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The auditors' way to acquire knowledge about a company's environment

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Abstract

Title: The auditors' way to acquire knowledge about a company's environment

The purpose with this study is to identify and explore how auditors proceed when acquiring knowledge about a company's environment; and which difficulties that arise when acquiring this knowledge. A qualitative research method has been used to do this study and eight auditors have been interviewed.

The risks in a company depend on which industry the company operates within. Therefore, it is very important that an auditor has an understanding of the whole company. ISA 315 requires an auditor to have an understanding of a company and its environment. This understanding will affect the auditor's risk assessments during audit process.

This study shows that interviews with the clients is an important information source when the auditors want to have knowledge about a company's environment. Other information sources the auditors in this study use are different media sources, colleagues and key ratios. One difficulty with acquiring knowledge about a company's environment is according to the respondents that it is hard to get a whole picture of a company. Another difficulty is that it might be hard for the auditors to know when they have enough information about a company's environment; information that makes it possible to do accurate risk assessments.

Keywords: Auditing, risk, industry, environment, ISA 315.

Introduction

To understand the whole company and its environment is a very important part for the auditor during the audit work. Through this understanding the auditor will be able to know where there might be challenges in the audit process (Knechel, 2007). Auditing means that an auditor should understand, review and report information about a company's stewardship, accounting and annual report (FAR, 2006). An auditor should also independently make statements regarding a company's financial information. The audit work makes it possible for the auditor to secure that the information disclosed by a company to the public is presenting a true and fair picture of the company. This certified information is then used by the company's stakeholders in their decision making processes (Romero, 2010). It is not possible for an auditor to guarantee that a company's financial information is totally without misstatements; the only thing an auditor can state is that no significant misstatements have been discovered (Law, 2008).

To be able to ensure that there are no significant errors in a company's financial information, the auditor needs to plan the audit very carefully. The planning of the audit work is a very essential part of the audit process. It is during the planning process the decisions are made about which areas the auditor will focus on during the audit. The information selected to be reviewed is the information where there is the highest risk for significant misstatements. (FAR, 2006)

When an auditor assesses which information is going to be controlled, he/she should consider many different types of risks (FAR, 2006). The risks an auditor should normally keep in mind are the detection risk, the control risk and the inherent risk; together these risks create the so called audit risk. The meaning of detection risk is that there is a risk of not finding misstatement during the audit process. Control risk is the risk that a company's own internal controls fail to detect an error. Inherent risk is the risk that comes with the company's business and this means that errors can occur before the company's internal controls are involved. The detection risk is the only one of these three risks that the auditor can affect during the audit process. The other two risks lies within the company (Iselin & Iskandar, 1996; Law, 2008). Different risks might arise depending on which industry the company operates in, because some risks are specific for a certain industry (ISA 315).

No companies are alike; they are all special and have their own specific conditions. Therefore, an auditor must gather information about both internal and external circumstances for every individual client company audited (FAR, 2006). The environment a company operates in may affect the company and the financial information disclosed by the company. More and more companies are now facing the effects the environment has on their company and this has become an interest among stakeholders (IAPS 1010). The growing complexity of company structures has led to a need for auditors that are familiar with the company's operations and its environment. An auditor has to understand how these factors can affect a company's financial statements (Lennartsson, 2010).

According to Allen, Hermanson, Kozloski and Ramsay (2006) there are several studies investigating how efficient an auditor is in finding risks in a company, by understanding the company's business processes. Earlier an auditor primarily focused on the balance sheet when assessing the risks in a company. Today an auditor has a broader perspective and is more focused on the company's environment and important processes within the company. Through this broader viewpoint the auditor gets an overall perspective of the company. (Allen *et al.*, 2006)

Low (2004) has examined how an auditor's planning of the audit process and the auditor's risk assessments are affected by the specialization an auditor makes within a specific industry. The investigation shows that if an auditor has great knowledge about a company's industry, the auditor's capability to identify risks in the company also improves. However, Allen *et al.* (2006) point out that there is a risk that industry specific factors are trivialized, because the risks might be considered to be normal within the industry. This leads to that some risks might be ignored, because the risks are not seen as relevant since these risks are accepted in the industry the company operates within. Furthermore, Low (2004) explains that an auditor who is an expert of a certain industry often makes changes in the standardized audit processes. By making changes in the standardized audit processes the audit becomes more efficient and covers the areas within the company where errors are most likely to be found.

The company structures today are becoming more and more complex. The result of this is that audit firms have started to educate their auditors to become experts of specific industries. This education starts early in the auditor's career and because of this the auditor has less audit experiences from different industries and his/her knowledge is not very broad. At the same time, this early specialization means that the auditor becomes an expert in a certain industry, which can make the audit more efficient (Low, 2004). An auditor’s ability to identify risks in a company increases if the auditor has a certain understanding and knowledge about the client’s industry. When an auditor has this specific industry knowledge it becomes easier to plan the audit process in a way that enables errors detection (Allen *et al.*, 2006).

The International Standards on Auditing (ISA) highlights risks that exist in a firm’s environment (Lennartsson, 2011). ISA 315 requires the auditor to acquire knowledge about the company to be audited; the auditor should also obtain knowledge about the company’s environment. This knowledge the auditor has collected is the base for the audit plan and it will also affect the auditor’s professional judgment during the audit process (ISA 315).

