

DETERMINANTS OF AUDIT RISK

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CERTIFICATION

We, the undersigned names hereby certify that this research work was carried out by Abanimun Ehinomen Glory with Matriculation Number: MGS1813617 of the Department of Accounting, Faculty of Management Science, University of Benin, Benin City in partial fulfilment of the requirements for the Award of Bachelor Degree (B.Sc.) Honors in Accounting.

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DEDICATION

This work is dedicated to God Almighty, for His grace, strength, wisdom, and guidance throughout this journey. Without Him, this would not have been possible.

I also dedicate this project to my lovely parents, Mr and Mrs Abanimun Christopher whose sacrifices, prayers, and endless love continue to inspire me.

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ABSTRACT

The objective of the study is to examine determinants of audit risk. In a bid to achieve the objectives of this study, the annual reports of the financial institutions in the Nigerian Exchange Group are stated in the period of 2019 to 2024. The method used in analyzing the data gathered for the study was the Panel least square regression technique.

The findings provided that audit firm size is significantly related to audit risk in Nigeria. The study also revealed that audit tenure is not significantly related to audit risk in Nigeria. Audit expertise is significantly related to audit risk in Nigeria. The study also revealed that audit client risk is insignificantly related to audit risk in Nigeria. In terms of significance, audit firm size exhibited a negative relationship; while audit tenure, audit expertise and audit client risk exhibited a positive relationship with audit risk in Nigeria.

CHAPTER ONE

INTRODUCTION

1.1. Background to the Study

Over the last few years, the need to manage risk has been recognized as an essential part of good corporate governance practice. This has put organization under increasing pressure to identify all the business risk they face and to know how to manage them. American Institute of Certified Public Accountants (AICPA) 1997 provide the auditor with the guide to assess the audit risk and define the audit risk model, identifying the key determinants of the audit risk are Inherent Risk, Control Risk and the Detection Risk. Previous literature about the audit risk highlights the difficulties to assess it and test the dependencies among components of risk (Dusenbury and all, 2023; Fukukura and Mock, 2019; Budescu and all, 2023; Contessotto and Maroney,2014).

Traditionally, auditors have used a risk based approach in order to minimize the chance of giving an inappropriate audit opinion, and audits conducted in accordance with ISAs must follow the risk-based approach, which should also help to ensure that audit work is carried out efficiently, using the most efficiency test based on the audit risk assessment. Auditor should direct audit works to the key risks (sometimes also described as significant risks), where it is most likely that error in transactions and balance will lead to the material misstatement in the financial statements. An auditor is required to plan and perform an audit

with professional skepticism, alongside recognizing that the circumstance might exist that may cause the financial statement to be misstated (ISA 200). Professional skepticism is defined as an attitude that includes a questioning mind and critical assessment of confidence (ISA 200).

Audit risk is fundamental to the audit process because auditors cannot and do not attempt to check all transactions. It will be impossible to check all of the transactions, and would be costly for the auditors to do so, hence the importance of the risk based approach towards auditing. Every organization is different, with a different attitude to the risk, different structure and different languages hence internal auditors have to be experienced in order to adapt or learn to adapt these ideas to the structures and languages of their clients. Several studies investigate the financial risk profile of audit firm portfolios using publicly available data, comparing portfolios characteristics of large versus small firms over time (Francis and Krishnan (2002); James and Raghunandan (1998); and Choi et al. (2004). Although either results were inconsistent as Francis and Krishnan (2002) report an increasing financial risk in large audit firms portfolios during the early 1990s, while James and Rashunandan (1998) and Choi et al. (2004) report a decline in financial risk during some period. Smaller clients choose smaller audit firms on the basis of fees. This factor suggests that client portfolio risk has recently increased among smaller firms, and may continue to do so. Smaller firms may be more prone to the list of correlated judgment errors, because their personnel are less than able to specialize and more likely to be assigned across multiple engagements (Beck and Wu,

2006). In general, extant research indicates that engagement quality control reviews reduce audit risk through a variety of means.

1.2. Statement of the Research Problem.

This project work is expected to discuss the determinant of audit risk. Researchers has noted that audit firms have developed method to monitor and control the risk that their professionals might violate auditing standards, professional values, or public interest in the act of performing their responsibilities (2023). These methods may include: Pre-engagement risk management; Risk management mechanisms available during the conduct of the engagement; Risk management mechanisms available offer the engagement. Unfortunately, although these methods/practices are being used every day, specific client risk factors such as prior illegal activities and financial reporting practices still exist. International Standard in Auditing (ISA) allow the auditor to adapt various risk management practices depending on the nature and severity of the identified risk factors including applying appropriate knowledge of the client and professional expertise. Previous studies imply that audit firms should assess client-specific and environmental risks, monitor the levels of those risk, and make decisions on individual clients within their chosen portfolio strategy.

