FAQs on Risk Assessment Enhancements

The AICPA has recently heightened its focus during peer review on risk assessments made during an audit. **As a result, and after considering nonauthoritative but recommended guidance the AICPA recently issued on this topic,** we have worked extensively with our outside authors/customers to make enhancements to our risk assessment guidance. This was done to ensure that our customers are well-served in this time of heightened peer review focus by the AICPA on auditors' risk assessment judgments.

Our overall PPC risk assessment methodology has not changed; rather, certain features have been enhanced to provide clarified guidance and to further assist auditors in applying professional judgment.

Refresher on Risk Assessment Requirements

The purpose of risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. In performing risk assessment, GAAS includes the following requirements:

- The auditor should identify and assess the risks of material misstatement at the financial statement level and relevant assertion level for classes of transactions, account balances, and disclosures.

- The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to risks of material misstatement at the relevant assertion level.

- Regardless 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.

- When there are significant risks at the relevant assertion level, the auditor should perform substantive procedures specifically responsive to the risks, including tests of details when the response consists of only substantive procedures.

In PPC's audit methodology, the overall decision of which further audit procedures will be performed is the selection of an audit "approach." One of the first steps in making that decision is to determine if an audit area is significant. An audit area is significant if it contains a significant transaction class, material account balance, fraud risk or other significant risk, or requires significant disclosures. The existence of a material account balance or disclosure in an audit area is enough by itself to make it a significant audit area.

Removal of the Audit Area Documentation Option

As more fully discussed in our September 2018 *Accounting and Auditing Update—Special Report*, peer reviewers noted that customers were misusing the option to permit documentation of risk assessment at the audit area level during the risk assessment process. This option was intended to provide simplified documentation when assessed risk was the same for all relevant assertions in an audit area. However, peer reviewers indicated they believed that some customers using this option were inappropriately *assessing* risk at the audit area level only rather than at the relevant assertion level. As a result, it appeared that evaluation of risk at the relevant assertion level as required by GAAS was not being performed. To address this issue, the option of documenting the assessed risk of material misstatement at the audit area level was removed. For those who had been using the feature correctly, the only difference is that now the same level of risk would be documented for all relevant assertions individually to show that you concluded each had the same level of risk. Those who may have been using it inappropriately, however, are now prompted to consider, assess, and document the risk of material misstatement at each assertion level, in accordance with GAAS.

Revisions Made to the Risk of Material Misstatement Table

Background

The risk of material misstatement (RMM) is the product of inherent risk (IR) and control risk (CR). The auditor is permitted to make an overall, or combined, RMM assessment at the relevant assertion level. Alternatively, the auditor can choose to make separate assessments of IR and CR and then combine them. How the auditor combines inherent and control risk to assess RMM is always a matter of auditor judgment. To assist auditors in determining the combined assessed RMM when separate assessments of inherent risk and control risk are made, the authors developed the RMM Table.

What was changed in 2019?

- Added ranges to the RMM Table.
- Modified one RMM level.

Why were ranges added to the RMM Table?

To provide auditors greater flexibility in exercising auditor judgment, we modified the RMM Table from reflecting specific levels (High, Moderate, Low) to ranges (Low to Moderate, Moderate to High) for some levels of combined RMM.

Peer reviewers have indicated that some auditors have not been appropriately evaluating RMM based on client circumstances. In addition, messaging from the AICPA indicates that (1) practitioners have not been giving due consideration to and exercising professional judgment in determining RMM, and (2) because RMM is a combination of separate judgmental assessments rather than a simple mathematical calculation, ranges address the relevant facts and circumstances.

The primary reasons for presenting a range for some combinations of IR and CR, as opposed to a single level of risk, relate to (1) the effect of using nonquantitative levels of risk rather than quantitative percentages and (2) the highly judgmental nature of risk assessment.