In the beginning of 2011 ISA was implemented in Sweden and, thereby, earlier audit standards (RS) were replaced. One of the biggest differences between the old RS and the new standards (ISA) is how they deal with the risk concept. ISA is clearer about how an auditor should identify risks in the client’s operations and the standards are focused on that an auditor should understand a company’s environment. In Sweden, it is debated whether an audit should be more risk oriented or not. Now, when ISA has been implemented in Sweden, the risk oriented approach has become more explicit. (Lennartsson, 2011)

Allen *et al.* (2006) mention that there is an increasing focus on the auditor to identify risks in a company by obtaining an understanding of the company’s processes and environment. This is also shown in ISA 315, the standard highlights that an auditor should obtain knowledge about a company’s environment. FAR (2006), Lennartsson (2010) and IAPS 1010 are all explaining that there are many different types of risk factors in a company. Therefore, it is important that an auditor acquires an understanding of the industry that the client company operates within. Low (2004) and Allen *et al*. (2006) describe that if an auditor has expert knowledge about a specific industry the auditor will have an increased capability to identify risks in a company within this industry. An auditor that has certain knowledge about a specific industry will perhaps make better risk assessments and, thereby, the probability to detect misstatements in a company's financial statements increase. This makes it interesting to examine how auditors do when they acquire information about a company's industry and its environment, information that enables an auditor to understand where there might be risks in the company. It is also interesting to examine which difficulties the auditors face when obtaining this information. The purpose with this paper is to identify and explore how auditors proceed and which difficulties arise when acquiring the knowledge and understanding about a company's environment that ISA 315 requires.

From the purpose of this article the following questions have been formulated:

- How do the auditors proceed when they acquire knowledge about the client company's environment?

- According to the auditors which difficulties arise when it comes to acquiring knowledge about the client company's environment?

Literature review

Materiality

An auditor does not review everything of a company's financial statements, because if the auditor should review everything it will be very time-consuming and hence expensive. Instead the auditor needs to construct an efficient audit, this is for example done by using a materiality level (FAR, 2006). FASB (2008) defines materiality as:

> *The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement*. (FASB, 2008, p. 6)

The purpose with the level of materiality is to find a level that makes it possible to detect material misstatements in a company's financial statements. To decide the level of materiality the auditor must use professional judgment and both qualitative and quantitative information need to be taken in consideration

(Blokdijk, Drieenhuizen, Simunic & Stein, 2003). Non-financial information is an important source that the auditor should consider during the decision about the materiality level. The auditor’s professional judgment will be influenced by the auditor’s previous audit experiences. Since the auditor uses professional judgment to decide the materiality level disparities could appear between different auditors’ materiality assessments, therefore, the materiality level may vary between auditors (Iselin & Iskandar, 1996).

The materiality level is a very important component of the audit work. However, many of the existing audit standards do not contain detailed guidelines about how the auditor should decide the materiality level; instead the auditor needs to use his/her professional judgment (Iselin & Iskandar, 1996; Gist & Shastri, 2003). When an auditor plans the audit process it is important that he/she makes good professional judgments about the level of materiality. The decision about the level of materiality will have a significant impact on the auditor’s work in later stages of the audit process (Blokdijk *et al*., 2003).

Which industry a company works within has a great impact on an auditor’s professional judgment about the materiality (Iselin & Iskandar, 1996). The materiality level together with other information about the client company will be used to determine what is going to be reviewed during the audit (Gist & Shastri, 2003).

Risk

Previously an auditor started the audit process by focusing on the financial statements, but today an auditor starts the audit process by acquiring knowledge about the company’s business risks (Flint, Fraser & Hatherly, 2008). Humphrey, Jones, Khalifa and Robson (2007) argue that the old audit methodology could be seen as transaction based and the new methodology as risk based. The change in audit approach has been developed during the last 20 years (Knechel, Kochetova-Kozloski & Salterio, 2010). This newer methodology is known as business risk auditing (BRA) (Flint *et al.*, 2008; Knechel *et al.*, 2010). Business risks are described by Bierstaker, O’Donnell and Schultz (2010) as something that can be a threat to the effectiveness of a company's business processes. In ISA 315 business risk is defined as:

> *A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies*. (ISA 315, p. 264, paragraph 4b)

The purpose with the business risk audit methodology is to make the audit process better. This is done by being more aware of different business conditions in the client company. The awareness of these different business conditions gives the auditor a better foundation when he/she makes judgment within the audit work (Knechel *et al.*, 2010). If the auditor uses his/her knowledge about a company's business risks the auditor's understanding of the company's processes will improve, which in turn will make the audit more effective (Bierstaker *et al.*, 2010).

To understand where there might be misstatements in a company's financial report an auditor needs to consider the company's business risks and strategy. The understanding of the business environment and strategic plans should be used during the analysis of the audit risk (Humphrey *et al.*, 2007; Knechel *et al.*, 2010). Knechel (2007) and Flint *et al.* (2008) claim that if the business risk increases the audit risk will also increase, therefore, the business risk is seen as an important component of the audit process. This because when there is a risk for failures in a business environment or strategy this should be considered when the auditor assesses the audit risk (Knechel *et al.*, 2010). When the audit risk is high there will be a need for more audit work and a low audit risk often demands less audit work (Low, 2004).

To know what to control in the audit the auditor first needs to identify all business risks in the company. When the auditor knows the business risks it is possible to find out where the financial risks might exist, thereby, the auditor knows what to control (Humphrey *et al.*, 2007; Flint *et al.*, 2008). The reliability for the financial statements disclosed by the company may be affected by the company's business risks. Thereby, it is important that the auditor takes these business risks in consideration during the planning of the audit (Bierstaker *et al.*, 2010).

Flint *et al.* (2008) mention that when business risk auditing was introduced the auditor continued to perform a lot of the audit tasks in the same way as before the implementation. A reason for this may be that it is difficult for an auditor to see the connection between business risks and how these affect a company's financial statements (Flint *et al.*, 2008; Knechel *et al.*, 2010). The tools an auditor uses today have been developed after changes in the audit environment. The result is that the audit tools have become more complex (Knechel *et al.*, 2010). To assess the business risks an auditor often uses decision making tools, especially when it comes to assess risks in a new client company. Still there could be a risk that the decision making tools affect the auditor's professional judgment (Allen *et al.,* 2006).

