Be Prepared!

What management accountants need to know about the new audit Risk Assessment Standards

BY JANET L. COLBERT, CIA, CPA

Management accountants develop and contribute information critical to financial statements, which outside auditors then use to conduct their independent examination. The American Institute of CPAs (AICPA) recently issued a package of Statements on Auditing Standards (SASs) that dramatically impact how CPAs plan and perform audits. Known as the Risk Assessment Standards, these eight standards address the concept of audit risk and provide extensive guidance on how the independent auditor should assess risk and apply the audit risk model. They also discuss audit procedures for responding to the assessed risks.

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To help in planning their own work and in anticipating detailed queries from external auditors, management accountants should understand the requirements of the new standards. Since management accountants prepare information that their external colleagues use, these internal experts have a critical impact on the financial statements and the audit engagement. In response to the new standards, management accountants might choose to adjust their own work and might elect to alter and enhance documentation of the work they perform.

The requirements in the new standards enhance the assessment of risks the external auditor makes on every audit engagement. To begin the assessment process, the auditor first obtains an understanding of the client by analyzing the environment that the entity operates in, including its internal controls. Management accountants may be called on to provide information as the auditor performs these steps. Armed with comprehension of the entity, the external auditor makes a rigorous assessment of the material misstatement risks in the financial statements.

After assessing the risks of material misstatements, the auditor develops a response to the risks. That is, the auditor plans procedures that address the risks of material misstatements, explicitly linking those procedures back to the assessed risks.

RISK ASSESSMENT STANDARDS

Here's a closer look at each of the eight standards.

1. Reasonable Assurance, Evidence

SAS No. 104, "Amendment to SAS No. 1, Codification of Auditing Standards and Procedures," discusses the attributes of audit evidence and the concept of reasonable assurance. According to SAS No. 104, the auditor is to obtain sufficient appropriate audit evidence when performing the engagement. The auditor gathers evidence to restrict audit risk to an appropriately low level to support the audit opinion. The low level of audit risk relates to the concept of reasonable assurance. Reasonable implies that the auditor provides a high, although not absolute, level of assurance.

2. Internal Control, Evidence

The second Risk Assessment Standard, SAS No. 105, "Amendment to SAS No. 95, Generally Accepted Auditing Standards," impacts the auditor's work on internal control and, like the previous standard, also addresses audit evidence.

Prior to the Risk Assessment Standards, the auditor was required to gain an understanding of internal control on every audit. The new SAS mandates a broader understanding in which the auditor must gain an understanding of the entity and its environment, as well as the system of internal control. Introduced in SAS No. 105, this point is emphasized in several other SASs in the Risk Assessment group.

Having gained an enhanced understanding of the entity, the auditor uses it for two purposes. First, the understanding aids in the assessment of the risks of material misstatement. Second, the auditor employs the increased understanding to design audit procedures that address those risks.

As auditors perform procedures, they obtain evidence that supports the audit opinion. Before SAS Nos. 104 and 105 were issued, previous guidance required sufficient, competent evidential matter to support the opinion. The new standard amends the terminology, noting that the auditor is to gather sufficient appropriate audit evidence. The term "appropriate" embraces relevance and reliability, which SAS No. 106 discusses more fully.

3. Evidence

SAS No. 106, "Audit Evidence," is the third Risk Assessment Standard. Like the others in the Risk Assessment group, this standard discusses the concept of sufficient appropriate evidence. Further, it defines audit evidence and discusses management assertions and the utilization of these assertions to assess risks and design audit procedures. SAS No. 106 addresses the quantitative and qualitative aspects of audit evidence, the characteristics that make up the qualitative nature of audit evidence, and the purposes of various audit procedures.

Definition of Evidence. Evidence comprises all information that supports the auditor's opinion on the financial statements. Data underlying the financial statements is encompassed within audit evidence.

The auditor gathers most evidence during the current engagement, but some may be obtained in other ways. Work that had been completed on previous audits is considered evidence as are procedures the audit firm performs while deciding to accept or continue to work with the audit client.

Assertions. SAS No. 106 stresses the importance of supporting management's assertions regarding the financial statements by gathering audit evidence. In this new standard, the number of management assertions noted in previous SASs is increased. These assertions are now categorized into three groups. The first applies to the income

Table 1: Assertions

INCOME STATEMENT	BALANCE SHEET	PRESENTATION AND DISCLOSURE
Occurrence	Existence	Occurrence and Rights and Obligations
Completeness	Rights and Obligations	Completeness
Accuracy	Completeness	Consistency and Understandability
Cutoff	Valuation	Accuracy and Valuation
Consistency		

statement. The next group embraces assertions related to the balance sheet, and the last includes those assertions addressing presentation and disclosure issues. The three groups and the assertions in each appear in Table 1.