In the light of the above, the following questions were carried out;

RESEARCH QUESTIONS;

1. Is there a relationship between audit size and audit risk?
2. Is there a relationship between auditors expertise and audit risk
3. Is there a relationship between auditors tenure and audit risk?
4. Is there a relationship between client business size and audit risk?

1.3 Objectives of the Study

The specific objectives of the study are to;

1. To determine the relationship between audit size and audit risk
2. To examine the relationship between auditors expertise and audit risk
3. To find out the relationship between auditors tenure and audit risk
4. To show the relationship between client business size and audit risk

1.4 Research Hypotheses

HO; There is no relationship between audit size and audit risk

HO; There is no relationship between auditors expertise and audit risk

HO; There is no relationship between auditors tenure and audit risk

HO; There is no relationship between client business size and audit risk

1.5 Scope of Study

This research work has a targeted population of 55 firms listed on the Nigerian Exchange Group but a sample size of 15 financial institutions will be used.

1.6 Significance of the study

This project is quite important to the following:

Fund provider and investors: These groups of person may include entrepreneur and business moguls who am their business, or are finites of other businesses.

Financial inform diaries: these include the banks, investment banks, stock exchanges, insurance companies' financial advisers etc.

CHAPTER TWO

Literature Review

In today's highly competitive audit environment, audit firms have focused their attention on conducting efficient, cost-effective audits. This has led to them adopting a risk-based approach in auditing; that is, identifying and assessing the risk of the financial statements being materially misstated and planning the nature and extent of their audit procedures accordingly (Porter, 2008). When planning the audit, the auditor considers what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific accounts, balances and classes of transactions, helps the auditor to determine what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level (Soltani, 2007).

2.1 Conceptualization of Audit Risks

The auditing profession is one of uncertainty and high level of business, financial and litigation risks, and with the collapse of corporations such as Enron Tyco International, Waste Management, there has been more stringent processes to ensure that auditors exercise due professional care and skill when performing audit assignments. Therefore, the requirement for professional judgement in assessing risk in this uncertain environment is a prerogative to the auditor. It is necessary for the auditor to ascertain and assess the nature of risk in the accounting records before giving an audit opinion. The level of uncertainty and risk in the audit environment influences audit strategy establishment and further increase the risk of audit failure. Audit risk is risk connected to the financial statements; it is about that they are not realistic and objective, and that the auditor is unable to detect that. Hence, auditors are required to make risk assessment as a basis for designing an audit plan that provides reasonable assurance of detecting misstatements in corporate financial statements (Asare and Wright, 2002). The assessment of the audit risk is particularly pivotal in the client acceptance decisions when auditors have to evaluate features of their potential new clients when making client portfolio management decision (Bedard and Johnstone, 2004). According to the Committee of the American Association of Accountants (American Accounting Association - AAA), an audit is defined as “a systematic process of objectively collecting and evaluating evidence related to reports on economic events and results in order to verify the level of

compliance between the existing operational reports and predetermined criteria and to distribute the results to interested parties”. It can be done internally by employees of the organization, or externally by an outside firm. The audit of financial statements consists of evaluating the quality of assertions versus specific criteria which in the end results in auditor’s opinion on the reliability of the financial statements (Amerongen, 2007). Bell et al (2005) stated that the relevance of risk assessment in auditing continues to be emphasized in literature as evidenced by issuance of new assessment standards. These standards suggest that a financial statement audit is a recursive process in which auditors make risk assessments related to various management assertions based on evidence. Thus the audit team must plan, collect and evaluate audit evidence in response to assessed risks and aggregate the evidence to form an opinion regarding the fair presentation of financial statements (Gupta, 2005; Adeniji, 2004; Dechow et al, 2011). For every audit case, the audit staff, the audit staff carried the audit risk and the possibility of submitting wrong opinions. Even though the audit staff has paid professional attention and presented proper audit opinion, which did not lead to audit failure, they might still face the risk of lawsuits because of the business failure of the auditee. Therefore, the auditors should understand more about the industry, and the enterprise of the auditees when receiving audit authorization and planning the audit (Arens et al., 2008). The auditor must be able to identify the risky areas of a business to determine which accounts are more susceptible to material misstatements. The auditor always plans sufficient procedures that will minimize the audit risk and maximize the detection of frauds, errors and

other irregularities in the financial statements. Having in mind that the audit risk is the risk that the auditor may express inadequate audit opinion when the financial statements are materially inaccurate, the concept of audit risk is a very complex concept in the audit process. If errors occur randomly, it is difficult for the auditor to predict the probability of their occurrence. It is difficult to determine the existence of the risk of audit, and even harder to measure its height, because it is a subjective category. The highest level of risk has positions in which it is easy to perform misappropriation, fraud and other criminal offences that are difficult to detect (e.g. sale in cash, the cash balance at bank, corrections of the value of doubtful and disputed receivables, etc).

