Risk Assessment: Peer Review’s New Hot Topic—How Will Your Firm Fare?

Most of us take our automobiles to a mechanic for one of two reasons: one is to have preventative maintenance performed, such as oil changes and tire rotations; the other is to have some problem corrected, such as an engine that won’t start or run correctly. The actions of the AICPA Peer Review Board (PRB) may serve similar purposes. Some of its actions are of a preventative maintenance nature to help ensure that attest engagements fulfill the desired purpose, while others are designed to address problems or concerns that have been identified during peer reviews. One such item that is gaining additional scrutiny is risk assessment. Although the auditing standards related to risk assessment have not recently changed, peer reviewers have been noting deficiencies in that area in a relatively high percentage of audits. As a result, beginning October 1st, the PRB will be requiring peer reviewers to consider otherwise compliant audit engagements with risk assessment problems to be nonconforming engagements with potentially significant peer review implications.

**Practical Consideration:**

In the context of peer review, a nonconforming engagement is one that is deemed as not performed or reported on in conformity with applicable professional standards in all material respects.

The purpose of this PPC Accounting and Auditing Update—Special Report is to share with you the PRB’s concerns; revisit the risk assessment standards; discuss the PPC methodology and how auditors may be misusing our forms in certain situations; and help you gain an understanding of what to expect in your next peer review.

**The Peer Review Board’s Concerns**

Members of the PPC editorial team regularly attend relevant AICPA conferences and standard-setter meetings, including the Auditing Standards Board, the Accounting and Review Services Committee, and the Technical Issues Committee. Plus, we monitor PRB meetings to help us stay abreast of new issues that could affect our customers. At the recent 2018 AICPA Peer Review Program Conference, the hot topic was risk assessment, and for good reason. 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. The most common issues noted were—

- Insufficient or a complete lack of risk assessment procedures
- Inadequate or missing linkage between risks assessed and the planned audit response
- Misuse of third-party forms

More than 10 years after the risk assessment standards were introduced, we hate to hear this continues to be a challenge—especially the last item on that list. So, we’re here to help. Let’s get started with a review of the risk assessment auditing standards.

Practical Consideration:

For firms that are serious about conducting effective risk assessment and ensuring that their audits fully comply with standards, our primary recommendation is that they adopt our SMART Practice Aids® Audit Suite (desktop) or Checkpoint Engage™ (cloud-based) audit workflow solutions. These solutions are dynamic, meaning that relevant information from each phase of the audit is automatically carried forward and presented to the auditor where needed in subsequent phases of the audit. This removes the auditor’s dependence on manual forms, manual processes, reading instructions, and remembering where relevant pieces of information and data points need to be considered. The workflow software does that for you, giving you much more confidence that your risk assessment process fully complies with standards. Our patented risk assessment process assists you in assessing and documenting the risks for each audit engagement, and then building your audit programs based on those documented risks and related assertions. The software contains extensive tips and guidance throughout the audit workflow process, presented to you at the point in the process where you need it. Plus, it provides a critical capability called “linkage view” which helps ensure that you’ve responded effectively and efficiently to all identified risks.

The Risk Assessment Standards

Risk assessment is required by AU-C 315. You should assess the risks of material misstatement at both (a) the financial statement level and (b) the relevant assertion level for account balances, transaction classes, and disclosures. An audit approach based on risk assessment provides methods to identify higher-risk areas and assertions so that audit effort can be focused on those areas. Risk assessment includes—

- Obtaining an understanding of the entity, including 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.

In AU-C 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, paragraph .14 defines audit risk as “the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.” It further explains that audit risk is a function of the risks of material misstatement and detection risk. The risk of material misstatement is a function of inherent risk and control risk. AU-C 200.14 defines these terms as follows:

Risk of material misstatement. The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:

Inherent risk. The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk. The risk that a misstatement that could occur in an assertion about a class of transaction, 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.
The combined effect of inherent risk and control risk is the risk of material misstatement. You assess inherent and control risks and then design audit procedures to reduce detection risk to an appropriately low level. Fraud risks may include both inherent and control risk attributes. Therefore, your assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud.

