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# AUDIT FUNCTION, RISK MANAGEMENT AND THE SIGNIFICANCE OF AUDIT OPINION

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***Abstract:*** *The objective of this concept study is to discuss and conceptualize the function of audit, risk management and the significance of audit opinion or audit reporting. In Malaysia, based on the Malaysian Code on Corporate Governance (MCCG), (2007; 2012 and 2017) clearly stated the role and responsibility of the auditor in corporate governance world. The existence of internal audit function for example is one of the crucial elements in corporate governance mechanism. Further, the existence of external auditor and audit committee in a company as a compliment to the function of an audit. Both internal and external auditors have their respective responsibilities in corporate governance world. For audit committee, it has the oversight function and as a board committee that monitoring the corporate governance as a whole. Although the full board of director is a top of rank in corporate governance element, the tasks of internal control, risks and any corporate governance issues are mandated to the audit committee.*

***Keywords:*** *Audit, Auditor, Risk Management, Corporate Governance, Malaysia*

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## Introduction

Audit is an important element in financial reporting because audit can enhance accountability and credibility of financial information provided (Sloan, 2001; Francis, Khurana & Pereira, 2003). Audit function can be divided into two groups: internal audit and external audit or independent audit. The objective and function of internal auditors are mutually important. Leung, Cooper and Perera (2011) highlighted a good correlation between the tasks performed by the internal auditors and objectives towards governing activities. They also added that in terms of the corporate governance process and the issue of risk management, internal control is the key factor for internal audit to make a worthwhile contribution. Mitra and Hossain (2011) supported that corporate governance is a mechanism that helps to improve the reliability of reported accounting information; investors are interested in obtaining this information which shows the impact of corporate activities (Quick & Wiemann, 2011). This argument is supported by Cohen, Gaynor, Krishnamoorthy and Wright (2007) that corporate governance is an important element for internal audit evaluation by the external auditor. Even though the internal audit still focusing on the risk management issues, but for external risks exposure such as marketing risk and competition risk, the responsibility on these risks should be focused by the external audit. For an audit committee, it has the unique function as a board committee to monitor this type of risks. The audit committee has the responsibility to see both internal and external risks and it became as a coordinator for the arrangement between internal and external auditors.

The external auditor or an independent auditor has the own function on the auditing process. The focus on the client's organization as a whole including the internal and external affair of the organization. The cooperation from internal auditor is very crucial to the external auditor especially in evaluating the internal control aspects including risk management. This evaluation is important before the auditing report is issued. Audit reporting is a communication tool to inform financial reporting users about their audits (Habib, 2013). Even though the issuance rate of modified audit opinion is low in most countries, but the risks and effect of providing this type of audit opinion is large (Habib, 2013). During the global financial crisis and economic downturn, the percentage of issuance of going-concern opinion and modified audit opinion rose drastically. Xu, Carson, Fargher and Jiang (2010) reported the increase in modified audit opinion rate from the period 2005-2007 (11.5-13.5 percent) to the period 2008-2009 (19.5-20.8 percent). This figure reveals that the issue of modified audit opinion also occurs globally.

The audit report or opinion issued by the independent audit determines the quality of financial reporting as a whole. The study done by Baber et al. (2012) tested the governance characteristics and quality of financial reporting during the period 1997 to 2005. They combined the internal and external governance characteristics, such as independent board members, management, employees and shareholders on the occurrence of accounting restatements. The interaction between internal and external governance characteristics were statistically significant with probability of accounting restatements only when both of them were considered as main effects and interacted with each other. The finding had an impact on the cooperation between internal and external governance, such as shareholders, managers and BODs as the determinant of financial reporting quality. Many countries have improved the audit quality though laws, rules, amendments on accounting and auditing standards as well as enhanced the independence of auditors.

Another important aspect that must be alerted by the external auditor is fraud in the financial reporting. The Statement on Auditing Standards No 99: Consideration of fraud in a financial statement audit of the American Institute of Certified Public Accountants (AICPA, 2007) provides guidance on how the auditors should plan and perform the audit work in order to obtain reasonable assurance whether the financial statements are free from material misstatements due to error or fraud. The standard has also introduced a new audit procedure for audit team members to discuss how items in financial statements might be susceptible to material misstatement due to fraud. Every member in the audit team must be alert on the probability of occurrence of fraud or error in every item in the financial statement. Auditing Standard No. 5: An audit of internal control over financial reporting that is integrated with an audit of financial statements of Public Company Accounting Oversight Board (PCAOB, 2007) is also concerned with the role of auditors in detecting fraud. This standard requires the auditors to extend the audit procedures in order to address the identified risks of material misstatement due to fraud. Some changes in this standard include obtaining evidence that is more reliable, the timing of doing the substantive tests and procedures must reflect the assessment of risk of material misstatement due to fraud. Auditors must think about the likelihood of occurrence of fraud in financial statement, especially fraud that is considered material.

