A Reflection on the Usefulness and Effectiveness of the Modern Risk-Oriented Audit in China

Qianshan George Gao, Shih-Jen Kathy Ho, and Audrey Agnello

Qianshan George Gao, Shanghai Lixin University of Commerce, China, gaoqs@lixin.edu.cn. Shih-Jen Kathy Ho, Niagara University, kh@niagara.edu and Audrey Agnello, Niagara County Community College, aagnello@niagaracc.suny.edu.

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ABSTRACT

The modern risk oriented audit (MROA) is the model adopted by the International Auditing and Assurance Standards Board (IAASB) for the global auditing and assurance profession. This is also the model adopted by the U.S. Auditing Standards Board (ASB) and the Public Company Accounting Oversight Board (PCAOB). By analyzing audit fees and auditors' opinions for 1,321 publicly traded companies on the Shanghai and Shenzhen Stock Exchanges in China from 2004 to 2008, this study critically reviewed the value as well as the effectiveness of the model, and inherent problems in the implementation of the modern risk oriented audit. Specifically, audit fees increased significantly in China during the sample period as a result of the issuance of new auditing standards by the Chinese Finance Department in 2006. But the auditors' opinions did not yield anticipated results. Finally, the inherent problems of the MROA model include the following:

Increased flexibility provided by the MROA model may have the unintended consequence of allowing less work to be performed, but at the same time satisfying outside reviewers in audit reviews, as it is not procedurally based. In our opinion, CPA's legal liabilities should be based mainly on the auditor's opinions issued, not on the auditing procedures applied. Auditors need to pay close attention to whether an auditee has completely disclosed the material uncertainties which affect future performance; if not, the auditors should disclose this information in the audit opinion. Otherwise, the auditors could be guilty of negligence or fraud.

With the MROA, the role of the auditor has been expanded to include expertise in evaluating business operational risks. The MROA only requires auditors to identify the existence of material risks, not the consequences of these risks. With the assistance of specialists, auditors should broaden their knowledge base, change the vocational culture of auditing and correct this inherent problem of the MROA.

Introduction

In 2006, the Ministry of Finance of China (2006) issued 48 auditing standards for Chinese Certified Public Accountants in the auditing and assurance profession. Those standards became effective in January 1, 2007. These new standards were issued to address changes in the social, economic, legal and auditing environments, trends in international auditing and to improve auditing practices. In many ways, it was a historical breakthrough. The focus of the Ministry's new standards was the introduction of the modern risk-oriented audit (MROA), which was covered in the following four standards (The Ministry of Finance of China, 2006):

1. "Chinese CPA Auditing Standards No. 1101 – Objective and General Principles of the Financial Statement audit"
2. "Chinese CPA Auditing Standards No. 1301 – Audit Evidence"
3. "Chinese CPA Auditing Standards No. 1211 – Understand the Entity Audited and its Environment and the Assessment of the Risk of Material Misstatement"
4. "Chinese Auditing Standards No. 1231 –Audit Procedures for Assessing the Risk of Material Misstatement"

The focus and strength of the modern risk-oriented audit (MROA) derives from an understanding of the audited entity and its environment, the assessment of the risks of material misstatement, the identification of possible areas of high business risk and the corresponding remedial audit procedures used to address those risks. Audit resources can be effectively deployed and audit risks properly controlled when employing the MROA. The MROA can be used to overcome the weaknesses of the traditional risk oriented audit and improve the overall quality of the audit. Therefore, a review of the adoption and effectiveness of the MROA will have significant practical implications.

A Review of the Development of the Modern Risk Oriented Model and Related Research

