

Risk Assessment Standards

Virginia Government Finance Officer's Association
Spring Conference

May 23, 2008

Presentation Objectives

1. Discuss background of risk assessment standards
 2. Illustrate the application of the audit risk process
 3. Highlight significant changes
-

Risk Assessment Standards

1. SAS No. 104, *Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures*;
 2. SAS No. 105, *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*;
 3. SAS No. 106, *Audit Evidence*;
 4. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*,
 5. SAS No. 108, *Planning and Supervision*;
 6. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*,
 7. SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; and
 8. SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*
-

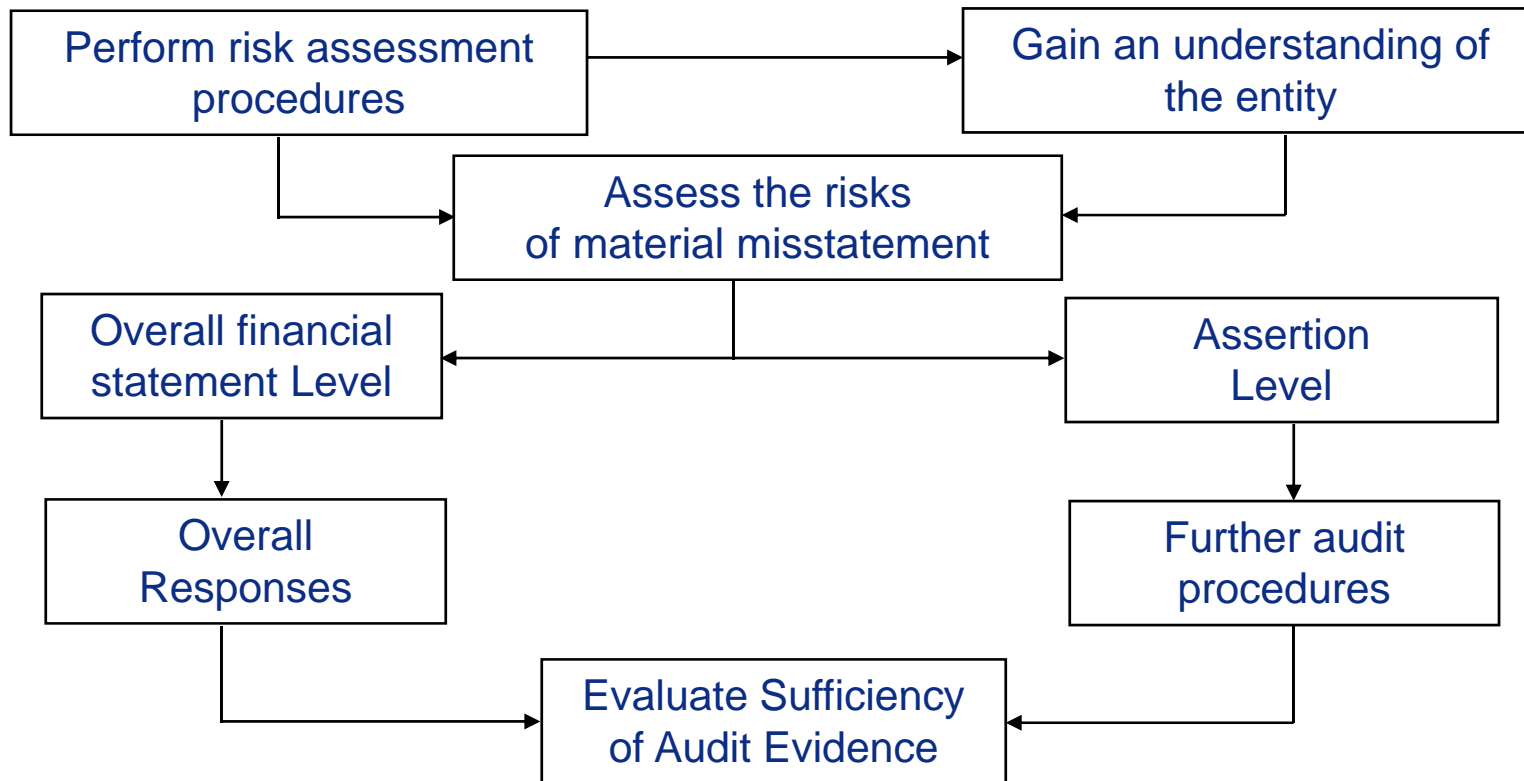
Background

- Objective is to guide auditors to areas of greatest risk whether caused by error or fraud
 - Issued in March 2006
 - Effective for periods beginning after December 15, 2006
-

