Report
December 19, 2018

Center for Plain English Accounting

AICPA's National A&A Resource Center

Author's Note

For the last 18 years, I have served as the AICPA's Vice President of Professional Standards and as the AICPA's technical director for auditing and assurance standards. As I retire from that position, it is with tremendous pleasure that I now have an opportunity to work with the wonderful professionals at the CPEA in its mission to serve as the National A&A Resource Center. In this new role, I hope that I can help or assist CPEA firms with their audit or assurance practice. In that spirit, I will be writing reports from time to time on various auditing and assurance topics; but I promise, in the name of our founder Dr. Ratcliffe, to try and write them in Plain English. If there's a particular audit or assurance topic that you think would be relevant or helpful, or if you believe that our CPEA team can help improve your assurance practice in some way, please send us an email (cpea@aicpa.org), we'd love to hear from you.

Chuck Landes, CPA

Speaking Plainly about Risk Assessment -- Part I

By: Chuck Landes

In March 2006, the Auditing Standards Board, in conjunction with the International Audit and Assurance Standards Board, issued a series of new auditing standards commonly referred to as the Risk Assessment Standards. Even though these standards are over 10 years old, we unfortunately still see too many signs that engagement teams are not properly executing their audit engagements in compliance with these standards. In our CPEA October 17, 2018 report, you will see that compliance with these standards has been given a renewed focus through the AICPA's Enhanced Audit Quality initiative as well as through Peer Review. The number of substandard engagements due to inappropriate risk assessment is believed to be north of 50%.

As a result of this renewed initiative, the first series of reports will take a deep dive into the risk assessment process. While these reports may not present anything new, our hope is that they will serve to remind CPEA members of some of the more common pitfalls and how those pitfalls can be avoided or corrected. While reading about risk assessment may seem boring, remember, an inappropriate risk assessment will most likely lead to a substandard audit. A substandard audit will most likely lead to trouble. Bottom line, we don't want trouble!

While it seems so basic, we begin this series of articles with the audit risk model. Over the years, many have heard me say at AICPA conferences, "YOU CAN'T PROPERLY APPLY THE RISK ASSESSMENT STANDARDS IF YOU DON'T UNDERSTAND THE AUDIT RISK MODEL."

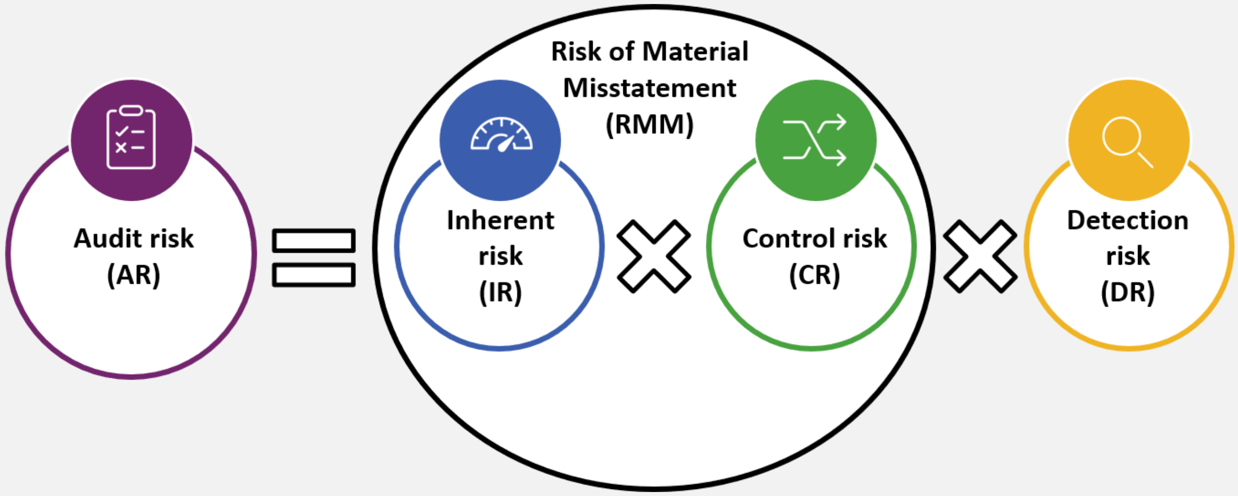
And, while many probably think they understand this model, we would challenge firms to take some time to reinforce what each element of the model means and how the audit risk model is used in designing the nature, timing, and extent of auditing procedures.