2.2 Review of Literatures

2.2.1. Audit Fees and Audit Risk

Since during financial crisis firms have higher business risk, auditors need to do more testing to control audit risk. Therefore, auditors need to charge higher audit fees. Audit fees are fees a company pays an external auditor in exchange for performing an audit. The value of an audit lies on the perception coming from users of audited statements on the auditor's ability to detect errors or breaches in the accounting system and to resist client pressures to disclose such discoveries. Auditing will have value to the extent that users of financial statements believe that the auditor is capable and he will not omit or deliberately choose which findings should be reported. Previous studies have well documented the effect of audit risk on audit fees. To overcome the difficulties to evaluate audit risk, other scholars usually use audit fees as a proxy of the auditor's effort, in terms of resources that auditors have to employ in the evaluation of the business risk of their clients, and therefore audit fees could be as a proxy of audit risk (Simunic, 1980; Hay et al., 2006; Hogan and Wilkins, 2008; Chen et al., 2012). Hogan and Wilkins (2008) found that audit fees are significantly higher for companies that showed significant weakness in internal control. Felix Jr., Gramlinga and Maletta (2001) found that internal audit contributes to reduce fees. Other studies put forward that audit fees, and in particular unexpected audit fees can be used to assess the client's accounting quality, since it is predictive of frauds, restatements and SEC comment letters (Hribar et al., 2014).

Auditors charge higher fees for risky clients (Simunic and Stein, 1996). The auditors will charge higher fees to compensate the higher risk associated with financially distressed companies (Simunic, 1980; Pratt and Stice, 1994; Simunic and Stein, 1996; Hay et al., 2006; Eshleman and Guo, 2013). Audit fees are significantly higher for bigger firms. Auditors tend to spend more effort and charge higher audit fee to control audit risk during financial crisis. Few studies like Sandra and Patrick (1996), Thinggaard and Kiertzner (2008), and Hassan and Naser (2013) argue that in large companies, there is a positive relationship between fees and risk, corroborating the fact that clients with higher risk demand higher fees.

2.2.2 Client Size and Audit Risks

Smaller clients may be more prone to the risk of correlated judgement errors, because their personnel are less than able to specialize and more likely to be assigned across multiple engagements (Beck and Wu, 2006). Beneish et al. (2008) report that client size attenuates the negative abnormal reaction to the announcement of internal control weaknesses. Research on both Section 302 and Section 404 disclosures of the Sarbanes-Oxley Act (SOX 2002) shows that internal control weaknesses are associated with clients that are smaller, financially weaker, rapidly growing, more complex, and which have ongoing restructuring (Doyle, Ge and McVay 2007a; Ashbaugh-Skaife et al. 2007). According to Kordelas (2012), big firms have less incentive to be involved in earning management because their financial statements are inspected and analyzed by third party financial specialists. Choi et al. (2010) maintains that the larger the company, the less chance they perform earning management.

2.2.3 Audit Firm Size and Audit Risk

A limited amount of research has examined alignment between clients and certain types of auditors based on factors such as the size of the audit firm (Shu 2000, Landsman et al. 2009). Audit firms enjoy economies of scale when their size expands (Watts and Zimmerman, 1990). Prior studies report a positive relationship between audit firm size and performance (Chen and Cheng, 2008; Chen et al., 2008). Lennox (1999) suggests that big audit firms are more capable in detecting signs of financial frauds that occur and disclose them in their audit opinion. This is confirmed in a research by Krishnan (2003) that states that big audit firms may perceivably reduce questionable accounting practices and report any error the management committed. Titard (1971), Hartley and Ross (1972), and Shockley (1981) in Wati and Bambang (2007) mentions two key reasons for why big audit firms are more independent than small ones, namely: separation of a department that delivers audit services and one that delivers non-audit services; and the revenues gained by an accounting firm is influenced by not only one client. Practically, the larger the company, the more complicated the organizational structure, and the higher the internal agency cost. As a result, companies employ larger audit firms to audit their financial statements to alleviate the agency cost (Simunic and Stein, 1996; Francis et al., 1999).

2.2.4. Audit Firm and Audit Risk

Audit firms are a professional service organization rendering services to companies by professional auditors. Ghosh and Lustgarten (2006) argue that segmentation of the audit

market occurs in part because some clients need internationally recognized auditors or specialized auditing services that can be provided only by the largest audit firms. Accordingly, they divide total samples into two categories: large (Big 4 or 5 auditors) and non-large auditors. Audit firms with lots of clients in the same industry (specialization in a given industry) will better recognize any audit risks characteristically present in the industry. Because creditors, investors and other stakeholders rely on the financial statements, audit risk may carry legal liability for a Certified Public Accounting firm performing audit work. An audit requires a Certified Public Accounting firm to make inquiries and perform test work on the financial statements. Audit firms carry malpractice insurance to manage audit risk and the potential legal liability. Academic research also suggests that the audit firms' geographical proximity to the components of audit risk has implications on audit risk itself (Choi et al. 2012). Audit firms will suffer damage as a result of giving wrong audit opinions. Such damage may be in monetary form paid either to the clients or third parties or simply loss of reputation. Monsouri et al. (2009) and Gull et al. (2009) found that specialized auditors have significant influence on the competence of detecting frauds.