Knechel *et al.* (2010) point out that there are some factors that may be seen as critical with the business risk audit approach. The business risk audit is very focused on business risk controls in a company's environment. To be able to find misstatements in a company's financial statements an auditor needs to assess a company's internal controls by using analytical evidences. (Knechel *et al.*, 2010)

An important part of the business risk audit methodology is that the auditor should use his/her experiences and professional judgment when the auditor considers a company's status. This means that the auditor assesses the company's financial position, strategy and business operations (Humphrey *et al.*, 2007). According to Bierstaker *et al.* (2010) the consideration of non-financial information is an important part of a risk based audit approach. If an auditor has knowledge of different parts of a company, not just financial knowledge, it is easier for him/her to understand how the business is going and what may be expected in the future (Flint *et al.*, 2008).

The knowledge an auditor has about a company's industry will improve the audit risk assessments done by the auditor. This knowledge will also improve the quality of the auditor's decisions during the planning of the audit (Low, 2004). According to Low (2004) and Bierstaker *et al.* (2010) it is important that an auditor takes the risk assessments into account already in the audit planning, because the planning of the audit will affect the auditor's professional judgments later in the audit process (Low, 2004; Bierstaker *et al.*, 2010).

Even if the auditor has assessed the business risks in the beginning of the audit process, the auditor needs to assess business risks continuously during the audit. New information might arise that changes the auditor's initial risk assessments (Allen *et al.*, 2006). The economic environment of a company is dynamic and, thereby, the business risks in a company will also change. Hence, information that the auditor has collected in the past may not be relevant anymore and the auditor needs to update his/her knowledge about the company's risks continuously (Knechel, 2007).

An auditor may miss some unexpected changes in a company's conditions; these changes could have been identified if the auditor had knowledge about the company's business risks. Changes that are seen as unexpected for an auditor without certain knowledge about the company's business risks may instead be seen as expected by an auditor with this knowledge, because the auditor will find explanations to the changes. (Bierstaker *et al.*, 2010)

A study done by Knechel *et al.* (2010) shows that an auditor's risk judgment becomes better when the auditor uses strategic analysis. This could be seen as a support to ISA 315 requirements. ISA 315 requires an auditor to have knowledge about the client company's environment and the auditor should be able to use this knowledge to make risk assessments during the audit (Knechel *et al.*, 2010). Through the risk based audit approach the auditor will gain knowledge about the client company that will affect the auditor's professional judgment when it comes to recognizing possible financial misstatements (Bierstaker *et al.*, 2010).

Professional judgment

A definition of judgment could according to Hatherly, Porter and Simon (2003) be as follow:

> *The concept encapsulates the notion of evaluating the circumstances and/or available evidence relevant to a known objective, and forming an opinion based on that evaluation. It contrasts with achieving an objective by means of following an established set of rules or procedures.* (Hatherly *et al.*, 2003, p. 60)

To make good judgments during the audit process the auditor needs adequate knowledge; the auditor will get this knowledge through both experience and training. The auditor will use this knowledge to create a framework that will assist the auditor when analyzing and identifying information. It is possible for the auditor to compare new information with his/her framework, which is comparing new information with old knowledge. (Bierstaker *et al.*, 2010)

When an auditor considers information that is gathered about a company, the auditor might see that the information is consistent with previous knowledge about the company. In this case there is no need to get more information and the collection of information is finished. In the opposite case, when the gathered information is not consistent with previous knowledge about the company, the auditor continues with the collection of information. This collection will continue until the auditor has acquired knowledge about why the new information is not consistent with the previous information. (Reinstein, Schroeder & Schwartz, 1996)

An auditor who works in an audit firm that is considered to be structured is expected to come up with similar conclusions as the other auditors at the same firm (Reinstein *et al.*, 1996). Cushing and Loebbecke (1986) describe structure as an audit methodology where the auditor uses audit tools which contain different stages that the auditor should follow during the audit work. These audit tools are designed in a way that covers the whole audit process (Cushing & Loebbecke, 1986).

An audit firm that is seen as unstructured believe that an auditor should use his/her professional judgment in the audit process. Therefore, it is acceptable to have some discrepancies between audit processes made by two different auditors, even if the circumstances are similar (Reinstein *et al.*, 1996). An unstructured audit firm changes the audit after the client company's specific characteristics and, thereby, the auditor's professional judgment has an important role in the audit work (Cushing & Loebbecke, 1986).

However, Cushing and Loebbecke (1986) found that both structured and unstructured audit firms emphasize that an auditor should use his/her professional judgment and the audit should be performed after the client company's specific circumstances. Brown, Fiedler, Kestel and Smith (2001) argue that financial reporting is very complex and a structured audit process with quantitative measures is not enough to assess the risks in a company. Because of this Brown *et al.* (2001) state that there will always be a need for an auditor that uses professional judgment to consider different information.

A structured audit methodology may improve the efficiency of the auditor's work. Because the auditor does not need to put so much effort in organizing the audit work and, therefore, the auditor's performance of unnecessary tasks will be reduced. A disadvantage with a structured audit approach is that there might be a risk that the auditor becomes mechanistic and inflexible in his/her professional judgment within the audit. The effect of this might be that the auditor misses important information that would have changed the auditor's conclusions. (Cushing & Loebbecke, 1986)

Hatherly *et al.* (2003) and FAR (2006) state that an auditor can use many different sources to get information about a company and its environment. Information sources that might be used by the auditor are, for example, the client company's different documents, publications regarding the company's industry and business. The auditor's colleagues may also have knowledge about the company's industry that might be useful for the auditor. However, interviews with persons that work within the client company often give the auditor most information (Hatherly *et al.*, 2003; FAR, 2006). Some information might be confidential and, therefore, trust is important between the auditor and the client (De Ruyter & Wetzels, 1999). But, according to Knechel *et al.* (2010) information may be more relevant and of a higher quality if it comes from another source than the company audited.