This risk assessment is used as a basis for designing and implementing audit procedures responsive to the assessed risks of material misstatement. Considering risks both individually and in combination with other risks and information, referred to as synthesis, helps you identify potential risks that might be associated with seemingly unrelated information. You ought to consider your accumulated knowledge about the entity and its environment from all sources when identifying potential risks of material misstatement.

**Failure to Assess the Risk of Material Misstatement.** The first risk assessment-related deficiency noted by the PRB was a failure to perform (or document) risk assessment procedures. Without doing so, you do not have an adequate basis for designing appropriate audit procedures to respond to the risks of material misstatement. At the conclusion of the audit, there would be no way of knowing whether pertinent risks had been addressed and reduced to acceptable levels; therefore, there would not be a basis to conclude you have obtained sufficient appropriate audit evidence to support your opinion. Risk assessment is the rudder that steers the ship, and without it, you simply cannot perform an effective, quality audit as required by standards.

Failure to perform risk assessment will clearly result in a nonconforming engagement for peer review purposes.

**Practical Consideration:**
Remember that if procedures or explanations are not documented in the audit workpapers, peer reviewers are to assume that they didn't happen. That is, peer reviewers can't accept oral explanations as evidence for undocumented procedures.

**Linkage.** The auditing standards relating to risk assessment emphasize “linkage” between assessed risks and the nature, timing, and extent of resulting audit procedures. That is, it is necessary to perform further audit procedures that are designed to respond to the risks of material misstatement at the relevant assertion level. The result is a targeted effort that considers the unique circumstances of each entity.

**Practical Consideration:**
Our SMART Audit Suite and Checkpoint Engage allow you to tie risks directly to program steps. Plus, the Linkage View allows you to know that you've responded appropriately to each identified risk.

Failure to link the planned audit response to the assessed risks of material misstatement by assertion presents a number of problems. First, it would lead to a failure to comply with the risk assessment standards if the assessed risks at the assertion level are not adequately linked to and addressed by the substantive procedures performed. This would result in a failure to document that you obtained sufficient evidence to support your opinion. While not necessarily a peer review concern, another common issue resulting from a failure to link assertion-level risks and procedures is over-auditing. If you perform a wide array of substantive procedures without focusing your approach based on risks, you may address the significant risk areas, but you'll also likely waste time and resources excessively testing areas of lesser consequence. Audit quality, client satisfaction, and profitability are all at stake when you fail to link risk assessment to the audit response.

**Practical Consideration:**
For more discussion of the risk assessment standards, see “Risk Assessment Audit Procedures,” in the September 2018 edition of *The PPC Accounting and Auditing Update*, and Chapters 3 and 4 of PPC's *Guide to Audits of Nonpublic Companies*.
The PPC Methodology and How Auditors May Be Misusing Our Forms

The problem leading to misuse of our forms is a common one: not following instructions. Who hasn’t gotten in a hurry assembling a store-bought bookcase and tossed the instructions aside? Unfortunately, instead of a handful of mysteriously leftover nuts and bolts, in the case of an audit, you could end up not complying with the auditing standards. At the 2018 AICPA Peer Review Program Conference, the PRB speakers noted that PPC practice aids are properly designed to comply with the auditing standards when used correctly. PPC had extensive discussions with the AICPA when incorporating the risk assessment standards into our forms. Therefore, if you’re using our practice aids as designed, you should be compliant with the risk assessment standards. Unfortunately, according to the peer review findings, misuse is occurring. We will further clarify a few of the more critical points in the 2019 editions of the PPC audit products, but in the meantime, here’s a refresher on the PPC forms-based methodology, how it is designed to work, and an overview of issues reported by the PRB.