Our guess is that most assurance staff (including some partners) will struggle to explain each of the elements and how they use the model in selecting the nature, timing, and extent of auditing procedures to perform. If your firm is similar to many of the firms that we're observing, auditing procedures are simply being selected from standardized audit programs with little to no thought of whether the procedures selected are responsive to the risks of material misstatement.

As an aside, many firms use a methodology that contains basic or core auditing procedures for each audit area. There are other auditing procedures that can be selected by audit area if additional assurance is warranted or certain circumstances exist and then finally more procedures can be performed if there are additional risks. Now, we're not suggesting that having core and extended illustrative procedures is a bad thing, but these illustrative auditing procedures are no substitute for understanding the risks of material misstatement and using professional judgment to select and tailor procedures that are responsive to those risks and which reduce audit risk to an acceptably low level.

If you think we're wrong about your staff's understanding of the audit risk model, ask an engagement team to write-out the audit risk model, explain the model and, then, explain how the model contributed to whether only basic procedures were performed, whether additional procedures were selected, and whether any specific risk procedures were selected. If the engagement team can explain each element and how the risk assessment maps to the design of the audit program, congratulations, there is no need to read the remainder of this report. But, if they can't, then, we suggest there is work to be done and we also suggest reading the remainder of this report.

The audit risk model is expressed as follows:



Audit risk is the risk that the firm will issue an unmodified report when, in fact, there is a material misstatement in the financial statements.

Inherent risk is the risk of material misstatement in an assertion, an account balance, or disclosure before consideration of any related controls.

Control risk is the risk that the entity's controls will not prevent or detect and correct a material misstatement.

Detection risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material.

As a reminder, auditors only affect detection risk since control and inherent risks are entity risks that exist independent of the audit and the auditor.

So, why do we even care about the audit risk model? Quite simply, because in performing an audit, it is the auditor's responsibility to obtain reasonable assurance. And, how do we know when reasonable assurance has been obtained? Reasonable assurance has been obtained when sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level. Therefore, if no idea exists related to whether audit risk has been reduced to an acceptably low level, then, we can't know whether reasonable assurance has been obtained.

We recognize that, in practice, we don't assign percentages to the model in thinking about the overall audit since that would be impractical. But, let's get theoretical for a moment to make a point. Let's assume that the auditor is willing to live with a 1% AR, which means that we're okay with a 1% risk that the financial statements are materially misstated. Let's further assume we will not rely on controls and that we assess control risk at 100% (small businesses don't have controls, right?) and let's assume overall IR is 50%.

So, what's the result if you perform all the basic audit procedures from the basket of illustrative audit procedures in your methodology and those procedures would detect 85% of all material misstatements (15% DR)?

If you answered WE ARE IN TROUBLE, you're correct because in this example there's a big problem in under auditing. Because there's a 15% DR by performing only the basic procedures, AR is 7.5%, well above 1% and so, based on our assumptions, reasonable assurance clearly has not been obtained.

So, what do we do? We immediately perform all the additional procedures from the illustrative list and we get DR down to 5%? You're good now, right?

NOPE, we're still in trouble. Not until you've reduced DR to 2% will you have reduced audit risk to the acceptably low level that we set of 1% in order to have obtained reasonable assurance.

So, what does this simple example teach us? I hope the following:

- You better have some sense of audit risk (AR) or the target that we're shooting for. Otherwise, you have no idea as to whether reasonable assurance has been obtained. Is anyone on the engagement team thinking about audit risk when designing and selecting the procedures to perform?
- The auditor's assessment of CR and IR is pretty darn important in planning the nature, timing, and extent of auditing procedures. Are we assigning the CR and IR assessments to others who have knowledge of the model and the elements or are we assigning the assessment to others who can merely fill out a checklist? [In our next report we will do a deep dive into control risk because we will challenge anyone who says that their client has no controls].
- Thinking about the mix of auditing procedures that are contained in audit methodology and understanding how each group or level of procedures reduces detection risk is essential. It's also very important that we map the procedures to the risks of material misstatement so that we have an idea of the detection risk (DR) that results from performing the mix of auditing procedures that have been selected.
- Near the end of any audit engagement we should step back and ask the important question - do the procedures performed and the evidence obtained reduce audit risk to an acceptably low level or is more work needed?

Understanding how the audit risk model works and how to use that theory when designing and selecting auditing procedures that are responsive to the risks of material misstatement trumps merely filling out a checklist.

As we plan upcoming audits, we need to ensure that every member of the engagement team understands the importance of RMM (or what can go wrong) and that professional judgment and professional skepticism is used to challenge whether sufficient appropriate audit evidence is being obtained to reduce audit risk to an acceptably low level.

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