Auditor specialization and auditor tenure

There are many studies that examine if there are differences in the audit quality depending on an auditors specialization in a specific industry and the auditor tenure. Almutairi, Dunn and Skantz (2009) describe that findings from these studies show that the audit quality increases when the auditor is specialized in the industry and when the auditor tenure has been long. Also Carcello and Nagy (2004) and Davies, Elder, Johnson and Lowensohn (2007) mention that an auditor that specialize in a certain industry is expected to perform audits with higher quality. An audit with higher quality is expected to find and prevent more errors than other audits (Carcello & Nagy, 2004; Davies *et al.*, 2007; Almutairi *et al.*, 2009).

When an auditor is specialized in a specific industry the auditor may have a better understanding for the company's operations; thereby, the auditor will also have better knowledge about the company's risks (Allen *et al.*, 2006; Kend, 2008; Lim & Tan, 2010). An auditor that is specialized in the company's industry has the opportunity to compare the client company's performance through benchmarking with the company's industry (Low, 2004). Low (2004) and Allen *et al.* (2006) mean that the auditor's risk assessments will be improved if the auditor is specialized in the company's industry. The risks in a company depend on which industry the company works within; the company's industry will also affect the nature and extent of potential misstatements (Lim & Tan, 2010).

Kend (2008) mentions that if a company is big and has a complex structure, it is better that the auditor has good knowledge about this specific company and not just knowledge about the industry. If the company, on the other hand, is small it is more important that the auditor has knowledge about the company's industry than knowledge about the specific company. An auditor has often a lot of clients which gives the auditor different perspectives on the industry. This will give the auditor knowledge about the industry that makes it possible for the auditor to give a small company guidance, because the auditor may have knowledge that does not exist within a small company. (Kend, 2008)

An auditor acquires specific knowledge about a certain industry through training and experiences with clients from this industry. It takes a lot of time to gain expert knowledge about an industry, but when the auditor finally got this knowledge he/she will maintain the knowledge for a long time (Davies *et al*., 2007). It is easier for a specialized auditor to keep the knowledge updated, than for an auditor that is not specialized. Because a person that already has specialized knowledge will easier acquire further knowledge (Lim & Tan, 2010).

Many of the tasks in the audit will be better performed if the auditor is specialized in a specific industry. An auditor that is specialized in a certain industry is more secure in assessing the inherent risk in companies within the industry. It may also be easier for the auditor to find misstatements if he/she is specialized in the company's industry. (Davies *et al*., 2007; Almutairi *et al.*, 2009)

If an auditor is expert in a specific industry the auditor will have more knowledge about the industry that a new client company operates within, than a non-expert auditor. This will give the expert auditor an initial advantage in understanding the client company. A non-expert auditor may obtain the same understanding of the client company as an expert auditor if the tenure is long, especially if the client company operates within an industry that is invariable. (Lim & Tan, 2010)

Almutairi *et al.* (2009) and Lim and Tan (2010) describe that long auditor tenure gives the auditor knowledge about the company's operations, its issues and risks; this knowledge will improve the quality of the audit. Iqbal, O and Wang (2009) mention that the audit will be more efficient when the auditor has a good understanding about the company, as a result of a long tenure. According to Lim and Tan (2010) the auditor will probably detect more misstatements when the auditor has had the client for a long time. One negative effect with long auditor tenure is that the auditor's independence may decrease (Almutairi *et al.*, 2009).

Methodology

This study has been performed through a qualitative research method. The reason for the choice of a qualitative research method is that it allowed us to gain a deeper understanding of the auditor's working processes. Through this method we were able to ask detailed questions about how the auditor proceeds, when acquiring knowledge about a company's environment. The qualitative research method made it possible for us to receive an overall view of the auditor's working processes, and supplementary questions were asked to the respondents if something was unclear. The choice of a qualitative research method is supported by Lundahl and Skärvad (1999) and Silverman (2006); their opinion is that a qualitative research method is suitable when you are going to study procedures and experiences.

We have done eight interviews with auditors from different audit firms. Five interviews have been done with auditors from two different audit firms that belong to the "Big Four". Two interviews have been carried out in two different audit firms that are considered to be big, but not included in the "Big Four". One interview has been done in a small local audit firm. Six of the auditors were approved public accountants and two of them were authorized public accountants. The auditors' experiences varied from four years up to 25 years. Two of the respondents were women, which means that six were men.

The interview questions were relatively open and developed in advance, according to Flick (2002) this is known as semi-structured interviews. We believe that this kind of interview is an appropriate method to use in this study, because we wanted the respondents to speak freely about how they proceed when acquiring knowledge about a company's environment, how they use the knowledge and which difficulties that might arise, see appendix 1 and 2. Our choice of interview approach is supported by Silverman (2006) thoughts, that this is a good method when you want the respondent to describe things and talk freely with a specific subject in mind.

The respondents had the questions sent to them in advance, which gave them time to reflect over their answers. We believe that we received the best out of the interviews by giving the respondents time to reflect over their answers in advance. We chose to record the interviews, because the questions were very open and it was easier for us to be more active in the conversation when we did not have to take notes. Christensen, Engdahl, Grääs and Haglund (2001) support our thoughts and claim that the interviewer can be more focused on listening and asking questions when the interview is recorded. However, Christensen *et al*. (2001) also mention that there might be a risk that the respondents' answers will be negatively affected by the recording. We do not see our questions as sensitive for the auditors and, therefore, we do not believe that this negative effect has had any significant impact on the answers. One of our respondents did not want us to record the interview, so instead we had to take notes. Maybe this could be the reason to why we got less information from this interview and why it was harder for us to get a clear picture of the respondent's answers.

Sometimes during the interviews the respondents interpreted the questions a bit wrong. These times it was very important that we guided the respondents by explaining the question a bit better. In this way the risk that the questions were misinterpreted by the respondents were reduced.

Analysis

Presentation of the respondents

This part of the article presents the results from our eight interviews. The respondents are anonymous and are called Auditor A to H. We will start with a short presentation of our respondents.

Auditor A is a woman that has been working at an audit firm for about 4 years. Her title is approved public accountant and she works at a "Big Four" audit firm.

Auditor B is a man that has been working at an audit firm for about 21 years. His title is approved public accountant and he works at a “Big Four” audit firm.