2.3 Theoretical Review

Theory envisages ensuring that the financial audit information reduces risk, reduces the risk that the information provided to users by public entities may not be correct. The theories are:

Context Theory

The context theory of classification states that judgements are assumed to be derived exclusively from stored exemplary information. The general idea of the context model is that classification judgements are based on the retrieval of stored information. The context model of classification as applied in this study is assumed that the ability to detect the likelihood of misstatements is derived from the auditors' stored exemplar information on the occurrence of misstatements. It is assumed that the level of misstatements of a client's company serves as a stimulus that the auditors will rely on to decide the likelihood of misstatements in the clients organization (Jaffar, 2009).

Attribution Theory

This theory explains that the expected level of future performance in a given task depends mainly on the given causes to which prior success or failure in the same task are attributed. Jaffer (2008) explains that attribution theory is used to suggest effect of auditor's ability to assess the risk on his/her ability to detect misstatements.

2.4 Audit Risk and Audit Risk Model

We identify four critical components of risk that affect the audit approach and audit income: Enterprise risk which is the risks that effect the operation and potential outcomes organization activities; Engagement risk which comes with the association with specific client; Financial reporting risk which is the risk that relates directly to the recording

transactions and the presentation of the financial statements; Audit risk which is the risk an auditor may provide an unqualified opinion on financial statements that are materially misstated. However, the core of elaboration is the audit risk. Adeniyi(2004) defined audit risk as the risk that auditor may give an inappropriate opinion on the financial statements. It is the probability that the audit would draw invalid audit conclusion and therefore express invalid opinion. It is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. The audit risk is the ultimate acceptable level that material momentary errors are not detected. The audit risk is considered as a unity of these two components: Risk Assessment, which is the risk during collecting and evaluating audit evidence; and Business Risk, which is the economic impact of audit assessment. Business risk is present even though the auditors perform an audit, and after the review of the financial statements give the appropriate report.

Audit risk as a whole consists in the existence of a potential possibility for the auditor to present a positive opinion on the audited financial statements (by mistake or on purpose), even in circumstances where they de facto contain material shortcomings in the result in the way of presentation. The business risk indicates the possibility the auditor in his/her professional activities to suffer loss or erosion of his/her business reputation as a result of any instigation or negative publicity in public, immediately initiated by the revision. Audit risk is inversely related to high engagement risk. The engagement risk is the risk an auditor incurs

by being associated with a failed client. If an auditor accepts a client with high engagement risk, the auditor must conduct a more rigorous audit by setting audit risk at a low level.

2.5.1 The Audit Risk Model

The audit risk model is the conceptual model that underlines the risk-based approach. It states that: $\text{Audit Risk (AR)} = \text{Inherent Risk (IR)} \times \text{Control Risk (CR)} \times \text{Detection Risk (DR)}$

The combination of inherent risk and control risk components (IR X CR) is called audited risk or occurrence risk or environment risk. The two risks mean the risk before the audit, which implies that the misstatement has already existed in the financial statement (Low, 2004; Khurana and Raman, 2004). The auditor cannot control these two risks; hence the auditor must assess their levels. The audit risk model shows that the amount, time and nature of audit procedures depends on the level of the client related risks.

Inherent Risk

Inherent is likelihood that an account balance or class or transactions contains a material without considering the internal accounting controls (IFAC 2007). Inherent risk is the susceptibility of an assertion to material misstatements assuming no related internal controls. It is the susceptibility of transaction to be recorded in error. According to ISA 400, in developing the overall audit plan, the audit should assess inherent risk at the financial statement level, as inherent risk are errors that occur in client's financial statements. Inherent risk implies that auditor should attempt to predict where misstatements are most and least likely in the financial statement segments. Inherent risk is measure in the likelihood that there are errors or fraud in a class of transactions. At the start of the audit, there is nothing that can

be time but changing the inherent risk. The auditor must assess the factors that make up the inherent risk and take them into consideration when obtaining the audit evidence. Auditors begin their assessment of inherent risk during the planning phases and update the assessment as the audit progresses. The auditor assess the level of the inherent risk based on his/her professional judgment, taking into the account factor that effect the appearance of inherent risk and whose occurrence cannot be controlled. These factors include unusual pressure on the company management, the integrity of the management and the nature of the business entity (Whittington and Pany, 2001; Adeniji, 2004; Empta,2005). The most important factors that determine the level of inherent risk are: susceptibility and account error; susceptibility of properly loss and fraud; complexity of individual transactions; transaction which are subject to strange way of processing and so on. Wustemann (2004) noted that inherent risk is influenced with factors like asset flow, general economic conditions and technical development. The inherent risk seems to be associated with the nature of client's business, size, complexity, leverage, and to significant accounts such as receivables and inventory, as well as experience of employees, internal incentive systems (Mcletta and Kida,1993; Mock and Wright, Arens et.al, 2007). O' leary 2000; Wah, 2000 and Hunton et al, 2004; stated that inherent risk is often heightened because issues such as inadequate trained personnel, improper data input and interdependencies among business processes can arise.

