RISK ASSESSMENT

NCACPA 2022 Local Government Conference

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Coastal Peer Review, Inc.

Coastal Peer Review

Administered by The North Carolina and Maryland Associations of CPAs

Learning Objectives

- Introduction to Coastal Peer Review, Inc.
- Overview Of Risk Assessment Process
- Introduction to SAS 145 and ED – Amendment to AU-C 935
- How to become a Peer Reviewer

Coastal Peer Review

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Coastal Peer Review, Inc.

Before 2021, the NC Association of CPAs and the Maryland Association of CPAs each administered peer reviews in their respective states.

Changes to peer review administration beginning in 2017 caused most peer review administering entities to reimagine their process and organization.

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Coastal Peer Review, Inc.

In June 2020, both the North Carolina Association of CPAs Board of Directors and the Maryland Association of CPAs Board of Directors approved joint peer review administration through a newly created entity, Coastal Peer Review, Inc.

The Coastal Peer Review Committee and RABs have members from both NC and MD.

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Peer Review Issue !

- Deficiencies in the auditor’s risk assessment procedures are a common issue identified by practice monitoring programs in the United States and worldwide.
  - In 2020 U.S. peer reviews, the currently effective AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, was the leading source of *matters for further consideration*

SAS 145

- In October 2021, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

SAS 145

- SAS No. 145 does not fundamentally change the key concepts underpinning audit risk. Rather, it clarifies and enhances certain aspects of the identification and assessment of the risks of material misstatement to drive better risk assessments and, therefore, enhance audit quality.

Overview of SAS 145

- Enhances requirements and guidance related to obtaining an understanding of the entity's system of internal control and assessing control risk

- Includes revised requirements to evaluate the design of certain controls within the control activities component, including general information technology (IT) controls, and to determine whether such controls have been implemented.

Overview of SAS 145

- Revises the definition of significant risk
- Spectrum of Inherent Risk
- Includes a new requirement to separately assess inherent risk and control risk
- A new requirement to assess RMM such that, if the auditor does not plan to test the operating effectiveness of controls, the assessment of the risk of material misstatement is the same as the assessment of inherent risk (Control risk is at the maximum level)
- Relevant Assertions
- Significant Class of Transactions, Account Balances or Disclosures
- A risk of material misstatement exists when (*a*) there is a reasonable possibility of a misstatement occurring (that is, its likelihood), and (*b*) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). There is a reasonable possibility when the likelihood of a material misstatement occurring is more than remote. If an assertion does not have an identified risk of material misstatement, then it is not a relevant assertion.

Overview of SAS 145

- A new “stand-back” requirement intended to drive an evaluation of the completeness of the auditor’s identification of significant classes of transactions, account balances, and disclosures
- Revised requirements relating to audit documentation
- New guidance on scalability;
- New guidance on maintaining professional skepticism

SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Early implementation is permitted.

Risk assessment

Resources

- Risk Assessment Toolkit: aicpa.org/riskassessment
- Audit risk assessment tool (includes videos)
- Self-study CPE and staff training materials
- Internal inspection aid
- Frequently asked questions

Peer Review Implications

- Temporary guidance related to assessing noncompliance is effective for peer reviews commencing on or before September 30, 2021
- Reviews commencing subsequent to this end date are subject to normal peer review guidance