Auditor C is a man that has been working at an audit firm for about 12 years. His title is approved public accountant and he works at a “Big Four” audit firm.

Auditor D is a woman that has been working at an audit firm for about 21 years. Her title is approved public accountant and she works at a small local audit firm.

Auditor E is a man that has been working at an audit firm for about 10 years. His title is approved public accountant and he works at a “Big Four” audit firm.

Auditor F is a man that has been working at an audit firm for about 25 years. His title is authorized public accountant and he works at a “Big Four” audit firm.

Auditor G is a man that has been working at an audit firm for about 12 years. His title is approved public accountant and he works at a big audit firm, but not a “Big Four” firm.

Auditor H is a man that has been working at an audit firm for about 25 years. His title is authorized public accountant and he works at a big audit firm, but not a “Big Four” firm.

Acquiring knowledge about an industry

Interviews with the client

Iselin and Iskandar (1996) and Bierstaker *et al.* (2010) argue that non-financial information is an important source when the auditor assesses the risks in a company. According to Hatherly *et al.* (2003) and FAR (2006) interviews with persons working at the client company are the information source that gives the auditor most information. If a company has confidential information De Ruyter and Wetzels (1999) point out that trust is essential between the client and the auditor. Gaining a really good knowledge about an industry takes a lot of time (Davies *et al.*, 2007). Almutairi *et al*. (2009), Iqbal *et al.* (2009) and Lim and

Tan (2010) claim that long auditor tenure will improve the audit. However, Allen *et al.* (2006) and Knechel (2007) argue that the auditor needs to update his/her knowledge about a company's risks continuously, because they might change over time.

All of the eight respondents in this study point out that interviews with the client company is a very important information source, when acquiring knowledge about an industry. Auditor G states that interviews are almost the only information source that he uses to gain knowledge about an industry. The respondent does not see any reason to mistrust information given by the client regarding the industry and he finds that the clients are those who know the industry best. In order to obtain as much useful information as possible from the client some respondents express that the relation with the client is important; and Auditor A claims that "*you need to have a good relation to the client and you need to have a good interview technique*" (Auditor A, our translation). Five of the auditors mention that interviews often are the first information source they use, before using other information sources about the industry. However, Auditors A, F and H differ a little bit from the other respondents. These three respondents argue that they first search for other information sources, because they want to have some essential knowledge about the industry before meeting the client. Auditors A, G and H highlight that acquiring knowledge about an industry is something that is done continuously through regular contacts with the client, which will increase the knowledge over time. The respondents do not see any great differences in their interview approach between when they have previous knowledge about the industry or not. The only difference the auditors express is that it takes longer to acquire knowledge about a new industry, and more questions need to be asked to the client; for example Auditor G argues that gaining knowledge is a more intense process the first year with the client.

All of the respondents see interviews as a very important information source and a lot of the respondents want to speak with the client before searching for information elsewhere, which supports Hatherly *et al.* (2003) and FAR's (2006) thoughts that interviews provide the auditor with a lot of information. The reason for this may be that the client works in the industry every day and, thereby, the client might have the best knowledge about the industry. De Ruyter and Wetzels (1999) point out that trust between the auditor and the client is essential. The auditors in our study also see this as a significant component, in order to get useful information. Through a good relation it might be easier for the auditor to acquire the information wanted, since the client perhaps speaks more freely and want to help the auditor as much as possible. Allen *et al.* (2006) and Knechel (2007) mention that the auditor's knowledge need to be updated often; it could be seen as the respondents express this opinion by arguing that the knowledge is acquired through continuous contacts with the client. It might be hard for the respondents to get all knowledge about an industry at once, but through continuous contacts the auditors might gain knowledge step by step and it is also possible to keep the knowledge updated. This study does not show any significant differences in how the respondents proceed during interviews with the client, between when the auditors have previous knowledge about the industry or not. However, there are opinions in this study that point out that it takes longer time to acquire knowledge when the client is new. This might be seen as a support to Almutairi *et al.* (2009), Iqbal *et al.* (2009) and Lim and Tan's (2010) statement that long auditor tenure will improve the audit. When the tenure is long the auditor may perhaps ask fewer questions and he/she can instead focus on updating the knowledge and get deeper knowledge, which might improve the audit.

Media

Hatherly *et al.* (2003) and FAR (2006) explain that an auditor can use different sources to gain information about a company's industry. The quality of this information may according to Knechel *et al.* (2010) be higher if it comes from another source than the client company. Lim and Tan (2010) point out that an auditor that already has knowledge about a certain industry will acquire further knowledge about the industry easier than other auditors.

Seven of the respondents in this study explain that they use the Internet as a source to get information about an industry, especially when they do not have any previous knowledge about the industry. Auditor G, on the other hand, states that he does not use the Internet when it comes to acquiring knowledge about an industry; instead he relies on the information given by the client. Those respondents who use the Internet search for information on the company's website and Google. According to Auditor B, there is always something useful to read about the company's industry on the Internet. Four of the respondents argue that it is common that they try to get information from industry organizations. Also, four respondents mention that they use newspapers and journals to find information about an industry. When it comes to acquiring knowledge through the Internet, journals and other media there is a difference in this study between when the respondents have previous knowledge about the industry or not. It seems like the respondents do not search for information in an active way when they are familiar with the industry. Five respondents express this by pointing out that those industries you are familiar with you are also interested in, hence, you automatically, without noticing it, absorb information regarding the industry. Auditor H states: "*I have an interest in knowing what is happening in the industry"* (Auditor H, our translation).

The respondents in our study use the Internet, newspapers, journals and other media to get information about an industry, and this supports Hatherly *et al.* (2003) and FAR's (2006) statement that an auditor uses different sources to get information. By searching for information in different media sources, the respondents can search for the information wanted, which may give them information of high relevance. This might support Knechel *et al.* (2010) who claim that information may be of a higher quality if it comes from a source outside the company audited. Through searching for information in this kind of sources, the auditors in this study receive different perspectives on the industry, not just the client company's perspective. A lot of the auditors in this study explain that they automatically keep updated with industries they are familiar with and have an interest in. This might be explained by Lim and Tan's (2010) thoughts that an auditor who knows an industry will quite easily acquire further knowledge.