Control Risk

Control risk is the risk that the internal control does not act preventively in the sense of correction of the material misstatements. It is the risk that client control will fail to prevent or detect a misstatement. Control risk indicates that the structure of internal control in the company will timely prevent or detect incorrect material claims. Control risk is probability that a material misstatement will not be detected by the internal accounting controls. Ideally, the control system around detect any material error before they enter the financial statements. Controls risk is expressed in coefficients (ranging from 0 to 1) or in indicators- percentage digits (ranging from 0 to 100%), where the beginning and the end of the range are extreme cases. The first cases (the beginning of the range) suggest that control structures are so reliable there is no possibility of error. The other extreme (the end of the range) indicate that internal control is unreliable and that there is high possibility that errors will occur. After the inspection of the internal controlling system, auditors usually decide to control the conditions in the environment (which is a part of inherent risk), the accounting system and the controlling procedures (Akhater 2007). If the accounting system and the controlling procedures are assessed as efficient and effective, then the control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Bedard and Graham (2002) indicate that the following factor will influence the assessment of control risk: the internal conditions of auditees, safety of EDP System, management information for detecting

corporate activities. Brazil and Agoglia (2007); Wright and Wright (2002); Bulkeley (2006) noted that control risk can also increase if the focus shifts from segregation of the duties to greater access to information, supervisory review and supplement internal control applications. Control risk seems to be determined by the management's attitude toward internal controls, corporate governance qualities and the audit committee independence and audit committee financial experience (Cohen et al, 2010). Both inherent risk and control risk have been found to be closely linked to audit adjustments (Runkhe and Schmidt, 2014).

Detection Risk

Detection risk is the possibility of existence of errors that auditors cannot disclose by the independent analytic procedure and have to test the details additionally. It is risk that audit procedure will fail to detect material misstatement that exists in relevant ascertain, either individually or when aggregate with other statements. It is a measure of the risk that audit evidence (substantive procedure planned by the auditor to detect misstatements in the financial statements) will fail to detect misstatements that could be material. Detection risk is the likelihood that a material misstatement will not be caught by the auditors procedures (IFAC 2007). The detection risk of a misstatement can be caused by the following factors: an inadequate or insufficient auditors procedures, error execution, misunderstanding the audit result and the adoption of random inspection (Gupta, 2005; Okezie, 2008). This risk has an impact on the assessment of the inadequacy of the supervision. If the auditor considers that

the risk of detection cannot be reduced to an acceptable level, he will express qualified opinion (eventually cancel further engagement) or will refrain from giving an opinion the audit report. It determines the number of substantial element of proof the auditor plans to accruals in order to reduce the detection risk to an acceptable level. This means that to achieve low detection risk, this could include: Applying more reliable forms of evidence, assigning more experienced auditors, and maintaining a closer supervision. So, the longer the amount of evidence, the lower the risk of failure to detect errors that are represent and this reduces the level of risk of detection. The detection risk is an integral part of audit planning. It determines the nature, timing and extent of independent activities, hence auditor are trying to define the planned level of defection, which is a function of the planned level of audit risk, the level of materiality and risk of errors.

The audit risk model though is limited to the fact that each component is treated as separate and independent when it ought not to. Hence many auditors use the model as a functional model, rather than a mathematical means. Despite this, the audit risk allows that auditor to consider that better internal controlled mean a lesser likelihood of misstatement.

2.5.2 Inter-Relationship

Inherent and control risks are often evaluated together, because between them there is a high degree of mutual dependence and positive correction. In contrast, the risk of detection has an inverse correction. That means in case of high inherent risk and weak controls, the auditor will set or accept a low risk of detection. Therefore, the lower the Detection Risk, the lower the Audit Risk.

2.5.3 Risk Assessment and Risk-Based Accounting

Risk assessment is the systematic process for assessing and integrating professional judgements about probably adverse conditions and/or events. It is the identification, measurement and prioritization of risk and auditable areas. The auditor provides reasonable assurance that the financial statement under audit is free from material misstatements. The auditors opinion in the reliability of the financial statement can be affected by misstatement from errors or fraud. Therefore, an effective and efficient audit require proper assessment of risk and proper allocation of effort, subsequent to risk assessment (Blay et al,2003) The audit risk model provide the framework for risk assessment. Through assessing engagement risk, auditors, gains a deeper understanding of the client overall risk profile. Through this engagement risk assessing and planning stage, the auditor obtains necessary client background to define the audit risk level as defined in the audit risk model. The auditor assesses engagement risk first, then sets audit risk. Once audit risk is set the auditor assesses control and inherent risk for each amount or class of amount in the financial statement, and

determines the detection risk (AICPA 1983). The auditor then plans the audit to determine the nature, timing and extent of auditing procedure to specific account balance or class of transaction, This way, the auditor is able to focus on collecting subjective, sampling based evidence to achieve the required detection risk level, thus reducing the risk of material misstatement to “negligible level” as envisioned by statement on auditor standard (SFAS)39(AICPA),and provide an overall assessment as to whether the financial statement are fairly presented.