Sufficiency and Appropriateness of Evidence. As noted, the auditor gathers sufficient appropriate audit evidence to support the opinion on the fair presentation of the financial statements. Sufficiency refers to the quantity of audit evidence, while appropriateness relates to its quality.

The quantity or sufficiency of audit evidence is impacted by the risk of material misstatement and by the quality of the evidence obtained. That is, the higher the risk of material misstatement, the more evidence will have to be obtained. If the quality of the evidence is low, more evidence is needed.

Two characteristics impact the quality or the appropriateness of evidence—relevance and reliability. To be deemed relevant, evidence must relate to management's assertions. For example, the observation of the entity's inventory count is relevant to the existence assertion. This procedure doesn't yield evidence that's as relevant to other management assertions.

The reliability of evidence is affected by its source and its nature. For example, evidence obtained from a party independent of the client is generally thought to be more reliable than evidence obtained from internal sources. Also, some audit procedures are typically more reliable than others. For example, positive confirmations provide better evidence than the negative form.

Audit Procedures. Procedures performed by the auditor can be divided into three groups: risk assessment procedures, tests of controls, and substantive procedures. Risk assessment procedures address risks at two levels—the financial statement level and the relevant assertion level.

Table 2: Audit Procedures

Inspection of Records or Documents
Inspection of Tangible Assets
Observation
Inquiry
Confirmation
Recalculation
Reperformance
Analytical Procedures

The second category of audit procedures is tests of controls, which are performed at the relevant assertion level.

The goal of the third group, substantive procedures, is to directly detect material misstatements. Auditors perform these tests, like tests of controls, at the level of the relevant assertion. The categories of substantive procedures include analytical procedures and tests of details. Analytical procedures are studies of relationships among data. In a test of details, the auditor is examining items within classes of transactions, account balances, or disclosures.

SAS No. 106 sets forth eight specific audit procedures, which are featured in Table 2. The auditor might use these procedures as risk assessment procedures, tests of controls, or substantive procedures.

4. Audit Risk, Materiality

SAS No. 107, "Audit Risk and Materiality in Conducting an Audit," addresses the interrelated concepts of audit risk and materiality. The new standard groups misstatements into two categories and also updates the previous audit risk model.

Misstatements. SAS No. 107 classifies misstatements as either known misstatements or likely misstatements. The known misstatement category includes those that result from inappropriate selection of accounting principles as well as misstatements arising from the misapplication of accounting principles. Further, misstatements of facts may yield known misstatements. This designation includes misstatements that result from overlooking or misinterpreting facts and those arising from mistakes in gathering or processing data.

Two sources give rise to likely misstatements. If management makes an estimate for a financial statement element that falls outside the range that the auditor considers reasonable, the difference between the estimate and the nearest endpoint of the range is a likely misstatement. Another item deemed to be a likely misstatement is an amount resulting from the extrapolation of findings. That is, when the auditor performs sampling procedures, the known misstatement located in the sample is projected to the population. That extrapolated amount, minus the known misstatements, is the second type of likely misstatement.

Audit Risk Model. As previously noted, audit risk exists at two levels—the overall financial statement level and the relevant assertion level. Further, per SAS No. 107, audit risk consists of two other risks. The first is the risk that the financial statements are materially misstated, also known as the risk of material misstatements (RMM). The second is the risk that the auditor won't detect the misstatements, which is detection risk (DR). Both RMM and DR have two components.

Inherent risk (IR) and control risk (CR) compose RMM. Inherent risk represents the susceptibility of an account to misstatements before considering applicable controls, while the risk that the system of internal control won't prevent or detect misstatements is control risk. The entity owns both IR and CR. That is, the entity can influence both, but the external auditor can't control the level of either. Rather, the auditor assesses IR and CR and uses the assessments during the engagement.

Analytical procedures risk (AP) and tests of details risk (TD) make up DR. AP is the risk that such audit work doesn't indicate that material misstatements are present in the account when indeed they are. TD is the possibility that the auditors' tests of details won't locate material misstatements that have entered the account.

In response to the assessed level of RMM, detection risk varies, and the external auditor adjusts the planned levels of AP and TD. In turn, the nature, timing, and extent of analytical procedures and tests of details are amended.

Table 3 shows the audit risk model.