Audit firm

Hatherly *et al.* (2003) and FAR (2006) point out that an auditor's colleagues might have information about an industry that is useful for the auditor.

According to Allen *et al.* (2006), Kend (2008) and Lim and Tan (2010) an auditor with certain knowledge about an industry will perhaps have a better understanding of a company, and Bierstaker *et al.* (2010) explain that this auditor will find explanations to different changes within the industry. Cushing and Loebbecke (1986) and Allen *et al.* (2006) mention that the auditor often uses decision making tools to help the auditor in the audit process. Cushing and Loebbecke (1986) call this a structured audit approach and this might affect the auditor's judgment, thereby, the auditor may miss important information.

Six of the respondents explain that they ask their colleagues when they feel insecure about an industry and want to have advices about what they should think about in this specific industry. Auditor E points out that if he does not have the knowledge there is always someone else at the audit firm who has the knowledge: "*colleagues are by far the best information source"* (Auditor E, our translation). Auditors C, E and H argue that through colleagues you can get information that lead you to other useful information sources. Four of the auditors in this study highlight that they use different audit tools that help them to acquire knowledge about an industry. For example these tools contain different questions the respondents can use when interviewing the client. Two of the auditors, Auditors A and B, explain that they also get information about an industry through internal e-mails, especially when it comes to news within an industry. This study does not show any great differences about how the respondents collect information through resources within the audit firm, between industries they are familiar with or not.

The respondents in this study ask their colleagues to get information about an industry, which supports Hatherly *et al.* (2003) and FAR's (2006) thoughts that the auditor's colleagues might have useful information. A reason to why the respondents ask their colleagues might be that the colleagues have knowledge that make them understand the industry and company's within the industry better in the way Allen *et al.* (2006), Kend (2008), Bierstaker *et al.* (2010) and Lim and Tan (2010) explain. The colleagues may also have experiences from similar clients and, therefore, they might know where to find more specific information about the industry. According to Cushing and Loebbecke (1986) and Allen *et al.*

(2006), an auditor can use decision making tools as a help in the audit process and this is something the respondents use when acquiring knowledge about an industry. However, the auditors in this study also use other sources to get information and, thereby, the respondents' professional judgment will probably not be affected by using decision making tools in this area in the way Cushing and Loebbecke (1986) argue.

Compare with other companies

A company's risks depend on which industry the company operates within (Lim & Tan, 2010). Iselin and Iskandar (1996) and Bierstaker *et al.* (2010) claim that an auditor's professional judgment is affected by his/her previous audit experiences. Through the auditor's earlier experiences Bierstaker *et al.* (2010) mention that the auditor will create a framework that he/she can compare new information with. An auditor that has knowledge about an industry will according to Low (2004) be able to compare companies within the industry with each other.

Four of the auditors in this study explain that they use key ratios when they want to have information about an industry. Auditors D, E and F state that by using key ratios it is possible to compare the client company's performance against its industry. However, Auditor G mentions that he has only used key ratios a few times and normally he does not use key ratios or benchmarking as a source to obtain knowledge about an industry. Three of the auditors, Auditors B, C and H, explain that they sometimes read annual reports from different companies within the industry to see if they have written anything interesting about the industry. Key ratios and annual reports are especially used when the respondents already have knowledge about the industry and the auditors want to have further information.

In accordance with Low's (2004) statement, the respondents in this study use both annual reports and key ratios to compare the audited company's performance against its industry; especially when the respondents have previous knowledge about the industry. By comparing a company against its industry the auditors in this study will not only get information about the industry; they will also have the opportunity to assess a company in relation to its industry. Through a comparison between a company and its industry the respondents may use their experiences and professional judgment in the way Iselin and Iskandar (1996) and Bierstaker *et al.* (2010) explain. If the respondents use their experiences and professional judgment when doing this comparison they might improve their understanding of both the individual company and its industry.

Acquiring knowledge about external circumstances

Interviews with the client

Flint *et al.* (2008) explain that if an auditor has knowledge about different parts of a company, not just financial knowledge, it will be easier for him/her to understand the company. Hatherly *et al.* (2003) and FAR (2006) claim that the auditor will often get most information through interviews. If the auditor tenure is long Almutairi *et al.* (2009), Iqbal *et al.* (2009) and Lim and Tan (2010) mention that the auditor's understanding of the client company will increase and, thereby, the audit might be more efficient. Humphrey *et al.* (2007) describe that an auditor assesses a company's status by using previous experiences and professional judgment.

Seven of the auditors in this study state that they interview their clients to get knowledge about different external circumstances that might affect the client company. The respondents are of the opinion that interviews are the best source when you want to acquire knowledge about external circumstances; because this kind of knowledge is hard to get elsewhere. Auditors A and B point out that through interviews it is easier to get an understanding about the whole company and create your own opinion about the client company's circumstances. However, six of the auditors in this study explain that it is hard to obtain a whole picture of a company's circumstances the first year auditing it, and the respondents claim that they learn more and more about a company year by year. However, this study does not find any differences when it comes to acquiring knowledge about external circumstances through interviews, between when the auditor is familiar with the company or not. Three of the respondents, Auditors C, F and H express that interviews is a good way to identify external circumstances, but they also argue that it is important to identify some of these circumstances by yourself, because the respondents are not always sure that the client knows which external circumstances that might affect the company. Auditor H also mentions that it is important to have some fundamental information before meeting the client, because: “*I cannot ask the client too stupid questions”* (Auditor H, our translation).