Risk based Accounting (RBA) is an audit approach where an auditor will focus on those areas where there are more likely to contain risk/errors. To adopt the use of RBA, auditors are required to gain a thorough understanding of their audit clients in terms of the organization, key personnel, policies and their industries (porter et al, 2005). The RBA aids the auditors to assess risk maturity. Risk maturity is the extent to which the board and management determines, assesses, manages and monitors risks. Risk responses are the means by which an organization elects to manage individual risks. The main categories are to tolerate the risk; to treat it by reducing its impact or likelihood; to transfer it to another organization or to terminate the activity creating it. Appetite and tolerance are objectives of the management teams in organizations, to respond to risk. Risk tolerance is an organizations willingness to accept deviation from its risk appetite. It is about what an organization can actually cope with. Risk appetite can be defined as the amount and type of risk that an organization is willing to take in order to meet their objectives. Organizations will have different risk appetite

depending on their sector, culture and objectives. Risk appetite and tolerance need to be high on any board agenda and is a core consideration of enterprise risk management approach. Organizations have to take some risks and avoid others. Traditional auditors have used a risk-based approach in order to minimize the chance of giving an inappropriate audit opinion, and audit conducted in accordance with ISA 315 gives an overview of procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered. These procedures include auditors making inquiries and having discussion with the entity's management about its objectives and expectations, and its plans to achieve those goals; performing analytic procedure which will help in identifying unusual transaction; and observing, and inspecting the entity and its environment, and so on.

Chapter Three

Methodology

3.1. Introduction

This section discusses the research methodology of the study. It describes the research design, the population and sampling, source of data, method of data analysis and model specification.

3.2. Research Design

The design applied here in this study is a cross sectional survey on Audit Risk in Nigerian financial institutions through the Nigerian Stock Exchange and their annual reports. This is to enable us establish the possible relationship between firms' characteristics and audit risk over a period of time.

3.3. Population of the study

In a bid to achieve the objectives of this study, the annual reports of the financial institutions in the Nigerian Exchange Group are stated in the period of 2019 to 2024

3.4. Sampling

Sampling is the choice of a part of the population in such a way that the part is a representative of the whole, so that judgement about the whole area is made based on the part (Uyimadu, 2005). The sample size is restricted to 15 companies.

3.5. Sources of data

In the course of conducting this study, data was obtained from secondary sources drawn from the Nigerian Exchange Group and Central Bank of Nigerian statistical bulletin and annual reports for the period (2019 - 2024).

3.6. Method of data analysis

Data extracted from the annual reports were duly presented in tables. The method used in analyzing the data gathered for the study was the Panel least square regression technique as indicated on the model specification below.

3.7. Model Specification

The model for the study is specified thus:

$$AR = F(\text{LEVERAGE, ROA, LOSS, BIG 4, AUDIT FEES})$$

This can be re-specified in regression form as:

$$AR = \beta_0 + \beta_1\text{LEV} + \beta_2\text{ROA} + \beta_3\text{LOSS} + \beta_4\text{BIG 4} + \beta_5\text{AFEE} + \varepsilon$$

Where:

AR = Audit Risk of company i in year t

LEV = Leverage ratio (long-term debts divided by total assets) of company i in year t

ROA = Return on Assets computed as net income divided by total assets of company i in year t

LOSS = Indicator variable that equals 1 if the firm incurred a loss and 0 otherwise of company i in year t

BIG 4 = Indicator variable that equals 1 if the firm's auditor is a big 4 auditor and 0 otherwise of company i in year t

AFEE = Natural logarithm of audit fees paid to auditors for their financial statement audits of company i in year t

CHAPTER FOUR

DATA PRESENTATION AND ANALYSES

4.1 Introduction

This chapter contains the presentation and analysis of data collected for this study. The statistical method of descriptive statistics, correlation analysis and regression technique will be used to analyze the data in order to achieve the research objective.

