

The Risk Assessment Auditing Standards: How to Efficiently and Effectively Comply on Smaller and Less Complex Audit Engagements

By Charles E. Landes, CPA

AICPA Vice President - Professional Standards and Services



Introduction

In March 2006, the AICPA's Auditing Standards Board issued a series of new auditing standards that are commonly referred to as the Risk Assessment Standards. Since that time, I've had many conversations with a number of practitioners around the country about the importance of the risk assessment standards and also how best to implement the risk assessment process on audits of very small entities.

Many senior partners have told me that these standards essentially provide guidance in a way that they learned to audit. In other words, it requires the auditor to understand the company, environment, and industry in which the client operates and then asks the auditor to design an audit plan tailored to that specific client and the risks of the specific client. This type of feedback is consistent with my own thinking about the standards, in that they provide guidance that should help auditors to do a better job of planning audits and making better decisions on how to audit higher risk areas. To state it a different way, they help the auditor work smarter.

Some practitioners that I encounter, however, can't quite seem to understand or appreciate why they need to spend the time performing a risk assessment. They tell me that it's an inefficient and futile exercise of preparing checklists without any benefit. When I'm able to more deeply quiz those practitioners, what I tend to find is really a different problem.

I find that while they do appreciate the theory of the standards, they are frustrated with their audit firm's methodology that seems to add many inefficient hours to the audit by having low level staff complete pages upon pages of checklists, while not getting to the heart of the issue, which is the identification of significant risks and the tailoring of the audit plan to respond to those risks. When I probe further why they don't change their methodology for this area of the audit, the simple and most common answer is that they don't have the time to make the change and they are afraid to deviate from their acquired methodology.

As a local firm practitioner for many of my 25 years in practice, I can sympathize with the smaller firm members who are trying to do many different things, from tax planning and return preparation to helping their client with an assortment of business issues while trying to conduct an efficient and effective audit.

This white paper attempts to simplify the practitioner's understanding of the risk assessment standards and process by focusing on the end game and how that objective can be achieved in an effective, yet efficient, manner.

Simplifying the Risk Assessment Standards and Process

Significant risks have a special meaning within the risk assessment standards. They are defined in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), as "an identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration."

What I found as a local firm practitioner auditing many small entities and what I expect many local firm practitioners find is that standardized audit plans do a good job of covering most of the general and routine risks in an audit. However, for every audit

client there was typically one, two, or maybe three higher risk areas that needed special consideration or attention in terms of modifying the standardized audit plan so that it was responsive to those higher or significant risks.

Using the 80/20 rule as an example, if we assume that a standardized audit plan will be response to 80 percent of the general audit risks, then what we want from the risk assessment process is an efficient and effective way that will help us identify and respond to the other 20 percent; because it's that 20 percent or the significant risks that contain the highest risks of error or fraud.

But if you have a good understanding of the audit client, its system of internal control, and the environment in which the client operates, do you really need voluminous checklists to be able to identify those areas of significant risks for a smaller and less complex audit client? The answer is typically no.

Therefore, the risk assessment process can be simplified as those procedures the auditor is required to perform to help the auditor identify and respond to areas of the greatest risk of material misstatement, giving emphasis to significant risks.

Step 1—Obtain an Understanding of Your Client and Its Environment

The first step in the process is to obtain and document an understanding of your client and its environment, including the industry in which that client operates, the regulatory environment, and other external factors.

As the auditor, you want to understand how your client makes money. What are the products it sells, who are its customers, what gives your client a strategic advantage? Does your client obtain a new customer because it is a low cost provider or does your client have a unique product or strategy that allows it higher than average profit margins?

You also want to obtain and document your understanding of the industry in which your client operates. This would include not only the type of industry, but whether that industry is very competitive, easy to enter, what unique revenue characteristics might it have, how quickly do the products change, and other circumstances? The AICPA's Audit Risk Alerts are a great place to obtain current information on specific industries.

As a former peer reviewer, I would be amazed when performing interviews how many times a staff person prepared an assortment of documents that supposedly documented this understanding but yet when quizzed on the client couldn't tell me the client's primary product, how its income and profit margins compared to industry peers, or the owner's strategy for being and staying in business. It was clear from these interviews that staff was merely filling out forms without understanding why they were even doing the work.

If any firm wants to make gains relative to the risk assessment process, it's critical that partners and staff, at all levels, understand the end game of what they are trying to achieve by performing risk assessment procedures.

How an auditor documents his or her understanding is a matter of firm policy in terms of how that understanding can be most efficiently and effectively documented. I always preferred documenting this understanding in a concise memo that was updated annually because I found a well written memo could tell a story about the company that a checklist could not.

But, however you obtain and document your understanding, remember the end game—where are the higher risks that the client will not get the accounting right and where does the standardized audit plan need to be tailored?

Step 2—Obtain an Understanding of Internal Control

The risk assessment standards require the auditor to obtain an understanding and document key aspects of the client's internal control over financial reporting. Some of you may immediately be thinking that your client has no controls so what's the purpose—that assumption is FALSE. All entities have controls even though they may not be documented.

Working from the COSO framework, think first about the control environment—does the owner want to do the right thing? How does the owner communicate his or her intentions to the employees? Although you might not realize it, how the owner acts and how the owner communicates expectations to employees are controls and these are controls that you want to document and determine that they have been placed in operation. A client, who is not willing to do the right thing, is a client you should run away from.

