

THE PPC GOVERNMENTAL UPDATE

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Risk Assessment Impacts Peer Reviews



Risk assessment continues to garner much attention and focus in the audit community. In response to recent peer review deficiencies in this area, the AICPA Peer Review Board (PRB) has announced that risk assessment will be a prime area of focus in upcoming reviews. As a result, they are making a few significant changes to peer reviewers' audit engagement checklists.

Background

At the 2018 AICPA Peer Review Program Conference, risk assessment was the hot topic. Peer reviewers will be more carefully scrutinizing the way auditors apply risk assessment due to a relatively high volume of findings in this area. In the PRB's most recent review cycle, approximately 10% of firms were deemed to have nonconforming engagements due to noncompliance with the risk assessment requirements in AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

Practical Consideration:

For more details on risk assessment issues noted by peer reviewers, see *The PPC Accounting and Auditing Update—Special Report*, published in September 2018 at <http://thomsonreuterstaxsupport.force.com/pkb/servlet/fileField?id=0BE0c000000XcXE>.

Peer Review Checklist Changes

The peer review audit engagement checklist is being updated to reflect this emphasis on risk assessment. We expect these new changes to the audit engagement checklist to be effective for reviews as of May 1, 2019. The first general question on audit engagement risk assessment has been expanded to cover more specific risk assessment requirements, including documentation of the following:

- Obtaining an understanding of the entity and its environment.
- Obtaining an understanding of

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relevant internal control, including the design and implementation.

- Identifying and assessing risk of material misstatement at the financial statement and relevant assertion levels.
- Determining whether identified risks are significant risks and evaluating the design and implementation of relevant controls.
- Documenting linkage between the assessed risk of material misstatement and the audit response at the relevant assertion level.
- Identifying IT risks and linkage to related testing.

In addition, the checklists now ask for identification of the three areas with the highest assessed risk of material misstatement (it previously asked for “two to three”).

The Internal Control and Control Risks section has been retitled as Risk Assessment Procedures and Related Activities. Existing questions have been modified and new questions have been added regarding the following:

- Performing risk assessment procedures to provide a basis for identification and assessment of risk of material misstatement at the financial statement and relevant assertion levels.
- Documenting details of the auditor’s understanding of the entity and its environment.
- Obtaining an understanding of relevant internal control relevant to the audit.
- Identifying and assessing risk of material misstatement sufficient to provide a basis for designing and performing further audit procedures.
- Identifying fraud risks.
- Performing substantive procedures specifically responsive to the identified significant risks.
- Designing and performing further audit procedures based on and responsive to the assessed risks of material misstatement at the relevant assertion level.
- Updating the audit strategy and plan in response to risks identified over the course of the audit.

A question in the Inherent Risk section is modified to clarify whether the auditor’s rationale for the level of assessed risk is evident in the working papers. Other changes are made throughout the checklist to emphasize the need to assess risk of material misstatement at the relevant assertion level. Reviewers are reminded when evaluating a “no” response to consider whether the error or omission is due to noncompliance with the risk assessment standards or to improper testing procedures.

What to Expect on Your Next Peer Review

In this current peer review cycle, even before the new audit engagement checklist goes into effect, you can expect a much more thorough analysis of your risk assessment procedures than you’ve had in the past. Until now, if there was evidence that a practitioner had performed some sort of risk assessment (even if inadequately documented, linked, or not performed at the assertion level), many peer reviewers have not identified the risk assessment process in MFCs (matters for further consideration) or FFCs (findings for further consideration). But for peer reviews beginning October 1, 2018, audit engagements that fail to comply with the risk assessment standards will be considered nonconforming engagements, with potentially significant peer review implications.

When nonconforming engagements result from a systemic cause, practitioners ordinarily receive a peer review rating of “pass with deficiencies” or “fail”. But the PRB has taken a less harsh stance in their guidance for firms that have nonconforming engagements caused solely by systemic noncompliance with the risk assessment standards. Rather than a rating of “pass with deficiencies” or worse, the PRB has indicated that firms will receive only an FFC with implementation plan and a peer review rating of “pass”. If you receive an FFC, an implementation plan will be required and will include one or more of the following: CPE, pre-issuance review, and/or post-issuance review. The PRB has indicated that it will develop webinars to satisfy these CPE requirements.

What Can You Do to Prepare?

Before your next peer review begins, you may want to review several of your audit engagements to make sure your risk assessment procedures were adequate and appropriately documented. Section 801 of *PPC’s Guide to Audits of Local Governments* includes practical guidance based on AU-C 230, *Audit Documentation*, on making changes or additions to the workpapers after the documentation completion date, such as documenting the specific reasons for the change and when and by whom the changes were made and reviewed. You should pay careful attention to this guidance if you choose to make changes to your workpapers after the documentation completion date.