4.2 Descriptive Statistics

The descriptive statistics of the model is presented in table 4.1

	AR	AUDFSIZ	AUDTEN	AUDCEXP	CLR
Mean	0.71875	2.46E-07	0.50225	0.299125	0.897042
Median	1	8.04E-08	0.5	0.33	0.391599
Maximum	1	2.86E-06	0.66	0.5	19.01268
Minimum	0	5.56E-09	0.5	0	-12.4103
Std. Dev.	0.451021	4.80E-07	0.016784	0.127666	2.826162
Skewness	-0.97307	3.571312	7.72868	0.366403	3.814354
Kurtosis	1.94686	16.06585	63.95304	2.003797	29.88489
Jarque-Bera	32.64362	1478.224	26361.35	10.19617	5206.629
Probability	0	0	0	0.006108	0
Sum	115	3.94E-05	80.36	47.86	143.5268
Sum Sq. Dev.	32.34375	3.66E-11	0.04479	2.591478	1269.964
Observations	160	160	160	160	160

Source: E-views Output

The descriptive statistics of the variables used in the analysis presented in Table 4.1 explains the range, minimum, maximum, mid values, spread and normality of the variables. The mean value of audit risk is 0.71875. It had a maximum value of 1 and a minimum value of value of 0 revealing a large variation thereby showing some degree of variability. Audit risk was however skewed to the left with a value of -0.97307 and is normally distributed at 32.64362. The mean values of all the explanatory variables are positive. All the explanatory variables were positively skewed. The Jarque-Bera probabilities with $p < 0.05$ is an indication that all the variables are normally distributed.

4.3 Correlation Analysis

In an attempt to examine the association between the dependent and independent variables, the correlation matrix was utilized. The correlation matrix highlights the relationship between all the independent variables in the study.

Table 4.2: Correlation Analysis

Correlation t-Statistic Probability	AR	AUDTEN	AUDFS	AUDEXP	CLR
AR	1.000000 ----- -----				
AUDTEN	-0.149509 -1.900668 0.0592	1.000000 ----- -----			
AUDFS	0.001039 0.013054 0.9896	-0.041462 -0.521612 0.6027	1.000000 ----- -----		
AUDCEXP	0.091819 1.159045 0.2482	0.324943 4.318832 0.0000	0.015013 0.188738 0.8505	1.000000 ----- -----	
CLR	0.121480 1.538374 0.1260	-0.078745 -0.992899 0.3223	-0.017914 -0.225213 0.8221	-0.040488 -0.509346 0.6112	1.000000 ----- -----

Source: E-views Output

The table shows that the co-efficient of correlation of a variable within respect to itself is 1.000. The correlation tests for the model in table 4.2 reveals that AUDFS, AUDEXP and CLR had a positive relationship with audit risk, while the remaining independent variable (AUDTEN) all showed a negative relationship with audit risk. The strongest relationship

existed between client risk and audit risk with a correlation value of 0.121480. Audit tenure (AUDTEN) exhibited the weakest relationship with audit risk with a value of -0.149509.

4.4 Regression Analysis

To examine the determinants of audit risk, multiple regression analysis was performed. The Binary Logit regression technique was therefore employed.

Table 4.3

Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	-1.624214	3.945025	-0.411712	0.6806
AUDTEN	-502137.2	228001.3	-2.202344	0.0276
AUDFS	3.600816	7.853385	0.458505	0.6466
AUDCEXP	1.851996	0.919253	2.014675	0.0439
CLR	0.068617	0.056147	1.222085	0.2217
McFadden R-squared	0.069244	Mean dependent var		0.718750
S.D. dependent var	0.451021	S.E. of regression		0.438704
Akaike info criterion	1.180981	Sum squared resid		29.63898
Schwarz criterion	1.296300	Log likelihood		-88.47845
Hannan-Quinn criter.	1.227808	Deviance		176.9569
Restr. deviance	190.1216	Restr. log likelihood		-95.06080
LR statistic	13.16471	Avg. log likelihood		-0.552990
Prob(LR statistic)	0.021883			
Obs with Dep=0	45	Total obs		160
Obs with Dep=1	115			

Source: E-views Output

Considering the binary nature of the dependent variable (CED), we adopted the binary logit regression approach. The McFadden R-squared of 0.069244 shows that the independent variable explains about 7% of the systematic variation in the dependent variable (audit risk). The LR-statistic of 13.16471 and the associated probability of 0.021883 shows that a linear relationship exists between the regressors and the regressands

The explanatory variable of audit tenure is statistically significant with $p=0.0276<0.05$. The variable reported a negative coefficient of -502137.2 which indicates that the audit fees reduces the level of audit risk among the sample studied.

The explanatory variable of audit expertise reported a positive coefficient of 1.851996 and a statistically significant z-statistic of 2.014675. The implication of the result is that firms audit e expertise have tendency for higher audit risk.

The explanatory variable of audit firm size is statistically insignificant, audit firm size reported a z-statistic of 0.458505. The explanatory variable of CLR reported an insignificant probability value of 0.2217 and a z-statistic of 1.222085.