Also, as you think about controls, think about how the bookkeeper or accountant makes decisions relative to account coding and classification? How does the bookkeeper determine that there are proper cutoffs with the recording of assets or liabilities? These are examples of essential basic controls that need to be understood and documented.

And as a reminder, if you're going to rely on the controls over account coding and classification, you'll need to test controls to make sure that those controls you think are effective, really are designed, implemented, and operating effectively.

You also might want to think about how the business owner monitors the financial results. This too is a control. If an account would be materially misstated in an internal monthly financial report, would the business owner likely spot that misstatement?

These are all examples of controls that should be understood and documented even in the smallest of clients. Although these controls may seem basic and elementary in nature, these are often the key controls for many small business entities. Additionally, it is likely that you will rely on these controls and, therefore, they need to be tested if they are going to be relied upon.

Therefore, an auditor who says “my client has no controls” needs to step back and understand what that statement means. If a control is a process designed to prevent or detect and correct misstatements, and your client has no controls, that would mean that your client has no processes or policies in place that would prevent or detect and correct a misstatement. If that’s the case, one has to ask how would you ever finish an audit given that situation?

But let’s remember, what are you looking for and why? You’re looking for processes (that is, controls) over accounts and assertions where there may be control weaknesses that could lead to material misstatements that will not be detected and corrected by the client and that might not be sufficiently covered by the standardized audit plan. Identifying those areas will help you identify significant risks.

Oh and by the way, make sure you accumulate those control deficiencies so you can assess whether they are significant deficiencies or material weaknesses—both of which you will need to communicate.

Step 3—Brainstorming Meeting

This step probably allows the best opportunity for the engagement team to identify significant risks as long as the engagement partner does not stifle the conversation. In conducting the brainstorming session, the engagement partner should allow for a free flow of ideas about how a material misstatement, whether caused by error or fraud, could occur.

Although the risk assessment and fraud standards do not require separate brainstorming sessions, I would encourage you to set aside a separate amount of time to just focus on fraud risks and how an employee of the client, including the owner, could perpetrate a fraud that would be material to the financial statements. Keep in mind that for smaller clients, the risk of misappropriation of assets may be a higher risk than the risk of a financial statement fraud.

This session should be conducted taking into consideration the client’s accounting processes and controls and taking into consideration the fraud triangle—incentive, opportunity, and rationalization.

Do not, for one second, assume that your client’s employees would never perpetrate a fraud. Never assume that the owner, even though he or she may be a friend, will never be tempted. As an auditor, you should always maintain your professional skepticism and always be alert to those threats that could ruin your career and your firm’s reputation.

At the sake of repeating myself, remember, the purpose of this exercise is to identify significant risks of misstatement, whether caused by error or fraud.

Step 4—Summarization of the Audit Risk Assessment

Now that your risk assessment process is almost complete, it is time to document your assessments and see what significant risks you’ve identified. These should be unique significant risks for this specific client, this specific year.

Depending on how your firm’s core audit plans have been developed, they will likely cover the “normal” audit risks. When you’ve identified those risks that are significant risks, and you’ve determined the accounts and assertions that could be affected, you need to design or draft audit plan steps that will uniquely mitigate the significant risks identified. This step should be performed or closely supervised by the engagement partner or manager as it takes years of experience to understand the type of audit procedures that should be applied to these high or significant risks. As part of the audit documentation, remember to document the linkage between the significant risks identified and the audit plans designed to mitigate and respond to those significant risks.

Chances are these audit procedures will be unique to this client and this year; therefore, asking a less experienced staff person with little or no experience to carry out these procedures is not a good idea. You’ll want someone in the firm who has the competencies and the experience to make certain that these unique audit steps are designed and completed appropriately and that the audit evidence obtained is sufficient in the circumstances.

Conclusion

I hope that this white paper has helped to explain the risk assessment procedures and has helped to simplify what needs to be done and why. As I mentioned at the beginning, the goal is to work smarter, not necessarily harder.

A top down approach, performed by a senior member of the engagement team who knows that the goal is to identify those significant risks that will not be covered by the standardized audit plans, should be more efficient and effective than a bottom up approach where low level staff are assigned to complete pages upon pages of checklists.

But remember, the risk assessment process is never complete until the audit report has been released. A quality audit is not a linear process rather it is a circular process. Therefore, as you assess audit evidence, especially in the significant risk areas, apply your professional judgment and skepticism to see whether your expectations have been met. If not, then you'll need to consider amending your risk assessment and performing other audit procedures.

Keep in mind that it is your responsibility to obtain sufficient appropriate audit evidence to reduce the risks of a material misstatement to an appropriately low level. Only then will you have obtained reasonable assurance for the issuance of your opinion.

Do not take this responsibility lightly; your firm is counting on you.

The AICPA has a number of resources to help you understand and apply the requirements of the risk assessment process, including its release of an *Audit Risk Assessment Tool*.

The *Audit Risk Assessment Tool* is designed to walk an experienced auditor through the risk assessment procedures and document those decisions necessary to prepare an effective and efficient audit program. This tool is designed to be used in lieu of cumbersome checklists by providing a top down approach to the identification of high risk areas to allow for appropriate tailoring of audit programs that will result in audit efficiencies.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.