Risk Assessment for Audits of State and Local Governments

A Governmental Audit Quality Center Web Event

Today’s speakers

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What we will cover

Audit Risk Model
Identifying Risk
Assessing Risk
Responding to Risk
Resources

Risk assessment is fundamental.
Non-conformity persists

> half

of firms failed to comply with AU-C Section 315 or 330.

Misconception driving non-conformity

Auditors can perform a quality audit without properly considering their client’s risk of material misstatement.
Panel discussion – What are you doing in your firms to focus on and address risk assessment?

Audit risk model

Risk of Material Misstatement (RMM)
What the audit is all about.

Identify RMM  →  Assess RMM  →  Respond to RMM

Skipped a step? Non-conforming engagement

<table>
<thead>
<tr>
<th>Audit step</th>
<th>Impact if omitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifying RMM</td>
<td>Non-conforming engagement</td>
</tr>
<tr>
<td>Assessing RMM</td>
<td>Non-conforming engagement</td>
</tr>
<tr>
<td>Responding to RMM</td>
<td>Non-conforming engagement</td>
</tr>
</tbody>
</table>

*This is true regardless of amount and type of substantive testing performed!*
Same assertion, different procedures

Inventory existence

Targeted selection

Random sample

Same assertion, different procedures

Investment Valuation

Targeted selection

Random sample or maybe scope
Identifying risk

Understanding your client and their environment

**What’s the point?**

To assess and respond to RMM, you should:

- Understand the nature of the client’s inherent risks, which means you should
- Understand the client and their environment

Same logic applies to internal control and gaining an understanding of the client’s internal control structure
Understanding industry, regulatory, and other external factors

General economic conditions
- How is economy around the government impacting it

Industry conditions

Competitive environment
- How there other governments near our client and what pressures, if any, does this put on the government

Supplier and customer relations
- Any specific pressures enacted by citizens

Understanding industry, regulatory, and other external factors (cont).
- Technological developments
  - Is the government utilizing IT systems appropriately
  - Cybersecurity
  - Using advanced IT functions (crypto-currency, etc.)
- Regulatory environment
  - Always a big influencer on our government clients – federal, state requirements, regulations or mandates
Understanding industry, regulatory, and other external factors (cont.)

• Legal and political environment
  – Similar to regulations, but could include impact of any local elections, or election cycles.

• Environmental requirements
  – Impact through GAAP – landfills, pollution remediation, asset retirement obligations

Nature of the entity

• Operations
• Governance
  – How influential is the governing authority on day to day operations

• Types of investments
  – Aggressive? Or does state law keep them low risk?

• Structure
  – Reporting entity considerations, many component units, JVs, other related parties?
Objectives & strategies & related risks

• Objectives are overall plans for the entity
• Strategies are operational approaches
  – Have there been any changes? Have conditions forced additional services?
    – Have seen more economic development by our governments.
• Business risks result from conditions that could adversely affect entity

Measurement and review of entity’s financial performance

• What does management measure in running the government?
  – Examples are budgets, variance analysis, key performance indicators
  – How is budget to actual performance measured?
    – How does management deal with the budget pressures?
• Understanding helps auditor in considering whether pressure to meet performance measures increase risk of material misstatement
Internal control - The auditor should:

- obtain an understanding of the five elements of internal control sufficient to…..
- assess risk of material misstatement of financial statements whether due to error or fraud to…..
- design the nature, timing, and extent of further audit procedures

Depth of internal control understanding

- Auditor needs to evaluate design of control and determine whether it has been placed in operation
- Improperly designed control may represent material weakness and should be communicated
- Inquiry alone is not sufficient
- Obtaining understanding is not sufficient to serve as tests of operating effectiveness
  - i.e. – can ‘t reduce control risk below maximum
What if I’m **not** testing controls, and control risk is high?

<table>
<thead>
<tr>
<th>Description</th>
<th>Understand level of control risk?</th>
<th>Understand nature of control risk?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Walkthrough</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>No walkthrough or other assessment</td>
<td>✓</td>
<td>X</td>
</tr>
</tbody>
</table>

Should still assess design and implementation of controls to understand the nature of control risk.

Using audit data analytics in risk assessment

- **Five Basic Steps**
  1. Plan the audit data analytics
  2. Access and prepare the data for the purposes of audit data analytics
  3. Consider the relevance and reliability of data used
  4. Perform the audit data analytics
  5. Evaluate the results and conclude whether objectives have been achieved
Using audit data analytics in risk assessment

Examples of ADA Risk Assessment Procedures
• Preliminary general ledger account balance analysis
• Sales tax collections trend by month
• Water fund receivables turnover
• Disbursements risk analysis
• Employees as vendor comparison

See AICPA Guide to Audit Data Analytics

Identifying “significant audit areas”

• Relative materiality of the account balance
• Relative significance of the transaction class
• Susceptibility to fraud
• Audit areas that
  – for other reasons have a high assessed level of inherent risk
  – have traditionally required significant adjustments
Typical “significant audit areas” for SLG