Risk Assessment Using the PPC Forms. Using PPC’s audit forms, you take the following steps to assess the risks of material misstatement at the relevant assertion level (references used are consistent across most PPC audit guides and practice aids):

- Identify any risk assessment factors that affect the risk of material misstatement for particular account balances, transaction classes, or disclosures based on the procedures performed during planning to understand the entity, its risk factors, its internal control, etc. Those procedures are documented on the CX-3.1, CX-6.1, CX-4 series, and CX-7.1.
- Determine significant audit areas.
- Describe the specific risks of material misstatement that affect the account balance, transaction class, or disclosure; identify the financial statement assertion(s) affected; and consider the significance of the risks.
- Make a qualitative assessment of inherent risk as high, moderate, or low.
- Make a qualitative evaluation of control risk as high, moderate, or low.
- Make a qualitative assessment of the resulting or combined risk of material misstatement as high, moderate, or low based on the prior evaluations of inherent risk and control risk.

Using PPC’s audit forms, the auditor’s risk assessment at the relevant assertion level is performed, synthesized, and documented using Part II of the “Risk Assessment Summary Form” at CX-7.1. That form is used to (a) identify significant audit areas; (b) identify fraud risks and other significant risks; (c) document the auditor’s assessment of inherent risk, control risk, and combined risk at the assertion level; and (d) select an audit approach that is responsive to the assessed level of risk at the relevant assertion level.

Risk Assessment at the Assertion vs. Audit Area Level. The primary issue that reviewers have seen with our practice aids is the misuse of the option to assess risk by audit area. AU-C 315.26 clearly states:

> 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.

As described above, the “Risk Assessment Summary Form,” located at CX-7.1 in PPC’s audit products provides a place to document this assessment. It also, however, allows users to document risk at the audit area level under certain, limited circumstances, but stresses that caution should be used when following that approach. The relevant instructions to our CX-7.1 include the following additional guidance and cautionary language:
Assess the risk of material misstatement at the relevant assertion level. For audit areas that are not significant, or for significant areas where you have not identified any specific risks, it may be appropriate and more efficient to document the risk assessment for the audit area as a whole. If that is done, the risk assessment is assumed to be the same for all assertions and ought to be at the highest level of risk for any assertion in the area. (Exercise caution when documenting the assessment at the audit area level. Failure to consider the level of risk related to each assertion could result in an inappropriate response.) However, for significant audit areas where you have identified one or more specific risks, document the risk assessment at the assertion level. When documenting the risk assessment at the assertion level, make an assessment for each relevant assertion regardless of whether you have identified any specific risks related to that assertion.

Note that use of the audit area option is only appropriate if the area is not a significant audit area and/or it has no specific identified risks. A significant audit area is defined in the instructions to CX-7.1 as one that contains a significant transaction class, material account balance, fraud or other significant risk, or that requires significant disclosures. Furthermore, assessing risk at the audit area level is not bypassing assessment at the assertion level, but rather signifying that risks have been assessed and are considered to be the same for all assertions. Based on our recent communications with PRB staff, it appears that this option is sometimes being over-used in practice to simplify or, by also defaulting to high risk (see discussion in the next section), to circumvent the risk assessment process. As noted in the above excerpt, doing so could lead to an inappropriate audit response and, for peer review purposes (especially for peer reviews performed after October 1st), result in the audit being identified as a nonconforming engagement. For these reasons, we specifically caution against assessing risk at the audit area level. We believe it is a best practice to always assess risk at the assertion level.

If you do determine that assessing risk at the audit area level is appropriate, make sure your documentation supports that conclusion. If you have determined that there were no identified risks, risks of material misstatement are consistent across all assertions, and/or the area is not a significant audit area as defined above, a best practice is to document that you have given this due consideration (rather than taking a prohibited shortcut) and can support your decision. Make sure, however, that this is also consistent with other planning and risk assessment documentation.

Defaulting to High Risk. Another issue noted in some peer reviews is that auditors have defaulted to a high combined risk of material misstatement at the audit area level to circumvent the risk assessment process altogether. It may seem more efficient to skip consideration of inherent risks and control risks at the individual assertion level, especially in audits of smaller entities. When using PPC's SMART products or Checkpoint Engage, this would result in generating the most comprehensive audit programs. However, without properly assessing risk, you can fail to appropriately tailor audit procedures, including their nature, timing, and extent, to address a risk that should have been identified and thus, miss the forest for the trees. In addition, as discussed in the Linkage section above, not only does this approach fail to comply with auditing standards, it also results in an inefficient audit and very likely a dissatisfied client.