To get knowledge about different parts of a company as Flint *et al.* (2008) mention, the respondents use interviews with the client as an information source. The auditors in this study believe that interviews is a good source that gives a lot of useful information, which could be seen as a support to Hatherly *et al.* (2003) and FAR’s (2006) thoughts that an auditor gets a lot of information through interviews. It might be hard for the auditors in this study to identify all circumstances that may affect a company, because they do not work inside the company. The clients, on the other hand, work daily in the company and, therefore, they might have knowledge about how the company is affected by different external circumstances. The respondents might get hold of this knowledge through interviews. Almutairi *et al.* (2009), Iqbal *et al.* (2009) and Lim and Tan (2010) argue that long auditor tenure will improve the auditor’s understanding of the client company; it could be seen as the respondents express this opinion by pointing out that it is hard to get the whole picture of a company the first year auditing it. There could be a lot of different external circumstances that affect a company and it may be hard for the respondents to get knowledge about all of these already the first year auditing a company. Some of the respondents describe that they also want to identify external circumstances by themselves. This might be seen as the respondents use their experiences and professional judgment to get information that will make them able to assess a company, which can support the statement made by Humphrey *et al.* (2007).

Information sources outside the company

According to Hatherly *et al.* (2003) and FAR (2006) there are many sources an auditor can use to get information about a company’s environment. Hatherly *et al.* (2003) and FAR (2006) continue and describe that colleagues might be a useful information source for the auditor. Kend (2008) argues that an auditor often has different perspectives on an industry, thereby, the auditor might have knowledge that does not exist within the client company.

Four of the auditors in this study explain that they use the Internet and different websites to get information about external circumstances that might affect a company, for example they sometimes use industry organizations' websites. Four respondents state that newspapers and journals can be a good information source when you want to have information about external circumstances. The respondents point out that you can keep updated about news that might affect a client company through newspapers and journals. Four of the auditors in the study explain that they often discuss different external circumstances with their colleagues. By discussing with their colleagues the auditors in this study claim that they have the opportunity to get information through their colleagues, who might have experiences from similar clients. In this study it seems like there is a difference between how the respondents search for information about external circumstances through the Internet, newspapers and journals, when they are familiar with the company or not. If the respondents are familiar with the company they do not look for information in an active way; instead they just try to keep updated about what is happening and sometimes they might see something that may affect a client company. However, this difference does not seem to exist in this study when it comes to getting information through colleagues.

That the respondents use the Internet, newspapers, journals and colleagues to get information about external circumstances might support Hatherly *et al.* (2003) and FAR's (2006) statement that there are many different information sources an auditor can use. By using many different information sources the respondents might get different perspectives in the same way as Kend (2008) mentions. Through different information sources about external circumstances the auditors in this study might obtain knowledge that does not exist within the client company; then the respondents can make the client aware of those external circumstances that they have found. According to Hatherly *et al.* (2003) and FAR (2006), colleagues might be a useful information source. The respondents seem to agree with this thought, because they often discuss with their colleagues to get information about external circumstances. A discussion with colleagues might result in new perspectives, about both where more information can be found and which external circumstances that may affect a company. Colleagues may be a useful information source, since they might have more experiences and knowledge than the respondent.

The usage of the acquired information

Low (2004) and Bierstaker *et al.* (2010) argue that risk assessments need to be considered already in the planning of the audit. According to Blokdijk *et al.* (2003), it is also important to use professional judgment to decide a level of materiality during the planning of the audit. Blokdijk *et al.* (2003) and Gist and Shastri (2003) explain that information about a company and the level of materiality will affect what is going to be controlled during the audit. To consider information, Brown *et al.* (2001) claim that an auditor needs to use professional judgment.

All eight of the respondents describe that the information they have acquired about a company's industry and other external circumstances will have an impact on how they plan the audit. Auditor D states: *"you plan the audit after the knowledge you have obtained"* (Auditor D, our translation), and Auditor H points out: *"the planning of the audit is the most important part of the audit process"* (Auditor H, our translation). All of the auditors in this study also mention that the information they have acquired will affect their judgment about which risks that exist in the company, thereby, the information will also affect the judgment about the materiality. Even if the respondents state that the information is an important component in the planning of the audit, five of the auditors in this study also argue that it is essential to have the information in mind during the whole audit process.

This study supports Low (2004) and Bierstaker *et al.*'s (2010) statement, because the auditors in this study think that it is important to take the collected information in consideration already in the planning process. Blokdijk *et al.* (2003) explain that a level of materiality needs to be decided by using professional judgment. This study shows that the respondents might use their professional judgment to decide a level of materiality, because the auditors explain that the information will affect their risk assessments and, thereby, their judgment about the materiality. According to Blokdijk *et al.* (2003) and Gist and Shastri (2003) the materiality level will impact the rest of the audit process. This might show how important it is that the respondents acquire relevant and correct information, otherwise there may be a risk that the auditors make misjudgments that will affect the audit. The auditors in this study argue that it is important to have the information about a company's industry and other external circumstances in mind during the whole audit process. This might be seen as support to Brown *et al.*'s (2001) statement that an auditor has to use his/her professional judgment. If the respondents have the information in mind during the whole audit process they might use their professional judgment to assess different situations while auditing.

Difficulties with acquiring information

Both Flint *et al.* (2008) and Knechel *et al.* (2010) describe that it could be hard for an auditor to see how different business risks might affect a company's financial statements. According to Bierstaker *et al.* (2010) an auditor without knowledge about a company's risks may miss changes in a company's conditions. Reinstein *et al.* (1996) claim that if an auditor finds out that the collected information is inconsistent with his/her previous knowledge, the auditor needs to continue the information search. An auditor does not review everything, because as FAR (2006) mentions, it will be too time-consuming and, therefore, expensive.