- Cash
- Investments
- Governmental Receivables
- Proprietary Receivables
- Payables & Expenses Expenditures

Typical “significant audit areas” for SLG

- Payroll & Benefits
- Capital Assets
- Debt
- Landfill Accruals
- Self-insurance Accruals
- Net Position/Fund Equity Classifications
Identifying “significant risks”

- Risks that require special audit consideration
- Based on inherent risk only
- Not always a fraud risk
- Often nonroutine transactions that require significant professional judgment
  - Complex calculations
  - Application of new/complex accounting principles
  - Related party transactions

Typical “significant risks” for SLG

- Budgetary pressure / cut-off
- Lack of routine close outs
- Significant estimates
  - Pension/OPEB
  - Landfills
  - Donated infrastructure
- New debt/financing transactions
- Transactions with Component Units/JVs
Objective of assessing risk

- Provide a basis for response
  - Nature
  - Timing
  - Extent
- Linked at the assertion (not account) level
- Assess risk at
  - Relevant assertion level
  - Financial statement level
  (affecting many assertions)
Process of assessing risk

- Identify any general risk assessment factors
- Determine those audit areas that are significant
- Describe the specific significant risks of material misstatement
- Assess the risk of material misstatement at the relevant assertion level

Audit risk model
Identifying RMM for relevant assertions

- Identify risks through understanding the entity
- Identify what could go wrong
- Consider magnitude of the risks
- Consider the likelihood of the risks

Assess the risk of material misstatement at the relevant assertion level
Keep in mind your Opinion Units

Panel discussion – Which of the steps in the process just highlighted are most challenging for your staff?
Calculating RMM

Documenting risk assessment

Auditor must document basis of risk assessment set at *any* level (AU-C 315.33)

<table>
<thead>
<tr>
<th>RMM Assessment</th>
<th>Required to document basis of risk assessment?</th>
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<tbody>
<tr>
<td>1. High</td>
<td>YES</td>
</tr>
<tr>
<td>2. Medium</td>
<td>YES</td>
</tr>
<tr>
<td>3. Low</td>
<td>YES</td>
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Defaulting to high RMM without understanding the client

Over-auditing → Inefficiency

Under-auditing → Non-conformity

Reducing inherent risk

Inherent risk:
- Risk of a material misstatement assuming no related controls
- Cannot be reduced based on competency of accounting staff

Control risk:
- Risk that a misstatement would not be prevented or detected and corrected by an entity’s internal control
Control Risk < Maximum

Must test controls

SLG transactions/assertions that can lead to higher RMM

- **Existence and/or Cut-off of Cash**: in decentralized cash handling functions
- **Cut-off of AR/Revenue**: budgetary pressures, recording unbilled receivables in enterprise fund
- **Cut-off and/or Completeness of A/P & Expenses**: budgetary pressures, lack of routine cut-off
- **Classification of Revenue**: bond covenant requirements
SLG transactions/assertions that can lead to higher RMM

**Completeness of Capital Assets**
- record all the additions in the governmental activities
- capture all donated infrastructure

**Valuation of Receivables**
- allowance for doubtful accounts in enterprise funds

**Valuation of Investments**
- with harder to value investments (level 3, etc.)

SLG transactions/assertions that can lead to higher RMM

**Valuation of Capital Assets**
- depreciation kept in excel prone to error
- judgement involved in valuing donated infrastructure

**Valuation of Debt**
- complex, non-routine transaction, especially refundings in the year of issuance

**Valuation of Significant Estimates (Liabilities)**
- pension or OPEB liabilities
- estimate plus complex accounting
- landfill liability
- self-insurance IBNR
Responding to risk

No linkage between risk and planned responses
No two audits are exactly the same.

Linking to substantive audit procedures

- RMM should be linked to planned substantive audit procedures
- All significant, relevant assertions should be linked to some substantive audit procedures within the audit program
- Areas of higher RMM should have more tailored/extensive substantive audit procedures
- Ensure the linkage between the RMM assessment and the audit program procedures is evident in your documentation
Responding to significant risks

- Special audit consideration = beyond the norm
- Often requires
  - Modifying standardized procedures or
  - Adding additional procedures
- One or more arise on most audits

Key point
If you aren’t tailoring your practice aids to address significant risks, you’re probably not complying with AU-C 330.

Improper use of third-party practice aids

“Basic” approach ≠ auto-pilot

“Extended” approach

- Pick the right procedures to address the client’s specific risks
- May need to tailor procedures or design your own
- Especially true with significant risks
Panel discussion – What are the most important participant takeaways from today’s presentation?
Relevant Guidance

• AU-C section 300, *Planning an Audit*
• AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*
• AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Risk assessment toolkit

Free resources available at [aicpa.org/riskassessment](http://aicpa.org/riskassessment), including:

• Audit risk assessment tool
• Staff training workshop
• Internal inspection aid
• Aid for identifying and testing controls at smaller entities
Internal control toolkit

Free resources available at aicpa.org/internalcontrol, including:

- Internal control over financial reporting tool template
- Process memo template
- Staff training workshop
- Internal inspection aid

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