4.5 Analysis of Diagnostic Tests

VARIANCE INFLATION FACTOR

Table 4.4

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	1.170336	970.9518	NA
AUDTEN	5.94E+09	1.426490	1.127807
AUDFS	4.630381	970.1200	1.075387
ACEXP	0.083543	7.324161	1.122596

Source: E-views Output

The results of the test of variance inflation factors is a further confirmation of the absence of the problem of collinearity of the regression variables. The centered variance inflation factors are all clustered around the value of 1.00 which indicates the absence of multicollinearity. The centered variance inflation factor has a benchmark of 10.00, beyond which is an indication of problem of multicollinearity

HOSMER-LEMESHOW TEST OF GOODNESS OF FIT

TABLE 5: RESULTS OF THE TEST OF GOODNESS OF FIT

	Quantile of Risk		Actual	Dep=0 Expect	Actual	Dep=1 Expect	Total Obs	H-L Value
	Low	High						
1	0.2260	0.5489	9	9.12675	7	6.87325	16	0.00410
2	0.5528	0.6547	5	5.98234	11	10.0177	16	0.25763
3	0.6580	0.6761	10	5.26101	6	10.7390	16	6.36004
4	0.6765	0.6895	4	5.10089	12	10.8991	16	0.34880
5	0.6896	0.7181	3	4.76190	13	11.2381	16	0.92814
6	0.7260	0.7787	3	3.82267	13	12.1773	16	0.23262
7	0.7800	0.7871	1	3.46435	15	12.5357	16	2.23746
8	0.7873	0.8204	4	3.23752	12	12.7625	16	0.22513
9	0.8211	0.8597	5	2.57747	11	13.4225	16	2.71412
10	0.8652	0.9663	1	1.65453	15	14.3455	16	0.28880
Total			45	44.9894	115	115.011	160	13.5968
H-L Statistic			13.5968		Prob. Chi-Sq(8)		0.0929	
Andrews Statistic			14.4244		Prob. Chi-Sq(10)		0.1545	

Source: E-views Output

The Hosmer-Lemeshow test of goodness of fit was used to test the correctness of the specified model. The H-L test of goodness-of-fit reported a relatively high probability value of 0.0929 which could not sustain the null hypothesis of mis-specified model. The implication of the result is that our regression model was well specified.

4.6 Test of Hypotheses

The study sets its decision rule for the acceptance of the hypothesis at 5% level of significance; hence, the null hypothesis would be rejected if the probability value (P value) is less than 0.05. The following are the results of the tested hypothesis:

Hypothesis 1

There is no significant relationship between audit firm size and audit risk.

From the regression result, it was observed that AUDFS with an absolute calculated Z-value of -2.202344 with a p-value of 0.0276 is greater than the critical Z-value of 1.96 at 5% level of significance. Therefore, we reject the null hypothesis which states that there is no significant relationship between audit firm size and audit risk.

Hypothesis 2

There is no significant relationship between audit tenure and audit risk.

From the regression result, it was observed that audit tenure with an absolute calculated z-value of 0.458505 with a p-value of 0.6466 is lesser than the critical z-value of 1.96 at 5%

level of significance. Therefore, we accept the null hypothesis which states that there is no significant relationship between audit tenure and audit risk.

Hypothesis 3

There is no significant relationship between audit expertise and audit risk.

From the regression result, it was observed that AUDEXP with an absolute calculated z-value of 2.014675 with a p-value of 0.0439 is greater than the critical z-value of 1.96 at 5% level of significance. Therefore, we reject the null hypothesis which states that there is no significant relationship between audit expertise and audit risk.

Hypothesis 4

There is no significant relationship between audit client risk and audit risk.

From the regression result, it was observed that CLR with an absolute calculated z-value of 0.056147 with a p-value of 0.2217 is less than the critical z-value of 1.96 at 5% level of significance. Therefore, we accept the null hypothesis which states that there is no significant relationship between audit client risk and audit risk.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The study attempted to empirically examine the determinants of audit risk in Nigeria. This chapter deals with the summary of findings, conclusion, and recommendations.

5.2 Summary of Findings

Based on the empirical analysis of the study, the findings can be summarized as follows:

1. There exist a negative and significant relationship between audit firm size and audit risk.
2. There exist a positive and insignificant relationship between audit tenure and audit risk in Nigeria.
3. There exist a positive and significant relationship between audit expertise and audit risk in Nigeria.
4. Audit client risk exhibited a positive and insignificant relationship with audit risk in Nigeria.

5.3 Conclusion

The broad objective of this study was to examine the determinants of audit risk in Nigeria. The empirical analysis provided that audit firm size is significantly related to audit risk in Nigeria. The study also revealed that audit tenure is not significantly related to audit risk in Nigeria. Audit expertise is significantly related to audit risk in Nigeria. The study also revealed that audit client risk is insignificantly related to audit risk in Nigeria. In terms of significance, audit firm size exhibited a negative relationship; while audit tenure, audit expertise and audit client risk exhibited a positive relationship with audit risk in Nigeria.

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