Auditing theory evolved with changes in auditing practice and the development of the MROA is no exception. In 1960, because of drastic economic changes and increasing market competition, the auditing profession was faced with great challenges. Between 1960 and 1980, lawsuits against certified public accountants escalated with approximately 300 lawsuits filed against the "Big Eight" auditing companies as a result of audit failures. These audit failures forced the auditing profession to rethink and to improve the auditing model and methodology (Li, 2009). In 1997, KPMG issued its study report entitled, "Auditing Organizations through a Strategic System Lens – the KPMG Business Measurement Process," which proposed a risk-based audit model focused on strategic analysis, process analysis, business measurement risk analysis and continuous improvement (Bell, et al., 1997). Since then Ernst Young, PWC and Arthur Andersen have also developed their risk oriented audit methodology. In May 2000, the UK, the U.S., and the Canadian standard-setting bodies and experts from academia formed a "joint task force" and issued a report titled "Developments in the Audit Methodologies of Large Accounting Firms" (Lemon, Tatum, &Turley, 2000). The task force found that the distinctive new risk oriented audit methodology, which is now known as the MROA, was better than the traditional risk oriented audit model in fulfilling the objectives of audited general purpose financial reports and improving value-added service to the clients. Because of this, the "joint task force" proposed that the standard-setting bodies modify related auditing standards in order to adapt to the needs of improved auditing methods. In October of 2003, IAASB issued the modified International Standard on Auditing No. 315: "Understanding the Entity and its Environment and Assessing the Risks on Material Misstatement" (IAASB, 2003). In 2006, the Chinese government issued the Chinese CPA Auditing Standards, which followed IAASB, and put greater emphasis on the identification and assessment of the risk of material misstatement and the corresponding audit procedures, which introduced the concept of the MROA as well other related auditing standards.

Most scholars who studied the theory and methodology of the MROA believe that the concept of "risk" in the MROA is different from that of the traditional ROA model in both meaning and application. For example, in the MROA, the focal points are strategic risks and operational risks, including the risk of intentional, non-sampling error of material misstatement. Because of this, auditors are expected to better assess the risk of material misstatement, and take appropriate remedial auditing measures, better allocating auditing resources, and consequently improve audit quality while reducing auditing failures. However, in the past decade, there were many who questioned the MROA. Knechel (2007) believed that the development of the MROA and the abandonment of many traditional auditing methods, to a certain extent, may have contributed to the audit failures of Enron, Global Crossing and WorldCom, to name a few. If the MROA can be combined with the strengths of traditional auditing methods, it may be more effective in the discovery of fraud. There are two studies which analyze the effectiveness of the MROA in auditing practice, Eilifsen and Wallage (2001) and Bell and Solomon (2002). Both studies confirmed the effectiveness of applying the MROA model in auditing practice.

The MROA is not without critics. Several scholars have studied the theory of MROA, the meaning and application of audit risk, the model of audit risk, the features of audit measurement procedures, and the application of MROA. For example, both Huang and Chen (2002), and Liu and Xu (2002), believe that lower audit litigation risk in the Chinese auditing environment resulted in moral hazard for auditors. Inevitably, Chinese auditors had a greater tendency to cut audit cost at the expense of audit quality in order to maximize economic benefits for auditing firms. Kong (2007) pointed out that low audit fees in China make it very difficult to apply the MROA, which is a very expensive endeavor. Wang (2006) thought that the overall quality of Chinese auditors was not sufficient for MROA implementation. Hu (2008), Cun (2009), and other researchers investigated the implementation of the MROA in the provinces of Guangxi and Shanxi. They both affirmed that the application of these new audit standards satisfied the profession's demand for diversification of services within the accounting profession and made the auditors more conscientious about business risk, which might help improve auditor performance and audit quality overall. On the other hand, because of the complexity of the MROA model, high audit costs, imperfect corporate governance, poor quality of auditing staff, and lack of cooperation from audit clients, Hu (2008) and Cun (2009) found that the MROA was, for the most part, applied superficially and that auditing procedures under the MROA were not followed properly. It was especially difficult to objectively assess the risk of material misstatement.

AN ANALYSIS OF THE EFFECTIVENESS OF THE APPLICATION OF THE MROA

In order to provide evidence whether or not the MROA is applied effectively in practice, this study focuses on two aspects of the application of the MROA: audit fees and audit opinions.

Research Questions

Research Question 1: The application of the MROA increases audit fees.

The economic distinction between the MROA and traditional audit risk model is that the MROA requires a comprehensive review of risk of material misstatement and the application of appropriate remedial audit measures, the amount of additional work involved in the analysis and judgment may result in an increase in audit fees. On the other hand, the traditional audit risk model, with its emphasis on more formalism, supports the decrease in audit cost, i.e. the focus of the audit shifts from cost control (traditional) to revenue enhancing (MROA) (Power, 2007). In China, the old auditing principle is to follow all necessary auditing procedures, as it is more mechanical and list driven. The approach under the MROA is to consider all risks of material misstatement, make sure that all risks are under proper control and apply appropriate auditing procedures. The MROA follows complex audit procedures and audit judgment which require an increase in the skill level of the auditing staff; hence, audit costs increase accordingly.