Failure to Tailor Audit Programs. This issue goes back to linkage between assessed risks and planned audit procedures. We provide comprehensive, standardized audit programs to cover a broad range of risks at the assertion level, and you need to tailor your programs by selecting specific procedures necessary to respond to any identified risks. However, peer reviewers are often finding that our audit programs are being used with no tailoring. If you're not tailoring audit programs, you may not be complying with AU-C 330. The audit programs provide a starting point for use in developing an audit response and determining the nature, timing, and extent of further audit procedures that need to be performed to respond to the assessed risk(s). They need to be tailored to respond to identified risks at the assertion level. The assertions addressed by each procedure are included in the audit programs, providing linkage between the assessed risks and related audit program procedures. Using the assessment of the risk of material misstatement by assertion as your basis, you can tailor your audit response.

Practical Consideration:

Our SMART Audit Suite and Checkpoint Engage will automatically streamline and tailor your practice aids and audit programs based on your answers to several setup questions at the beginning of an engagement. Planning questions not applicable to your client’s situation will automatically be removed and audit programs will be automatically tailored. Plus, the SMART Design filter allows you to ensure your audit programs are highly tailored by assertion in response to identified risks.
What to Expect on Your Next Peer Review

Effective for peer reviews commencing October 1, 2018, you can expect a much more thorough analysis of your risk assessment procedures than you’ve had in the past. Until now, if there is evidence that a practitioner has performed some sort of risk assessment (even if inadequately documented, linked, or performed at the assertion level), many peer reviewers have not identified the risk assessment process in MFCs (matter for further consideration) or FCCs (finding for further consideration). But for peer reviews beginning October 1st, audit engagements that fail to comply with the risk assessment standards will be considered nonconforming engagements, with potentially significant peer review implications. The following table summarizes the new peer review guidance:

<table>
<thead>
<tr>
<th>Nonconforming Engagement(s) related to Risk Assessment and Other Noncompliance</th>
<th>Nonconforming Engagement(s) related to Risk Assessment—Isolated or Systemic?</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>No noncompliance other than risk assessment</td>
<td>Isolated</td>
<td>MFC</td>
</tr>
<tr>
<td>No noncompliance other than risk assessment</td>
<td>Systemic</td>
<td>FCC and implementation plan</td>
</tr>
<tr>
<td>Other deficiencies or significant deficiencies</td>
<td>Systemic</td>
<td>Deficiency or significant deficiency with corrective action</td>
</tr>
</tbody>
</table>

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 FCC with implementation plan and a peer review rating of pass. If you receive an FCC, 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 be developing webinars that will satisfy the CPE requirement in many cases.

Practical Consideration:

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. Sections 802 and 1818 of PPC’s Guide to Audits of Nonpublic Companies include practical guidance based on AU-C 230, Audit Documentation, on making changes or additions to the workpapers after the documentation completion date, including 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.

To help you learn more about risk assessment, 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. Further guidance on peer reviews is included in PPC’s Guide to Quality Control.

We also offer a variety of training on how to use our SMART Audit Suite and Checkpoint Engage so that you take full advantage of all of their features. For further information, call us at (800) 431-9025, option 3, or click the following link to access the Learning Center: http://support.checkpoint.thomsonreuters.com/training.

Order Information

If you wish to receive The PPC Accounting and Auditing Update monthly newsletter that discusses current accounting and auditing topics, please go to tax.thomsonreuters.com or call (800) 431-9025, option 1, to order.
Acknowledgment of Copyright

This Special Report contains quotations from AU-C 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, and AU-C 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, which are copyrighted by the American Institute of Certified Public Accountants. Such passages have been reprinted with the permission of the American Institute of Certified Public Accountants.