To get information about everything in a client company's environment that might affect the company, is something that five of the respondents find kind of tricky. The auditors in this study claim that it might be hard to know exactly what might affect a company and, thereby, it is also hard for the auditors to know what kind of information they are looking for. The respondents also mention that the client does not always know what kind of information the auditor is interested in; thereby, the client might forget to give the auditor some information because the client does not realize that the information is important for the auditor. Two of the respondents, Auditors D and E, highlight that it is sometimes difficult to know when you have enough information about a company's environment; this means that it is hard to know when you do not have to search for more information. The respondents explain that if they search for more information than needed it will take a lot of time; Auditor E states: *"we cannot dig too deep in every little detail"* (Auditor E, our translation). Auditors A and B explain that another difficulty is that it sometimes is hard to understand how a company's financial statements might be affected by different circumstances in the company's environment. However, Auditors F, G and H do not see any significant difficulties with acquiring information about a company's industry and other external circumstances.

In this study there are opinions that it might be hard to see the connection between different circumstances in a company's environment and the effect these will have on the company's financial statements; this is also something that Flint *et al.* (2008) and Knechel *et al.* (2010) describe. The reason to why the respondents see this as difficult might be that it is hard for the auditors to see the whole picture of the company and understand everything that happens. The auditors in this study explain that it is hard to get knowledge about everything that might affect a company; the result of this might be that the auditor misses changes in a company's conditions in the way Bierstaker *et al.* (2010) argue. The respondents express opinions that it is hard to know when you have enough information and they explain that you cannot search for information too long. Reinstein *et al.* (1996) describe that the auditor continues the search for information if the information is inconsistent with previous knowledge. This study might show that it is difficult for the respondents to know when they have enough information and knowledge about a company's environment that makes the respondents able to assess the company's risks. From this study it is also possible to see that it seems like the respondents have in mind that the search for information cannot be too time-consuming, which could be seen as a support to FAR's (2006) thoughts. That it is essential to think about how long time the information search takes, might show how important it is to use the right information sources and not search for information in the wrong places.

However, there are many different information sources that an auditor can use and this might be the explanation to why some respondents do not see any difficulties in gathering this kind of information.

Conclusion

Our study shows that the respondents think that interviews with the clients is an important information source when it comes to acquiring knowledge about a company's environment, which means industry and other external circumstances. The clients work in the companies daily and might, thereby, have knowledge that is hard for the auditors to get from another source. There is a slight difference in the interview approach between when the auditors are familiar with both the client company and its industry or not. If the auditors do not have any previous knowledge, more questions need to be asked and it takes longer time to acquire an understanding of the company's environment.

Other sources the respondents use when acquiring knowledge about a company's environment are different media sources, for example the Internet, journals, newspapers and industry organizations. Through this kind of information sources the auditors get different perspectives that will increase their knowledge and understanding about a company's environment. When the respondents have previous knowledge about a company's environment they do not search for information through media sources in an active way. Instead they automatically keep themselves updated through these sources, because the auditors are interested in what is happening in a company's environment.

Colleagues are also an information source the auditors in this study use to acquire knowledge about a company's environment. The colleagues might have previous experiences and knowledge that are useful for the auditors when getting an understanding of a company's environment. To get knowledge about a company's industry the respondents sometimes use decision making tools as a help with what they should think about in a specific industry.

When the respondents have previous knowledge about a company's industry they may compare the company's performance against its industry, through key ratios and annual reports. By doing this comparison the auditors might get a deeper understanding of the industry and the status of the client company.

The knowledge the auditors in this study have acquired about a company's environment affect how they plan the audit and, therefore, it will also affect the whole audit process. This might show how important it is that the auditors gather useful information about a company's environment that makes them able to assess the risks in a company accurately.

This study shows that the respondents think that it is sometimes hard to get the whole picture of a company the first year auditing it; because of this it is also difficult to get knowledge about the company's environment. The auditors learn more and more about a company every year and through long auditor tenure the auditors' knowledge about the company's environment will increase. According to the respondents, it may also be hard to see the connection between a company's environment and the effect it has on the company's financial statements. The reason for this difficulty might be that it is hard to get knowledge about everything in a company's industry and other external circumstances.

Another difficulty that arises when it comes to acquiring knowledge about a company's environment is that the respondents think that it is hard to know when you have enough information. The information gathering cannot take too long and be too time-consuming. This might show how important it is to use the right information sources from the beginning and that the auditors must know where to look for information. However, it is important to notice that some of the auditors in this study do not see any difficulties in acquiring knowledge about a client company's environment.

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Appendix 1

Intervjufrågor

Frågorna behandlar vilket tillvägagångssätt revisorn använder sig utav för att få kunskap om ett företags omvärld. Kunskap som gör det möjligt för revisorn att identifiera riskerna i företaget.

- Hur många år har du arbetat i revisionsbranschen?
- Hur gör du för att få förståelse för en bransch du **inte** har särskilt stor kunskap om sedan tidigare?
- Hur gör du för att hålla dig uppdaterad om en bransch som du redan har kunskap om?
- Hur gör du för att få kunskap om de yttre omständigheter som är specifika för ett företag, när du **inte** har särskilt stor kunskap om företaget sedan tidigare?
- Hur gör du för att hålla dig uppdaterad om yttre omständigheter som är specifika för ett företag, när du är bekant med företaget sedan tidigare?
- På vilket sätt använder du den kunskap du inhämtat om företagets situation och omvärld när du planerar vad som skall granskas i företaget?
- Vilka svårigheter anser du existerar med att inhämta information om ett företags situation och omvärld (dvs. bransch och yttre omständigheter)?

Appendix 2

Interview questions

The questions are about how the auditor proceeds when acquiring knowledge about a company’s environment; knowledge that makes it possible for the auditor to identify risks in the company.

- How many years have you been working in the audit industry?

- How do you proceed to acquire an understanding of an industry, when you do **not** have previous knowledge about the industry?

- How do you proceed to keep yourself updated about an industry you already have knowledge about?

- How do you proceed to acquire knowledge about a company’s external circumstances, when you are **not** familiar with the company?

- How do you proceed to keep yourself updated about a company’s external circumstances, when you are familiar with the company?

- In which way do you use the knowledge you have obtained about a company’s environment when planning what to review in the company?

- Which difficulties do you see with gathering information about a company’s environment (i.e. industry and external circumstances)?