


Building on Our
Core Values 

Risk Assessment Standards


**Midwestern Intergovernmental
 Audit Forum**

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Audit and Attest Standards

Presentation Objectives


- ◆ Discuss the background and the reasons why the SASs were issued.
- ◆ Discuss how the SASs affect existing practice.
- ◆ Provide an overview of the SASs.



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Risk Assessment Standards

1. SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*;
2. SAS No. 105, Amendment to Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*;
3. SAS No. 106, *Audit Evidence*;
4. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*;
5. SAS No. 108, *Planning and Supervision*;
6. SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*;
7. SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; and
8. SAS No. 111, Amendment to Statement on Auditing Standards No. 39, *Audit Sampling*



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Background

- ◆ Based on research
- ◆ Objective is to direct auditors to areas of greatest risk whether caused by error or fraud
- ◆ Exposed in 2002 and 2005
- ◆ Issued in March 2006.

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Significant Changes to Existing Practices

- ◆ Identifying and assessing the risks of material misstatements.
- ◆ Designing and performing tailored further audit procedures responsive to assessed risks at the relevant assertion level
- ◆ Linkage.

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Overview of SASs

SAS No. 104, Amendment to SAS No. 1

- ◆ SAS No. 104 expands the definition of "reasonable assurance" as a "high level of assurance"

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Overview of SASs

SAS No. 105, Amendment to SAS 95, *Generally Accepted Auditing Standards*

- ◆ “The entity and its environment, including its internal control” replaces “Internal control”
- ◆ “Further audit procedures” replaces “tests to be performed”
- ◆ “Audit evidence” replaces “evidential matter”
- ◆ Reflects new use of terms required by SAS No. 102.

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Overview of SASs

SAS No. 106, Audit Evidence
(Amends SAS 31)

“The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.”

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Overview of SASs

SAS No. 106, Audit Evidence

- ◆ Provides guidance regarding:
 - Audit evidence
 - Audit procedures
 - Use of assertions

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Overview of SASs

SAS No. 107, Audit Risk and Materiality
(Amends SAS 47)

“The auditors should perform the audit to reduce audit risk to a low level that is (in his or her judgment) appropriate for expressing an opinion on the financial statements.”

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The auditor should consider audit risk at both:
 - a. Overall financial statement level
 - b. Assertion level

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ At the account balance, class of transactions, or disclosure level, audit risk consists of:
 - a. Combined risk assessment, which consists of:
 - 1. Inherent risk
 - 2. Control risk
 - b. Detection risk

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures.
- ◆ The auditor should have an appropriate basis for this assessment.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The determination of materiality is a matter of professional judgment
- ◆ Based on the perception of users

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The auditor determines materiality to:
 - Perform risk assessment procedures,
 - Identify and assess the risks of material misstatement,
 - Design and perform further audit procedures,
 - Evaluate whether the financial statements taken as a whole are presented fairly.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ An auditor uses benchmarks to determine materiality. Examples are:
 - Total revenues
 - Profit before taxes
 - Total assets
 - Net assets

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ Tolerable Misstatement (or error)—is the maximum error in a population (e.g., the class of transactions or account balance) that the auditor is willing to accept.
- ◆ Tolerable misstatement is used to design substantive procedures.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

Example of the use of tolerable misstatement in designing substantive procedures:

Planning Materiality	\$100,000
	50%
Tolerable Misstatement	\$80,000

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Overview of SASs

Example of the use of tolerable misstatement (continued):

Accounts Receivable Balance	\$50,000
Scope of testing (10% of \$50,000)	All items > \$5,000
Based on the above calculation of TE, the auditor may send out confirmations to test the existence and completeness assertions of items greater than \$5,000, plus a random sample of smaller amounts.	

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The auditor should reassess the materiality determined during the planning process. Failure to do so may result in inadequate audit procedures.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ The auditor must accumulate:
 - a. Known misstatements.
 - b. Likely misstatements –include:
 - 1. Audit differences involving auditing estimates and
 - 2. Projected misstatements based on extrapolation of audit evidence.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

Auditor's responses to identified misstatements

Type of misstatement	Request management to:
Known	Correct misstatements
Likely - projected	Examine accounts or class of transactions
Likely - estimates	Review assumptions and methods

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ Evaluating audit findings – the auditor must consider the effect (individually and in the aggregate) of misstatements (known and likely) identified by the auditor that are not corrected by management.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ Iron Curtain vs. Rollover
 - The SEC has undertaken a project to study this issue and its findings are expected soon.
 - Guidance in SAS No. 107 is neutral until accounting is settled.

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ Qualitative considerations. Examples are:
 - Potential effect on trends
 - Changes bottom line
 - Potential effect on loan covenants
 - Increases management's compensation
 - Likelihood that misstatement may become material in future periods

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Overview of SASs

SAS No. 107, Audit Risk and Materiality (continued)

- ◆ Other considerations:
 - Management's bias
 - Undetected misstatements

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Overview of SASs

SAS No. 108, Planning and Supervision
(Amends SAS 1 and SAS 22)

"The auditor must adequately plan the work and must properly supervise any assistants."