The use of nonquantitative levels of High, Moderate, and Low rather than specific percentages means that a nonquantitative level already represents a band, or range, of percentages. For example, an auditor may regard CR assessments of 75% and 95% (i.e., there is a 75% or 95% risk that controls will not prevent, or detect and correct, a material misstatement) as both being High, and assessments of 10% and 20% as both being Low. The authors believe that the various combinations of quantitative assessments enable the auditor to assess risk within a range of nonquantitative levels rather than mandating assessment at a single nonquantitative level, and that providing a range of nonquantitative levels encourages practitioners to exercise auditor judgment and provides greater flexibility in doing so. A range from Moderate to High, for example, allows the auditor to identify a RMM of Moderate when the quality of evidence supporting the IR assessment is strong and High when it is less persuasive, such as evidence from only inquiry and observation for a client for which the auditor has limited experience.

Why was one RMM level modified?

The specific RMM levels previously reflected in our products (High, Moderate, Low) are all within the specified ranges included in the 2019 RMM Table, with one exception. When IR is assessed as Low and CR is assessed as High, the combined RMM in the RMM Table was modified from Low to a range of Moderate to High. This new range is consistent with recommended guidance included in the AICPA's Risk Assessment Resources developed on the topic.

It is important to remember that the purpose of the RMM Table in our products is to serve as a guide, but ultimately risk assessment is based on the auditor's professional judgment and may vary. For example, if, based on the facts and circumstances of a specific engagement, an auditor determines that the IR assessment is Low, the CR assessment is High, and the overall RMM assessment is Low for an assertion, the authors believe that this could be appropriate, so long as each assessment is supportable and appropriately documented.

The judgmental nature of the auditor's risk assessment also helps to explain why, when IR is Low and CR is High, the likely result falls within a range of Moderate to High RMM rather than Low. An assessment of RMM being Low when IR is Low and CR is High would be driven by the IR assessment, which is typically based on a lower quality of evidence from inquiry and observation rather than the higher quality of evidence required for an assessment of CR being Moderate or Low. That said, an auditor's assessment can differ from the RMM Table. The determination of RMM is subjective and based on auditor judgment. An auditor may decide that separate assessment of IR and CR is not necessary and instead assess RMM directly. This alternative is permitted by the standards; however, the authors believe that separate assessment of IR and CR is a best practice. As such, direct assessment of RMM is currently not a functionality in Checkpoint Engage or SMART Practice Aids.

An auditor, for example, may conclude that the existence assertion for PP&E is a relevant assertion. Auditing standards define a *relevant assertion* as one that has a reasonable possibility of containing a misstatement(s) that would cause the financial statements to be materially misstated. The normal audit approach to PP&E is to examine additions to the audited ending balance of the prior year. If the additions in the current year are not significantly greater than performance materiality, there are no significant accounting judgments involved (such as no self-constructed assets), and generally no other specific risks, an auditor may decide to assess RMM directly as low. Although this approach is permitted by standards, as previously noted, the authors believe that separate assessment of IR and CR is a best practice, and direct assessment of RMM is not a current functionality in Checkpoint Engage or SMART Practice Aids.

What does a control risk assessment of high represent?

AU-C 315.14 requires auditors to evaluate the design of controls relevant to the audit and determine whether they have been implemented. That requirement applies whether or not the auditor intends to test the operating effectiveness of controls and rely on an assessment of CR lower than High. In other words, an auditor cannot default to a CR of High without having at least evaluated the design and implementation of controls relevant to the audit, as required by GAAS. Nevertheless, even after obtaining an understanding of the design of relevant controls and their implementation, an auditor cannot assess CR as less than High without testing the operating effectiveness of relevant controls. (An auditor may decide not to rely on and test the operating effectiveness of controls for efficiency reasons.) Thus, an auditor's assessment of CR may be High, even though he or she has not identified a significant risk or significant deficiencies in controls.

In some cases, an auditor may assess CR as High because of an identified significant risk for which there are no controls that would prevent a material misstatement, or detect and correct one that occurred. This situation would necessitate audit procedures that are specifically responsive to the risk identified and assessed. In such cases, the auditor may conclude that a combined RMM of High better depicts the level of risk and the audit effort necessary in the circumstances.