Significant Changes to Existing Practices

1. Identify and assess the risks of material misstatements
 2. Design and perform tailored further audit procedures responsive to assessed risks
 3. Provide linkage between assessed risks and audit responses
-

Overview of Risk Assessment Process



SAS 104 – Amendment to SAS 1

Due Professional Care

Key Provisions

- Defines *reasonable assurance* as “high level of assurance

Difference from Previous

- Clarifies meaning of *reasonable assurance*

SAS 105 – Amendment to SAS 95

GAAS

Key Provisions

- Expands scope of understanding in 2nd fieldwork standard from “internal control” to the “entity and its environment, including internal control.”

Difference from Previous

- Understanding of entity to be part of audit planning with emphasis that I/C was primarily part of planning. Now that understanding is part of assessing risk of material misstatement, understanding ultimately supports the opinion on f/s

SAS 105 – Amendment to SAS 95

GAAS (continued)

Key Provisions

- Quality and depth of understanding is emphasized by change for “planning” to “assessing the risks”

Difference from Previous

- Emphasizes the link between understanding, assessing risks, and design of audit procedures. “Generic” audit programs may not be appropriate.
- “*Further audit procedures*” (test of controls + substantive tests) replaces “*tests to be performed*”
- “*Audit evidence*” replaces “*evidential matter*”

SAS 106 – Audit Evidence

Key Provisions

- Audit evidence = “all information used by the auditor in arriving at conclusions on which opinion is based.”
- Recategorizes assertions; expands presentation and disclosure (P&D) guidance; and describes how to use assertions to assess risk and design procedures

Difference from Previous

- No definition of audit evidence
- “*Sufficient, appropriate audit evidence*” replaces “*sufficient, competent evidence*”
- Recategorizes assertions to add clarity
- P&D assertion expanded and includes assertion that information in disclosures should be “expressed clearly”

SAS 106 – Audit Evidence (continued)

Key Provisions

- Defines relevant assertions as those that have a meaningful bearing on account fairness
- Provides additional guidance on reliability of various kinds of audit evidence

Difference from Previous

- Term “relevant assertions” is new
- Expands guidance discussion of the competence of evidential matter and how different types may provide more or less valid evidence

SAS 106 – Audit Evidence (continued)

Key Provisions

- Identifies “risk assessment procedures” (RAP) as audit procedures performed on all audits
 - Obtain understanding of entity & environment, including internal controls
 - Assess risks of material misstatements at f/s and assertion levels

Difference from Previous

- “RAP” which are necessary to provide a basis for assessing risks of material misstatements. Results of RAP, with results of further audit procedures, provide audit evidence to support opinion on f/s

SAS 106 – Audit Evidence (continued)

Key Provisions

- Describes types of audit procedures that may be used alone or in combination as RAP, tests of controls, or substantive procedures
- Guidance on uses and limitations of inquiry

Difference from Previous

- RAP include:
 - Inquiries
 - Analytical procedures
 - Observation and inspection
- Inquiry alone is not sufficient to evaluate the design of I/C and to determine whether implemented

SAS 107 – Audit Risk & Materiality

Key Provisions

- Must consider audit risk and determine materiality level
 - Determine extent and nature of RAP
 - Identify & assess risk of misstatement
 - Determine nature, timing, & extent
 - Evaluate whether f/s are presented fairly with GAAP

Difference from Previous

- Previous “should consider” – now “must consider”
- Explicit that audit risk and materiality are used to identify and assess risks

SAS 107 – Audit Risk & Materiality (continued)

Key Provisions

- Risk of material misstatement (RMM) = assessment of inherent + control risks
- Auditor should assess RMM as basis for further audit procedures. Risk assessment is a judgment, auditor should have appropriate basis
- Assessed risks and basis should be documented

Difference from Previous

- Consistent use of “risk of material misstatement”
- Auditor should have and document basis for audit approach
- Eliminates auditor to assess control risk “at the maximum” without a basis for assessment

SAS 107 – Audit Risk & Materiality (continued)

Key Provisions

- Accumulate all known & likely misstatements (not trivial), and communicate them to management
- Request management to respond when misstatements are identified

Difference from Previous

- Additional guidance on communicating to management
 - Additional specific guidance on how to determine threshold for accumulating misstatements
 - Specific guidance for appropriate auditors responses
-