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Overview of SASs

SAS No. 108, Planning and Supervision (continued)

- ◆ SAS No. 108 discusses:
- ◆ Appointment of the independent auditor,
- ◆ Establishing a written understanding with the client,
- ◆ Preliminary engagement activities,
- ◆ The overall audit strategy,
- ◆ The audit plan,
- ◆ Determining the extent of involvement of specialists,
- ◆ Additional considerations in initial audit engagements.

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Overview of SASs

SAS No. 109, Assessing Risks

“The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.”

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ Risk assessment procedures and sources of information about the entity and its internal control are:
 - a. Inquiries
 - b. Analytical procedures
 - c. Observation and inspection

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ The auditor should consider the results of the fraud risk assessment performed during planning along with other information gathered in identifying the risks of material misstatements.

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ Discussion among audit team:
 - a. Can be held at the same time as the discussion specified in SAS 99.
 - b. Objective is for members to gain a better understanding of the potential for material misstatements.
 - c. An opportunity for more experienced members to share their insights.

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ Understanding the entity and its environment, including its internal control.
 1. Industry, regulatory, and other external factors
 2. Nature of the entity
 3. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
 4. Measurement and review of the entity's financial performance
 5. Internal control

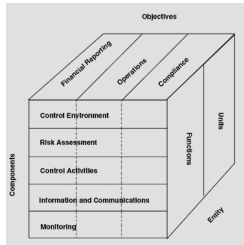
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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ Internal control (same as SAS 55, as amended)



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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ The auditor should obtain a sufficient understanding of internal controls to:
 - Evaluate the design of controls relevant to the audit,
 - Determine whether the controls have been implemented.

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ The auditor should identify and assess the risks of material misstatements at:
 - Financial statement level
 - The relevant assertion level

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ Significant risks
 - Require special audit consideration
 - Different than high inherent risk
 - Often relate to significant nonroutine transactions and judgmental matters

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Overview of SASs

SAS No. 109, Assessing Risks (continued)

- ◆ The initial assessment of the risks of material misstatement may change as additional audit evidence is obtained. For example:
 - The results of test of controls indicate that the controls may not be operating as expected.
 - Substantive audit procedures detect misstatements greater or more frequent than the auditor's risk assessment.

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Overview of SASs

SAS No. 110, Performing Procedures
(together with Assessing Risks amend SAS 55)

“The auditor must obtain sufficient appropriate audit evidence through audit procedures performed to afford a reasonable basis for an opinion regarding the financial statements taken as a whole.”

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ SAS No. 110 provides guidance on:
 - a. Determining overall responses
 - b. Designing and performing further audit procedures

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ Overall responses may include:
 - Exercising professional skepticism
 - Assigning more experienced personnel
 - Changing the timing and extent of audit procedures
 - Using specialists

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ Audit Approach
 - a. The auditor should have an appropriate basis for the audit approach.
 - b. Defaulting to a maximum control risk without an appropriate basis is no longer permitted.
 - c. Nature, timing and extent of further audit procedures should be based on risk assessment.

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ Test of controls should be tested:
 - a. Auditor's risk assessment includes an expectation of the operating effectiveness of controls, or
 - b. Substantive procedures alone do not provide sufficient audit evidence

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ Test of Controls may be rotated
 - The auditor should test the operating effectiveness of controls at least every three years in an annual audit
 - The auditor should update his or her understanding to ensure controls have not changed
 - If the auditor plans to rely on control that have changed, the auditor should test the controls

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ If the auditor plans to rely on controls that mitigate significant risks, the auditor needs to test those controls in the current period, that is, these controls cannot be rotated.

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Overview of SASs

SAS No. 110, Performing Procedures
(continued)

◆ Substantive Procedures

- Design and perform substantive procedures regardless of risk assessment
- Should include:
 - agreeing financial statements to the underlying records
 - examining material journal

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Overview of SASs

SAS No. 110, Performing Procedures
(continued)

◆ Significant risks

- Design and perform procedures responsive to risks.
- May consist of test of details and substantive analytical procedures.

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Overview of SASs

SAS No. 110, Performing Procedures
(continued)

◆ Adequacy of presentation and disclosure

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Overview of SASs

**SAS No. 110, Performing Procedures
(continued)**

- ◆ Evaluating the sufficiency and appropriateness of the audit evidence obtained
 - Auditors need to reassess the assessment of the risk of material misstatement
 - Auditors need to determine whether the tests of controls performed provide an adequate basis for reliance.
 - Auditors should not assume that instances of fraud or errors are isolated.

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Overview of SASs

SAS No. 111, Amendment to SAS 39, Audit Sampling

- ◆ More guidance regarding tolerable misstatement
- ◆ Sampling considerations

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Concluding Remarks

- ◆ The standards are effective date for audits of financial statements with periods beginning after 12/15/06 (FY 07 audits)
- ◆ To assist implementation of the standards an audit guide will be issued.
- ◆ Read Audit Risk Alert entitled, *Understanding the New Auditing Standards Related to Risk Assessment* for a summary of the standards of highlights of significant changes.

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Concluding Remarks

- ◆ To keep abreast of other ASB projects, please visit our website:
<http://www.aicpa.org/members/div/auditstd/index.htm>
- ◆ If you have a question about Audit and Attest Standards, please call our Technical Hotline:
(888) 777-7077
- ◆ Email – hhasty@aicpa.org

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Questions?