<u>What is the relationship between CR and IR?</u> The auditing standards define IR as the susceptibility of an assertion to material misstatement "before consideration of any related controls." The authors believe this means that when IR is assessed, an auditor does not assume the client has no relevant controls but, instead, as the definition indicates, assesses susceptibility to material misstatement before considering the controls contained in the system of internal control. The IR assessment is based on the auditor's assessment of what can go wrong at the assertion level. The possibilities of what can go wrong before taking account of relevant controls affect the auditor's assessment of IR and are dependent on the facts and circumstances. For example, if what could go wrong for a relevant assertion is limited primarily to clerical errors that may occur in the recording of routine transactions, the situation will be assessed differently than when what can go wrong relates to application of accounting standards that are complex or require subjective judgments. The auditor may decide it is appropriate to assess IR as moderate in the former situation and high in the latter. The assessment of what can go wrong with respect to an assertion before considering controls also affects what controls an auditor considers relevant when the auditor makes the preliminary assessment of control risk and decides whether to test and rely on relevant controls.

<u>How can you reduce CR and RMM?</u> Although an auditor may initially decide to assess CR as high because he or she does not intend to rely on controls, it may later be determined that there is a need to lower the assessment of CR and, in turn, the RMM. The auditor can do this by identifying key controls that have been designed and implemented effectively and testing their operating effectiveness. The *AICPA Risk Assessment Resources, Examples of Controls in Small Entities* publication provides specific examples of controls that may be present in small entities that, if an auditor determines are present, may be tested to allow assessment of CR at a level below High. Some of those controls follow:

- The owner/manager periodically reviews profit and loss statements, and significant variances from budget and/or prior periods are investigated.

- All accounts are reconciled monthly.

- Procedures exist and are followed to restrict access to the accounting software.

Will your audit approach change?

The addition of ranges to the RMM Table will not affect functionality in Checkpoint Engage or SMART Practice Aids. A specific RMM assessment is necessary in Checkpoint Engage and SMART Practice Aids to logically generate an audit program to be used as a starting point for the auditor in developing an audit response. The RMM values automatically populated by the software now represent the low end of the new suggested ranges and are consistent with previous editions, except for the Low inherent risk/High control risk assessment, as previously discussed. The resulting suggested audit approach, however, is still consistent with prior editions, as discussed further below.

As in previous editions, an auditor's assessment of RMM may differ from the RMM Table, and the RMM values populated by the software can be judgmentally changed by the auditor as needed to address the relevant facts and circumstances. Once updated in 2019, Checkpoint Engage and SMART Practice Aids will include expanded guidance on when to consider revising the suggested risk assessment, so auditors can make well-considered and supportable risk assessment judgments.

In the PPC audit methodology, the selection of an audit approach (Limited, Basic, or Extended) provides a starting point to respond to risks. Also in the PPC audit methodology, if an audit area is considered significant, an audit program (using the Basic or Extended audit approach) is always recommended, regardless of the combined RMM. (That is, the authors do not consider a Limited approach to be appropriate for a significant audit area.)

Once the audit programs are generated in Checkpoint Engage or SMART Practice Aids, it is important that the auditor use Linkage View to further tailor the audit program based on the specific risks identified for each assertion. Linkage View allows the auditor to simultaneously view the identified risks and audit program steps for each assertion, making it easier for the auditor to add, delete, or modify procedures as necessary to ensure that (1) identified risks are addressed and (2) the audit program does not include unnecessary audit procedures.

An audit area is significant if it contains a significant transaction class, material account balance, fraud risk or other significant risk, or requires significant disclosures. The existence of a material account balance or disclosure in an audit area is enough by itself to make the audit area a significant audit area. Nonsignificant audit areas have no relevant assertions. If the audit area is not significant, the Limited Procedures approach will be appropriate and no audit program is necessary. However, the authors believe the Limited Procedures approach without modification is not appropriate for a significant audit area.

The recommended audit approach for an audit area should not ordinarily change as a result of the changes made to the RMM Table, as demonstrated below.

Significant or Nonsignificant Audit Area	**Combined RMM—Prior Year**	**Prior Year Audit Approach**	**Combined RMM—2019**	**2019 Audit Approach**
Nonsignificant Audit Area	Low for all assertions	Limited	N/A, as it is a nonsignificant audit area	Limited
Significant Audit Area	Low for all assertions	Basic	Low for all assertions	Basic
Significant Audit Area	Low for all assertions	Basic	Moderate for at least one assertion	Basic
Significant Audit Area	Moderate for at least one assertion	Basic	Moderate for at least one assertion	Basic