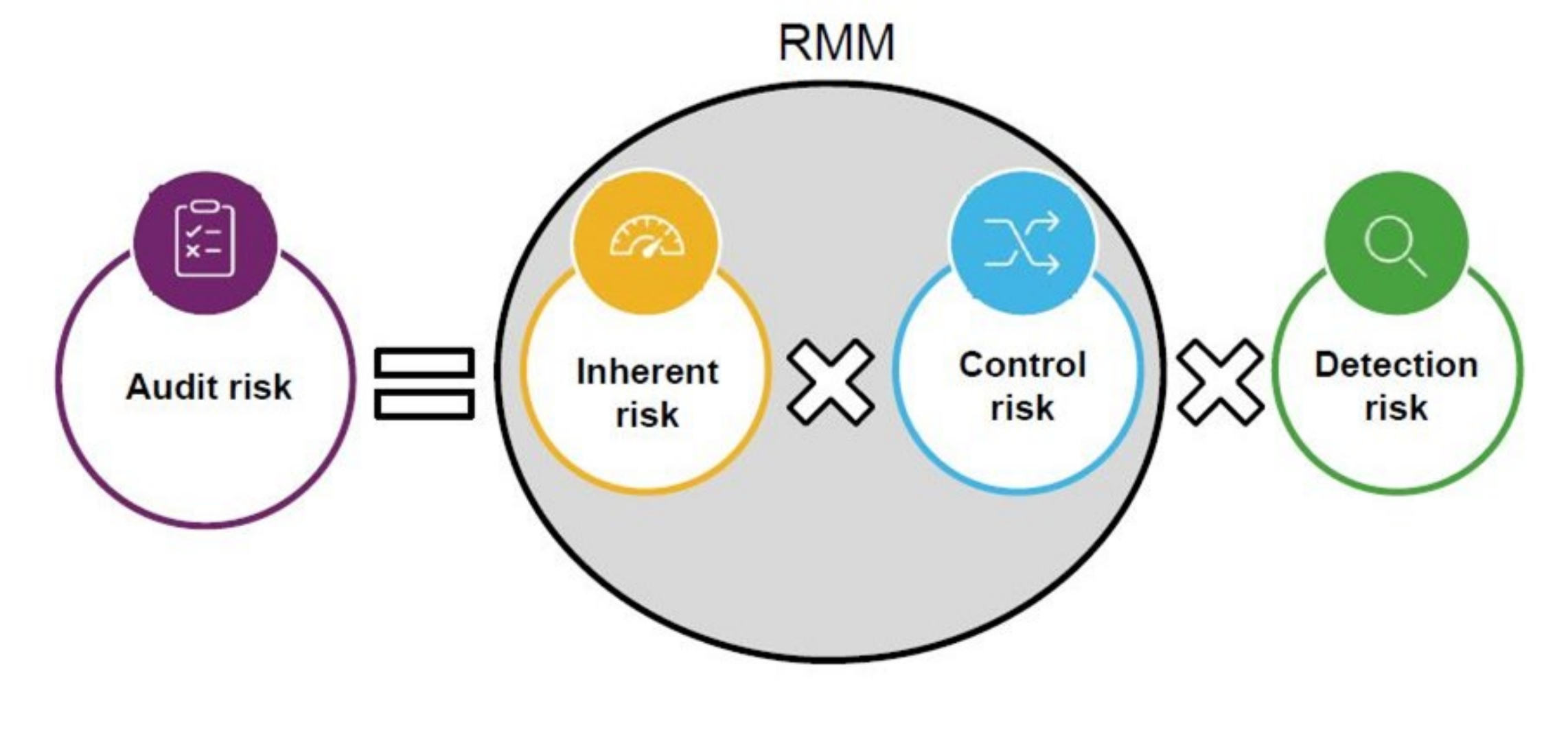
The goals of identifying, assessing and responding to risk are at the core of every audit. Identifying and assessing a client's specific risks drives the audit procedures you should perform and helps you avoid inefficient over-auditing. Even more seriously, this process helps you avoid a failure to obtain sufficient appropriate audit evidence to support your opinion.

The Audit Risk Model: Your First Step In Risk Assessment

Bob Dohrer, AICPA Chief Auditor, American Institute of Certified Public Accountants

Don’t be Afraid to Ask Questions

To plan your audit, you need to identify your client’s specific risks. To identify the risks, you’ll need to gain an understanding of the entity, and that means asking lots of questions. It also means keeping your eyes and ears open, observing the client and getting a good feel for their environment. The last thing you want is for a risk to go undetected. So, if you are unsure of something or need clarification, don’t be shy – ask questions.



The Audit Risk Model: Your First Step In Risk Assessment

Bob Dohrer, AICPA Chief Auditor, American Institute of Certified Public Accountants

Inherent Risk

- Inherent risk is the susceptibility of an assertion about a class of transactions, account balance, or disclosure to misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. [AU-C sec. 200.14]

- Is the auditor's basis for the assessed levels of risk documented in the working papers? [AAG-ARR 5.70]

General Audit Engagement Checklist
PRP Section 20,400 - Pg. 20,418, A201

Reducing inherent risk

Inherent risk cannot be reduced based on competency of accounting staff

- Inherent risk: risk of a material misstatement assuming *no related controls*
- Control risk: risk that a misstatement would not be prevented or detected and corrected by an entity's internal control
- Staff competency = part of control environment

Control Risk

- Control risk is the risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. [AU-C sec. 200.14] An assessment of control design and implementation is required on every audit, whether or not controls are tested and relied on. Specifics regarding the account being reviewed should consider the inherent risks and whether specific controls exist to address the inherent risk by assertion.