Table 3: Modified Audit Risk Model

AR = RMM x DR

AR = (IR x CR) x (AP x TD)

Where:

AR = audit risk
RMM = risk of material misstatements
DR = detection risk
IR = inherent risk
CR = control risk
AP = analytical procedures risk
TD = tests of details risk

5. Planning, Supervision

Another new statement, SAS No. 108, "Planning and Supervision," supersedes guidance provided in previous standards and deals with the understanding of the engagement and planning issues. Previous professional guidance had noted that the auditor is to obtain an understanding with the client as to the nature of the engagement; this requirement is repeated in SAS No. 108. While older standards permitted the understanding to be either in writing or orally, this new statement mandates a written understanding.

Per SAS No. 108, the auditor is to develop an overall audit strategy while planning the engagement. The strategy is then used to effectively organize, staff, and conduct the audit. The standard points out that an audit strategy and an audit plan differ because the strategy exists at a higher, broader level, while an audit plan contains more detail.

During the engagement's planning phase, the auditor should determine if professionals with specialized skills might aid in performing the work. For example, the use of information technology (IT) experts, the valuation of specialized inventories, or consultation with actuarial scientists may be necessary for specific clients. If auditors determine that specialized expertise is advisable, steps such as locating qualified experts, contracting with them, and scheduling their work should occur during the planning stage.

6. Understanding and Assessing Risks

The title of SAS No. 109 is "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement." Together with SAS No. 110, "Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained," this standard supersedes previous guidance on the auditor's consideration of internal control.

As other SASs in the Risk Assessment group do, SAS No. 109 notes once again that the auditor obtains an understanding of the entity and its environment, including its internal control. The standard suggests audit procedures that might be employed to gain such an understanding, which include inquiries, observation, inspection, and analytical procedures.

7. Responding to Risks

As mentioned, SAS Nos. 109 and 110 together provide guidance related to internal control. The latter standard also discusses audit procedures to be performed in response to assessed risks. Further, previous guidance that addressed substantive tests performed prior to the date of the balance sheet is superseded by SAS No. 110.

As noted, the auditor responds to the assessed RMM at two levels—the overall level of the financial statement and the level of the relevant assertion. If the auditor elects to respond to RMM at the overall level, a decision may be made to assign more experienced staff to the engagement or to contract with individuals possessing specialized skills. The auditor may also develop tests that are less predictable. Other responses include adjusting the timing of the tests and increasing the level of professional skepticism. Finally, the auditor considers whether a substantive approach or an approach combining both substantive and control tests is most appropriate.

SAS No. 110 notes, as does SAS No. 107, that the auditor may also respond to RMM at the level of the individual assertion. That is, the nature, timing, and extent of planned audit procedures can be adjusted to accommodate varying levels of RMM.

SAS No. 110 goes on to stress the significance of audit documentation, which must include the auditor's overall response to RMM and the responses at the assertion level. Further, the auditor should record the link between the assessed RMM and the nature, timing, and extent of planned procedures. To complete the documentation, the results of the procedures performed as well as the conclusions reached from those procedures are included in the files.

8. Sampling

The final standard in the Risk Assessment group takes up the topic of the auditor's use of sampling. SAS No. 111, "Amendment to SAS No. 39, Audit Sampling," features guidance to address both statistical and nonstatistical sampling. The new standard includes a discussion of tolerable misstatement, a concept essential to sampling methodology, as well as components of the audit risk equation.

SAS No. 111 notes that the auditor should set tolerable misstatement at a level below that of materiality for the financial statements. This practice allows for the accumulation of the various tolerable misstatements from across the accounts in the financial statements.

Like other standards in the Risk Assessment group, SAS No. 111 addresses RMM and its components. Specifically, because both IR and CR are used in sampling models, the two risks should be quantified. But the auditor should bear in mind that, while quantified, the figures for IR and CR are arrived at subjectively by applying the auditor's judgment.

FOR MANAGEMENT ACCOUNTANTS

By understanding the new procedures that external auditors must perform, management accountants can plan their own work appropriately. As a result of the increased external audit work, they may need to adjust their procedures and enhance the documentation. Finally, an understanding of the Risk Assessment Standards helps them anticipate inquiries that the external auditors may make of them. This helps management accountants stay one step ahead of the auditors in anticipating their needs and in preparing information for their external colleagues. ■

Janet L. Colbert, Ph.D., CIA, CPA, Cr.FA, is a professor of accounting at Eastern Kentucky University in Richmond, Ky. You can reach her at (859) 622-8881 or jan.colbert@eku.edu.