SAS 108 – Planning & Supervision

Key Provisions

- Guidance on
 - Appointment of auditor
 - Establishing understanding with the client
 - Preliminary activities
 - Overall audit strategy
 - Audit plan
 - Involvement of specialists
 - Use of IT specialists
 - Initial audit considerations
 - Supervision of assistants

Difference from Previous

- Guidance consolidated from existing standards
- New guidance on:
 - Overall audit strategy – broad approach to how audit to be conducted (considering scope, deadlines, recent developments)
 - Audit plan – More detailed than strategy, describes nature, timing, and extent of risk assessment and further audit procedures
 - Establish written understanding with client regarding services for each engagement

SAS 109 – Understanding Entity & Environment and Assessing Risks

Key Provisions

- Describes audit procedures to obtain understanding of the entity and its environment, including I/C

Difference from Previous

- Perform RAP (inquiries, observation, analytical) to gather info and gain understanding. Previous standards did not describe procedures to be used.
- Information may be provided by variety of sources, including prior audit knowledge (provided certain conditions met), and results of client accepted and continued procedures.
- Describes imitations of inquiry.

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- Audit team to discuss susceptibility of f/s to misstatements

Difference from Previous

- Requires brainstorming session to discuss risks of material misstatements (can be performed with fraud brainstorming)

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- Purpose of obtaining understanding is to identify and assess RMM and design & perform audit procedures responsive to assessed risk.

Difference from Previous

- Directly links the understanding with the assessment of risk and design of further audit procedures.

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- Auditor should assess RMM at both f/s and relevant assertion levels

Difference from Previous

- Previous – concept of assessing risk at f/s level
 - Now – Expanded, explicit guidance
 - Directs auditor to determine how risks at f/s level may result in risks at assertion level
-

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- How to evaluate design of entity's controls and determine whether adequate and implemented

Difference from Previous

- Previous – understand I/C to plan audit
 - Now – understand I/C to assess risks
 - Previous – understand I/C as part of understanding entity
 - Now – evaluate the design of controls and whether implemented. Involves considering whether control is capable of effectively preventing or detecting and correcting material misstatements. More work than simply gaining understanding of I/C.
-

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- Auditor to consider whether any assessed risks are significant that require special audit consideration or for which substantive procedures alone do not provide sufficient appropriate audit evidence

Difference from Previous

- Previous standard did not include the concept of “significant”
- Significant risks exist on most engagements
- Auditor should gain understanding of I/C and perform substantive procedures on significant risks. Substantive analytical procedures alone are not sufficient.

SAS 109 – Understanding Entity & Environment and Assessing Risks (continued)

Key Provisions

- Extensive guidance on the matters that should be documented.

Difference from Previous

- Guidance on documentation is significantly greater than previous standards.

SAS 110 – Performing Audit Procedures in Response to Risks

Key Provisions

- Guidance on determining overall responses to address RMM at f/s and the nature of those responses

Difference from Previous

- Previous guidance included addressing RMM at f/s level and developing overall response in context of audit planning. SAS 110 repositions consideration of risk so assessment is as a result of and in conjunction with performing RAP.
 - Consider how assessment of risk at f/s level affect individual f/s assertions so may design and perform tailored further audit procedures.
 - List of possible overall responses to RMM at f/s level is expanded.
-

SAS 110 – Performing Audit Procedures in Response to Risks (continued)

Key Provisions

- Further audit procedures (test of controls or substantive procedures) should be responsive to assessed RMM at the relevant assertion level

Difference from Previous

- Previous – concept of audit procedures responsive to risks embedded in audit risk model. Now – repeated emphasis to provide clear linkage between understanding, risks, and design of FAP
- Documentation of linkage now required

SAS 110 – Performing Audit Procedures in Response to Risks (continued)

Key Provisions

- Provides guidance on matters auditor should consider in determining nature, timing, and extent of audit procedures

Difference from Previous

- Guidance greatly expanded and addresses issues not previously included
- Nature of procedures is most important in responding to risks
- Certain substantive procedures on all engagements
 - For each material class of transactions, account balance, and disclosure
 - Agreeing f/s to accounting records
 - Examining materials JE and other adjustments made in preparing f/s

SAS 111 – Amendment to SAS 39

Audit Sampling

Key Provisions

- Guidance on auditor judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls

Difference from Previous

- Enhanced guidance on tolerable misstatement. In general, should be less than materiality to allow for aggregation in final assessment.
- Ordinarily sample sizes for non-statistical samples are comparable to samples sizes for effectively designed statistical sample with the same sampling parameters.