General Audit Engagement Checklist
PRP Section 20,400 - Pg. 20,418, A202

Risks of Material Misstatement

- Risks of material misstatement exist at two levels: (1) the overall financial statement level and (2) the assertion level for classes of transactions, account balances, and disclosures. Risks of material misstatement at the assertion level consist of two components; inherent risk and control risk. Generally accepted auditing standards do not ordinarily refer to inherent risk and control risk separately, but rather a combined assessment of the risks of material misstatement. However, the auditor may make separate or combined assessments of inherent and control risk depending on the preferred audit techniques and methodologies and practical considerations.
  [AU-C sec. 200.A38; .A40-.A41; .A44]

General Audit Engagement Checklist
PRP Section 20,400 - Pg. 20,418

Risk assessment is fundamental.

Risk Assessment Procedures

The auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement.

The risk assessment procedures should include the following:

a. Inquiries of management and others within the entity
b. Analytical procedures
c. Observation and inspection

Understanding the Entity and Its Environment

The auditor should obtain an understanding of the following:

a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework. (Ref: par. .A25-.A29)

b. The nature of the entity, including
   i. Its operations;
   ii. Its ownership and governance structures;
   iii. The types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives; and
   iv. The way that the entity is structured and how it is financed, to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: par. .A30-.A34)

AU-C Section 315.12 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Understanding the Entity and Its Environment (continued)

c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial report framework and accounting policies used in the relevant industry. (Ref: par. .A35)

d. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement. (Ref: par. .A36-.A42)

e. The measurement and review of the entity's financial performance. (Ref: par. .A43-.A48)

Identifying Audit Areas to Assess Risk

- Financial statement classes of transactions, account balances and disclosures
- Appropriate level of disaggregation
- Consideration of risk characteristics
- Other characteristics – when it is acceptable to group financial statement accounts/disclosures

Identifying and Assessing the Risks of Material Misstatement

To provide a basis for designing and performing further audit procedures, the auditor should identify and assess the risks of material misstatement at

a. The financial statement level and
b. The relevant assertion level for classes of transactions, account balances, and disclosures.

For this purpose, the auditor should

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements

Assessing risk

Identifying “significant risks”

- AU-C 315.04: Risks that require special audit consideration
- AU-C 315.28: Based on inherent risk only
- AU-C 315.A139: Often nonroutine transactions that require significant professional judgment
  - Complex calculations
  - Application of new/complex accounting principles
  - Nonroutine related party transactions

Understanding the Entity and Its Environment (continued)

In exercising professional judgment about which risks are significant risks, the auditor should consider at least

a. Whether the risk is a risk of fraud;
b. Whether the risk is related to recent significant economic, accounting, or other developments and, therefore, requires specific attention;
c. The complexity of transactions;
d. Whether the risk involves significant transactions with related parties;
e. The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
f. Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual. (Ref: par. .A139-.A143)

AU-C Section 315.29 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

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 auditors aren't tailoring audit programs to address significant risks, they're probably not complying with AU-C 330.

Substantive Procedures

If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk.

When the approach to a significant risk consist only of substantive procedures, those procedures should include tests of details. (Ref: par. .A58)

AU-C Section 330.22 - Performing Audit Procedures in Response to Assessed Risks and Evaluation the Audit Evidence Obtained

Responding to Risks that are *Not* Significant Risks

Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. (Ref; par. .A45-.A50)

AU-C Section 330.18 - Performing Audit Procedures in Response to Assessed Risks and Evaluation the Audit Evidence Obtained

Substantive Procedures

The auditor's substantive procedures should include audit procedures related to the financial statement closing process, such as

a. agreeing or reconciling the financial statements with the underlying accounting records and

b. examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: par. .A57)

AU-C Section 330.21 - Performing Audit Procedures in Response to Assessed Risks and Evaluation the Audit Evidence Obtained

Documenting risk assessment

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

RMM Assessment	Required to document basis of risk assessment?
1. High	YES
2. Medium	YES
3. Low	YES

Identify your client's controls

All entities have controls. Before you think, "He hasn't seen some of my clients!", consider the following definition:

> *A control is any policy or procedure used by an entity to prevent, or detect and correct, a misstatement.*

Based on that definition, if you have a client where the owner reviews financial results, communicates the important of quality or sets a strong "tone at the top" by demonstrating integrity, your client has controls.