Research Question 2: When auditors use the MROA, the probability of issuing an unmodified opinion with additional explanatory paragraphs (UOE) increases when there is a major economic uncertainty in the operating environment.

An UOE does not change the auditor's opinion; it just increases the information content of the audit report. When auditors are confident that sufficient and appropriate audit evidence is collected and the financial statements are fairly presented in all material respects, but the auditors want to emphasize certain important events, an unmodified audit opinion followed by emphasis-of-matter paragraph may be issued. Examples of circumstances where the auditor may consider adding an emphasis-of-matter paragraph include the following (IAASB, 2008, ISA 706, Paragraph 6):

• An uncertainty relating to the future outcome of exceptional litigation or regulatory action.

• Early application (where permitted) of a new accounting standard (for example, a new International Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date.

• A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

The uncertain events refer to matters that may impact the financial reports, but are beyond the control of management and their occurrence is contingent upon future actions or events. In the traditional ROA model, the inherent risks for an entity include risks relating to the industry, the business environment and operating risks. In traditional auditing practice, the inherent risk is typically set at 100%, and the focus of the audit is placed on control risk and test of details. On the other hand, the MROA starts from the assessment of the operating risk. Not only does it require strict implementation of substantive procedures, but it also places greater emphasis on the assessment of the risk of material misstatement. Therefore, under the MROA, any major uncertainty in the operating environment of the entity will have greater impact on the auditor's opinions, and increase the probability of issuing an unmodified opinions with additional explanatory paragraphs (UOE).

Sample and Data

The data was taken from the Guotai data bank (n.d.). The sample included all A shares companies traded on the Shanghai and Shenzhen Stock Exchanges in China from December 31, 2004 to December 31, 2008, with complete five year annual financial reports available. Companies with B shares were deleted. The companies that were delisted, merged with other companies during the period, or issued stocks after 2006 were also excluded. There were 1,331 listed companies selected in total. To ensure data comparability, 10 companies which did not denominate their audit fees in RMB were excluded.

During the sample period of 2004 to 2008, the annual Chinese GDP growth rate exceeded 10% from 2004 to 2006, and peaked in 2007 at 11.4%. But after midyear 2008, Chinese economic growth and nearly all prices of various assets except real estate fell dramatically due to the international financial crisis (China GDP and inflation data, 2012). Meanwhile, in 2007 the Ministry of Finance's auditing standards for Chinese Certified Public Accountants (MROA standards) were put into practice in China. So the implementation of the new standards coincided with the global economic meltdown, a severe economic crisis, and that provided the most appropriate background for examining the two research questions above.

Analysis of Results

The effect of MROA implementation on audit fees

Table 1 below shows that audit fees per company rose dramatically in 2006 and 2007 with a growth rate of 12.5% and 9.44% respectively. The magnitude of the significant increases in audit fees per company in 2006 and 2007 support the first research question. Chinese companies used the calendar year as their fiscal year. The auditors' reports for C-2006 financial statements had to be completed in 2007 and the audit work had to follow the MROA standards which became effective in January

1, 2007. Therefore, the abnormal and largest audit fee growth disclosed in 2006 provided strong support for research question 1: the application of the MROA increases audit fees. Because not all companies disclosed their audit fees, those companies without audit fee data were deleted from the sample which resulted in a change in the sample size from 1,177 companies in 2005 to 1,094 companies in 2006, a difference of 83. If we assume that no audit fees were paid by those companies not disclosing audit fees and if we recalculate the growth rate assuming that the sample size was 1,177 for 2006, the audit fee per company would have been 67.13 (ten thousand RMB) with a growth rate of 4.9% in 2006. This result would still support the first research question. As for 2007, the abnormal high growth rate in audit fees may be partially attributable to the high inflation rate in 2007.

The effectiveness of MROA implementation based on audit opinions

The global financial crisis climaxed in 2008. It offered an ideal background for the study of the second research question. The American subprime mortgage crisis emerged in 2006, and it swept across the world's major financial markets in 2007. From 2004 through 2008, China was experiencing high economic growth at a rate above 10%, and continued until the second quarter of 2008, when China genuinely suffered because of the crisis. Chinese growth plunged to 6.8% in the fourth quarter of 2008, and then nearly all asset prices dropped precipitously during the second half of 2008 (China GDP and inflation data, 2012). According to the second hypothesis above, with material uncertainty in the economy and the fair prices of assets, the ratios of unmodified opinions with additional explanatory paragraphs (UOE) for 2007 and 2008 using the MROA method were expected to rise sharply. The UOE ratio for the 2008 mid-term audit reports would likely be very high as well, because the end of June 2008 was the most critical turning point for the Chinese economy in recent years.