More importantly, ISA 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements provides guidance to auditors to identify and assess the risks of material misstatement of the financial statement due to fraud and obtain sufficient and appropriate audit evidence regarding the assessed risks of material misstatement due to fraud. This international standard also requires the auditors to identify the events or conditions that contribute to the occurrence of fraud or fraud risk factors. An environment in a company that is not effectively controlled may contribute to fraud. The auditor must provide reasonable assurance that financial statements are free from material misstatement, whether due to error or fraud. The above standards and guidelines have helped the auditors to better implement their duty in detecting fraud in financial statements (Albrecht, Albrecht & Albrecht, 2008). However, the higher expectation by investors and shareholders for auditors to detect fraud in financial statement has widened this gap (Hegazy &Kassem, 2010). Fraud is a type of internal risk that can occur especially when the internal control is weak and it contributes to the issuance of modified audit opinion by the auditor.

**Finding and Discussion**

The internal audit function is important even if there is a separate risk management committee (RMC) because internal audit function employees have expertise on accounting transactions and responsibility for the company's internal control system as a whole. A separate RMC has to take advantage of this by cooperating with internal audit. Risk of fraud can be detected because of the expertise of the internal audit staff on accounting transactions. Risk management plays an important role in a company. Subramaniam *et al.* (2009) reported that the management of risks is an integral part of good business practice. The RMC can manage those types of risks associated with the company effectively (Sullivan, 2001). The main function of the RMC is to tackle every single risk that the company will face. A strong RMC can ensure a company will survive in the future. Blay, Geiger and North (2011) argued that modified audit opinion issued by the auditor evidences that there is a substantial amount of doubt about the future viability of the company. Demirkan and Platt (2009) suggested that the quality of the board's committees plays a significant role in the quality of financial reporting. The characteristics of the RMC which is also a board's committee has implications and can influence the quality of financial reporting (Iyengar, Land & Zampelli, 2010). The type of modified audit report is a red alert of the failure of the company (Masyitoh & Adhariani, 2010).

MIA revised its Recommended Practice Guide (RPG 5, Revised 2013) that provides guidance for auditors to engage with clients on risk management and internal control statements included in the annual report. Paragraph 44 of this revised practice guide clearly states that auditors need to issue qualified, adverse or disclaimer opinion if there are insufficient or appropriate evidences relating to clients' risk management and internal control practices; or there are circumstances that are material to the inconsistency or non-disclosure of information relating to clients' risk management and internal control practices.

The internal audit function can add value to the companies' operations, and at the same time, support the function of the audit committee. This is supported by Soh and Martinov-Bennie (2011) that audit committee and internal audit function have good interaction between them, consistent with studies in the USA by Beasley, Carcello, Hermanson and Neal (2009); and Cohen, Hayes, Krishnamoorthy, Monroe and Wright (2009). Besides, internal auditing has become increasingly important in recent years as a useful monitoring mechanism in corporate governance (Sarens & Abdolmohammadi, 2011). In terms of risk management, Sarens and De Beelde (2006a, 2006b) found a significant relationship between level of risk and control awareness and role of internal audit function. More people from the corporate community are looking to the internal audit function to help in the problem of corporate reporting and internal control (Bailey,Gramling & Ramamoorti, 2003). Gramling, Maletta, Schneider and Church (2004) argued that in case of corporate reporting failure or scandals, one should not blame only the internal audit function.

The whole system of corporate governance should have responsibility for corporate failures or scandals, starting from the BODs, i.e., whether their monitoring function is enough to implement best practices of corporate governance, including risk management (Ishak & Mohamad Nor, 2017). The senior management also has responsibility for how they run the company and practice good governance. The interaction among BODs, internal audit and audit committee is important as each of them has different functions and different responsibilities. The BODs, through its RMC, is responsible for the risk profile of the company, especially on the external risk issues, whereby the internal audit is responsible for the company's internal control, including accounting transactions. All these efforts can ensure the effectiveness of risk management and corporate governance practices in the company.

**Conclusion and Recommendation**

There are many users of financial reporting, such as investors, lenders, management, authorities and the public (Ishak, 2016). How they interpret the financial statement and financial reporting is different; it depends on how far they understand the technical terms in the report and the extent to which the report is useful for them (Duncan & Moriarty, 1998; Church, Davis & McCracken, 2008; Gray, Turner, Coram & Mock, 2011). The standard audit report is issued to accommodate all the users of the financial statement. The standard audit report adds value and credibility to financial statement and facilitates the users to easily understand and make correct decisions (Coram, Mock, Turner & Gray, 2011). However, previous studies have found that there are gaps in how users and auditors perceive the financial statement (Low, 1984; Best, Buckby & Tan, 2001; McEnroe & Martens, 2001). Gay and Schelluch (1993) supported that the gap occurs due to the financial statement's reliability and role of auditors in adding value to the financial statement. The existence of RMC especially the separate RMC as a complimentary for the task of risk profile of the company. It was a board committee that has the monitoring and oversight function should coordinate the functions of internal and external auditing. This situation will less the burden of task for audit committee that has the crucial tasks on accounting transactions.

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