Evaluate the design and implementation of your client's controls

On every audit, you are required to:

A. evaluate the design of controls relevant to the audit, and

A. determine whether these controls have been implemented. *This isn't the same thing as testing the operating effectiveness of controls*.

Understanding the Entity and Its Environment (continued)

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel.

******Most Common Peer Review Finding******

AU-C Section 315.14 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Why does COSO matter for small audit clients?

Considering the COSO Elements and Principles helps the auditor identify risks

Understanding the Entity and Its Environment (continued)

Control environment. The auditor should obtain an understanding of the control environment. As part of obtaining this understanding, the auditor should evaluate whether:

a. Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior and

b. The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are not undermined by deficiencies in the control environment. (Ref: par. .A78-.A88)

Understanding the Entity and Its Environment (continued)

Risk Assessment- If the entity has established a risk assessment process (referred to hereafter as the *entity's risk assessment process*), the auditor should obtain an understanding of it and the results thereof.

If the entity has not established such a process or has an ad hoc process, the auditor should discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor should evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances or determine whether it represents a significant deficiency or material weakness in the entity's internal control. (Ref: par. .A91)

AU-C Section 315.17-.18 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

COSO – Elements and Principles of Internal Control

Elements of internal control	Principles
Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change

Understanding the Entity and Its Environment (continued)

Control activities relevant to the audit. The auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. However, the auditor should obtain an understanding of the process of reconciling detailed records to the general ledger for material account balances. (Ref: par. .A99-.A105)

COSO – Elements and Principles of Internal Control

Elements of internal control	Principles
Control Activities	10.Selects and develops control activities 11.Selects and develops general controls over technology 12.Deploys through policies and procedures
Information & Communication	13.Uses relevant information 14.Communicates internally 15.Communicates externally
Monitoring Activities	16.Conducts ongoing and/or separate evaluations 17.Evaluates and communicates deficiencies

If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity’s controls, including control activities, relevant to that risk

What if client has no controls?

All entities have controls

- How could audit risk be reduced to an acceptably low level?

Common controls at small entities

- Strong “tone at the top”
- Owner communicates importance of quality
- Accounts reconciled monthly
- Owner reviews financial results
- Log-in credentials
- Limits on check signing
- Physical access to cash, limited inventory
- Invoices marked “Paid” to avoid double payment
- Payroll reviewed by owner
- AP system doesn’t allow new vendor entry without authorization

What do the standards require? (AU-C 315.14)

- Obtain an understanding of controls relevant to the audit
  - What can go wrong?
  - Do controls **exist** to mitigate risks?
- Evaluate the **design** of the controls
- Determine whether they have been properly **implemented**
- This is a high bar!

Example: Impact of walkthrough

- One approach: Subsequent receipts testing
  - Set dollar threshold; look at all receipts in scope
- Insights from walkthrough
  - Controller did not identify uncollectible receivables
  - No write-offs were recorded
- **How would the auditor's approach change because of the walkthrough?**

Key point
Even if you aren't testing controls, walkthroughs can affect the nature, timing and extent of substantive procedures.

Evaluating operating effectiveness of controls

- Different from evaluating design/implementation:
  - Evaluate whether the controls were **effective** in **meeting their objective** throughout the **reporting period**
- Is this a required procedure?
  - Only required if placing reliance to reduce substantive testing
- No operating effectiveness? No reliance!

SAS 145- Primarily Indirect Controls

- Control Environment
- Entity’s Risk Assessment Process
- Entity’s Process to Monitor the System of Internal Control

SAS 145- Primarily Indirect Controls

- SAS No. 145 includes requirements to understand, and evaluate certain aspects of, the control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control components. The auditor's required understanding includes the ongoing tasks and activities, or processes, geared to the achievement of the entity's financial reporting objectives.

- Audit evidence for the auditor's understanding and evaluation may be obtained through a combination of inquiries and other risk assessment procedures (for example, corroborating inquiries about the entity's processes through observation or inspection of documents). The auditor exercises professional judgment to determine the nature and extent of the procedures to be performed to the meet the requirements of SAS No. 145.