However, Table 2 shows that the ratio of UOEs in 2007 and 2008 went down, not up. Although the ratio of UOEs to all reports did not change much from 2005 to 2008, it did increase slightly in 2007. According to Huang and Xu (2009), 1,588 Chinese companies (excluding 14 banks), which issued A stock on Chinese stock markets in 2008, experienced a 30% drop in general net profit compared to 2007. Because the 2008 world financial crisis shook the real economy of China but not the financial industry until later, the lack of increase in UOEs indicates that auditors had not taken sufficient consideration of the financial crisis and material economic uncertainties when they performed audit work during 2008 to 2009. According to Chinese government regulations, the audits of calendar year 2007 financial reports of listed companies should have been completed before the end of April 2008. While auditors were performing audits during the first four months of 2008, few of them recognized the onset of the economic crisis, which would later significantly affect the financial performance of most companies.

More surprising were the mid-term audit reports in 2008. Independent audits were not legally required for mid-term financial reports, so only 75 companies issued their audited financial reports in 2008. Among these audit opinions, there were 69 unmodified opinions and 6 UOEs, of which 3 companies had huge losses. A follow-up of the performance of the 69 companies in the second half of 2008 indicated a significant erosion of their performance compared to the first half of the year (see table 3). No company received an adverse audit opinion.

Tables 2 and 3 indicate that from the perspective of audit quality, the effect of implementation of the MROA were not evident, at least for the first two years.

Conclusion and Reflection on the MROA Model

Based on the analysis of data collected for the years 2004 through 2008, we conclude this paper with the following observations.

First, the MROA standards were put into practice by Chinese CPAs during 2007 and 2008. The implementation of the MROA did increase audit fees, but the effectiveness of MROA was not substantiated in the quality of audit reports. The first two years of MROA implementation in China brought nothing but higher costs and higher audit fees.

Why was the application of MROA in China so disappointing? One possible explanation is that some auditing staff in China were not fully trained in applying the MROA, and some may have lacked sufficient professional skepticism; i.e. they paid too much attention to past accounting items which caused audit risks, but were not sensitive to the uncertainties of important future economic and accounting events.

Further, the research gives us the following insights. The procedures of the MROA are less rule based and, therefore, require more professional judgment than the traditional audit model. Auditors can reduce some substantive procedures according to the outcomes of audit risk ratings. The MROA is designed to allow auditors greater flexibility in allocating their audit resources according to the degree of audit risk identified and assessed, so that audits can be done efficiently and effectively. However, the flexibility of audit procedures opens the opportunity to pick and choose whatever best fits the auditors' interests. With the MROA model, whether an auditor complies with audit standards during the audit process is greatly linked to the probability of being sued for negligence or fraud. It is easy for a CPA to trim substantive procedures, so as to reduce audit costs, yet avoid the risk of being sued because of a lack of prescribed procedures. In China, lawsuits rarely result when an auditor neglects the economic uncertainties which impact future accounting periods only. We advocate for the effective application of the MROA and its requirements, based mainly on the quality of audit opinions, not audit procedures in determining an auditor's legal liabilities. Specifically, auditors should pay close attention to whether an auditee has disclosed all material uncertainties which impact the performance of the next accounting period; if not, auditors should mention those points in audit opinions, or be liable for their negligence or fraud.

Secondly, the MROA requires auditors to be able to identify risks, including market risk, operational risk, internal control risk and so on. But some risks, especially macro-economic risk, market risk and industry-specific risk can be difficult for auditors to identify. Even company management may find them difficult to detect and assess. Under the MROA, the role of the auditor has been expanded to require the development of expertise in evaluating various risks beyond the typical qualification of an auditor. This is an inherent paradox in the MROA model. Fortunately, the MROA requires only that auditors identify the existence of material risks which will affect future operational performance; auditors do not need to predict the consequence of these risks. It is up to the users of financial reports to consider their impact. It is very difficult to predict the outcome of an economic problem, even if there are only two possible results. Auditors may rely upon specialists for help, and with the broadening of auditors' knowledge base and a change in the vocational culture, auditors will ultimately learn to identify business risks and remedy the inherent defects of the MROA model.

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Web Appendix

A web appendix for this paper is available at:

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