's economic and operating environment rather than by the new audit methods. Finally, the presence of the research team while the audit was being conducted may have had an impact on the observed behavior. While important, these limitations do not undermine the objectives of this paper to identify and test expectations about a business risk audit process.

The issues presented in this paper suggest a number of research avenues to be pursued in external assurance services. A critical area for research is the impact of new audit methods on audit effectiveness and quality. Empirical evidence of audit quality must be gathered over many engagements and time periods to be able to systematically address this question. Archival and empirical research could also address the demand for assurance services by examining the relationship among audit fees, audit effort, services rendered by auditors, and alternative assurance services. Analytical modeling could be used to address the trade-off of external assurance and other approaches to controlling risks in an organization, as well as examining independence issues. Finally, experimental and/or survey research could be undertaken to assess the types of external assurance services decision makers are willing to demand from accountants and the potential returns that auditors may hope to receive for investments they make in such services. The demand for external assurance services is likely to continue to grow, both because accountants have relevant expertise to deliver such services and because owners can benefit from engaging such services. However, the manner in which the market for assurance services will evolve is an open question that can benefit from further research.
REFERENCES