- SAS No. 145 does not require the auditor to evaluate the design or determine the implementation of individual controls within these components. However, the auditor may, based on the auditor's professional judgment, identify controls within these components that address risks of material misstatement at the assertion level for which the auditor evaluates design and determines implementation

SAS 145 –Primarily More Direct Controls but May Be Indirect Controls

Information System and Communication

- SAS No. 145 includes a requirement to understand, and evaluate certain aspects of, the information system and communication component. For this component, the auditor's understanding includes, among other things, the flows of transactions and other aspects of the entity's information-processing activities for significant classes of transactions, account balances, and disclosures as well as the entity's communication of significant matters.

- SAS No. 145 does not require the auditor to evaluate the design or determine the implementation of individual controls within the information and communication component. It is important to note that the auditor's identification and evaluation of controls in the control activities component is focused on information-processing controls, also known as *transaction controls*.

SAS 145- Primarily Direct Controls

Control Activities

- SAS No. 145 includes specific requirements to understand certain controls within the control activities component that address risks of material misstatement at the assertion level.

Control Activities

For the identified controls that address risks of material misstatement at the assertion level, the auditor is required to evaluate the design and determine whether the controls have been implemented. The identified controls include the following:

- Controls that address a risk that is determined to be a significant risk
- Controls over journal entries and other adjustments as required by AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence
- Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

Control Risk at Maximum

- When the auditor does not plan to test the operating effectiveness of identified controls, the auditor's evaluation of the design and determination of the implementation of controls may still assist in the design of substantive procedures. When identified controls are designed effectively

- and implemented, risk assessment procedures may influence the auditor's determination of the nature and timing of substantive procedures to be performed (for example, the auditor may determine to perform inspection, rather than external confirmation, or to perform procedures at an interim date, rather than at period end).

General IT Controls

- SAS No. 145 now defines the terms *risks arising from the use of IT* and *general IT controls*. SAS No. 145 requires the auditor to identify general IT controls that address the risks arising from the use of IT and to evaluate their design and determine their implementation.

- General IT controls need not be identified for every IT process. General IT controls are identified based on the risks arising from the use of IT. To identify the risks arising from the use of IT, the auditor identifies the IT applications and other aspects of the entity's IT environment that are subject to such risks. Such IT applications and other aspects are identified based on the identified controls that address the risks of material misstatement at the assertion level, as described in the preceding table under "control activities." Appendix E, "Considerations for Understanding IT," of SAS No. 145 includes guidance that may be relevant in identifying IT applications and other aspects of the IT environment that may be subject to risks arising from the use of IT.

Proposed Amendments to AU-C Sect. 935- Compliance Audits

.16 ***In adapting and applying the requirements of section 315 to identify controls that address risks of material noncompliance, the auditor should perform risk assessment procedures, beyond inquiry, to evaluate whether the following controls that address risks of material noncompliance are effectively designed and determine whether those controls have been implemented:***

a. ***Controls over journal entries and other adjustments as required by section 240,*** **Consideration of Fraud in a Financial Statement Audit**

b. ***Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures, which include***

> ***i. controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, and***
>
> ***ii. controls that are required to be tested for operating effectiveness by the governmental audit requirement as required by paragraph 24 of this section***

c. ***Other controls that, based on the auditor's professional judgment, the auditor considers are appropriate to enable the auditor to identify and assess risks of material noncompliance and design further audit procedures.***

Proposed Amendments to AU-C Sect. 935- Compliance Audits

.19 For identified risks of material noncompliance for each applicable compliance requirement, the auditor should assess inherent risk by assessing the likelihood and magnitude of noncompliance. In doing so, the auditor should take into account how, and the degree to which, inherent risk factors affect the susceptibility of compliance requirements to noncompliance.

.21 For identified risks of material noncompliance for each applicable compliance requirement, the auditor should assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls. If the auditor does not plan to test the operating effectiveness of controls, the auditor should assess control risk at the maximum level such that the assessment of the risk of material noncompliance is the same as the assessment of inherent risk.

Questions and Discussion

Becoming a Peer Reviewer

Qualifications:

- Member of AICPA and Active CPA License
- Active in public practice at supervisory level in A&A with five years recent experience
- Associated with a firm that received a PASS report
- Knowledge of Professional Standards (including Peer Review and QC/QM standards)

Benefits you, your firm and your profession!