Practical Consideration:

Checkpoint Learning offers relevant CPE courses such as Risk Assessment and Audit Risk (CLRSKA), a convenient 1-credit course that addresses risk assessment at the relevant assertion level, planning the audit, and the impacts of the assessment on procedures and audit risk. For additional information, see <https://checkpointlearning.thomsonreuters.com/CourseFinder/CourseDetails/Risk-Assessment-and-Audit-Risk/11793>.



Obtaining an Understanding of Internal Control in Government Audits

During every audit performed in accordance with AICPA auditing standards—regardless of industry—you are required to perform risk assessment procedures, which include:

- Obtaining an understanding of the entity, including its internal control.
- Identifying and assessing the risks of material misstatement of the financial statements, whether due to fraud or error. This includes an evaluation of both inherent risk and control risk at the relevant assertion level.
- Evaluating risks at the financial statement level and identifying risks that affect only specific assertions.

For single audits (audits performed under the Uniform Guidance), you are required to also perform risk assessment procedures related to federal awards, which include:

- Obtaining an understanding of the entity and its major programs, including its internal control over those programs.
- Relating identified risks to what can go wrong at the relevant compliance level for each major program.
- Considering the likelihood and magnitude of the risk of noncompliance having a direct and material effect on major programs and the financial statements.

- Considering the findings from previous audits and whether any corrective actions have been taken.

Obtaining an understanding of internal control over the financial statements and major programs is an important part of performing risk assessment procedures.

Deficiencies Noted in Obtaining an Understanding of Internal Control

During the AICPA Peer Review Board's most recent review cycle, approximately 10% of firms were not properly assessing risk or linking their assessments to further audit procedures planned and performed. A staggering 40% of identified issues related to failure to gain an understanding of internal control when identifying an entity's risks. Without understanding the nature of the entity's controls, you can't identify related risks or design appropriate audit procedures to respond to the risks. In 13% of identified issues, there was an assessment of control risk as less than "high" without applying tests of controls. You can only reduce control risk below maximum when you have tested controls and are relying on their operating effectiveness.

In the April edition of this newsletter, we outlined similar problems in single audits, such as:

- Believing it is appropriate to rely on internal control walk-throughs over financial reporting to eliminate the need for testing controls over compliance.
- Believing that by assessing control risk as "high," the need to test controls over compliance can be eliminated.
- Performing tests of details as part of their financial statement audit, while doing no work to assess compliance with direct and material requirements, and inappropriately classifying the procedures as "dual-purpose tests" (forgoing any compliance testing).

Practical Consideration:

This study and several other risk-assessment-related resources are available at www.aicpa.org/eaq/aicpa-risk-assessment-resources.html.

Requirements for Obtaining an Understanding

Obtaining an understanding of internal control relevant to the audit that is sufficient to assess the risks of material misstatement necessitates that you develop a thorough and robust knowledge of all five components of internal control: control environment, the entity's risk

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assessment, information and communication systems, control activities, and monitoring. Additionally, you are required to evaluate the *design* of those controls and determine whether they have been *implemented*.

To evaluate the design of controls, you consider whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements of the financial statements and noncompliance of major programs in audits performed under the Uniform Guidance. You also need to determine if the control, as documented or described, exists and the entity is using it.

Determining whether a control has been implemented confirms your understanding of control design and helps ensure that the risk assessment is based on accurate information. Implementation means that the controls exist and are being used. Generally, procedures such as observation or inspection, in combination with inquiries, are used to verify implementation. Inquiry alone cannot provide a sufficient understanding of internal control over the financial statements and compliance with direct and material compliance requirements of major programs when performing a single audit.

Tests of Operating Effectiveness

Tests of operating effectiveness of controls aren't required in every financial statement audit. You may conclude that controls are appropriately designed and implemented but decide that additional tests of

operating effectiveness are not warranted. Among other reasons, this decision might be based on the following:

- Materiality and inherent risk considerations.
- Feasibility of performing tests.
- Audit efficiency considerations.

While tests of operating effectiveness of controls are not required in every financial statement audit, the Uniform Guidance requires auditors to plan the testing of internal control over compliance to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program. The extent of the understanding of internal control that is sufficient is a matter of professional judgment and, among other things, may be affected by factors such as the following:

- Materiality and significance of related risks.
- The auditor's prior experience with the client.
- Size of the entity and the nature of the client's operations.

Practical Consideration:

For single audits, it is important to understand that the Uniform Guidance requires tests of operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient. However, tests of operating effectiveness of controls for the financial statement audit is not required.

