Risk Assessment and the Audit Process

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Mauldin & Jenkins, LLC
mjcpa.com

Timothy M. Lyons, *SLG Practice Lead Assurance Partner*
tlyons@mjcpa.com

Presentation Overview

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- The Risk Assessment Process
- Internal Controls
- Documenting Assessments & Linkage to Audit Testing
- Questions?

The Risk Assessment Process

Why Assess Audit Risk?

Picture this: You’ve finally made it through busy season. You’ve booked a family trip to a remote cabin in the mountains to unplug and relax. Your out-of-office message has been turned on and you’ve planned plenty of outdoorsy activities for you and your family. You’ve written out a packing list and checked off every item:

Clothes? Check.
Hiking boots? Check.
Bug spray? Check.
Snacks and entertainment to ward off your kids’ boredom- and hunger-related complaints during the long car ride? Check.

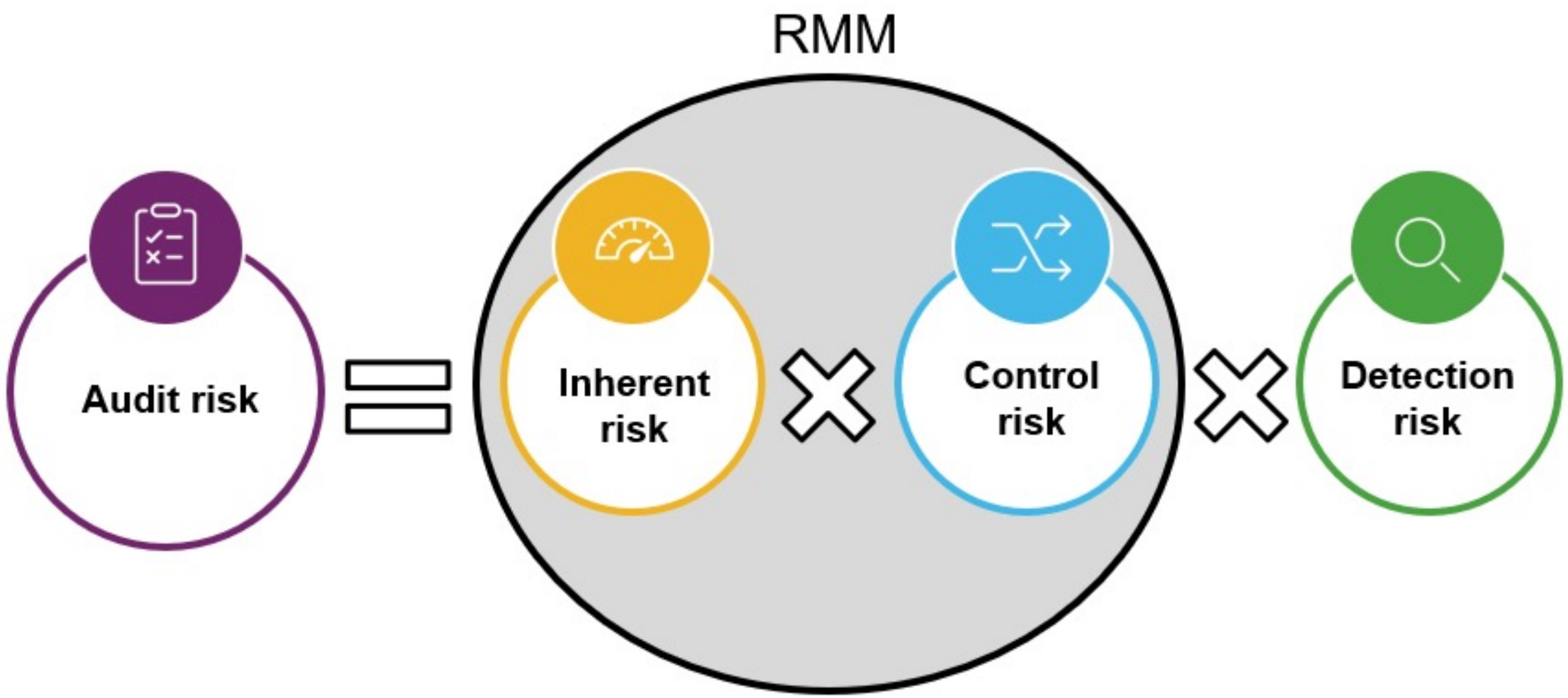
The car’s all packed, everyone’s buckled in and your GPS is set up on the dashboard. Now that you’re ready to embark on a journey to the middle of nowhere, you reach for your GPS…

The Risk Assessment Process

Why Assess Audit Risk?

<u>…and throw it out the window?</u>

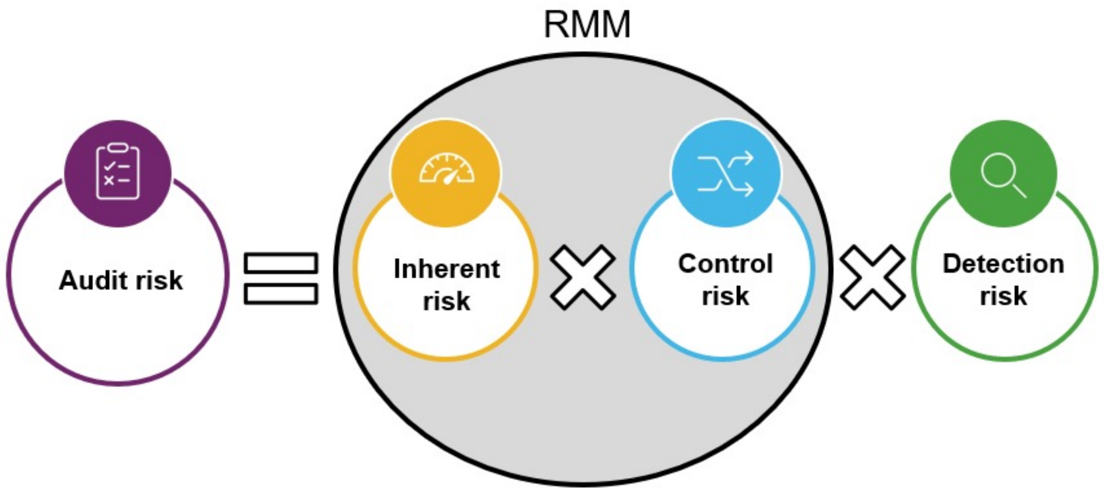
The Risk Assessment Process



The Risk Assessment Process

Audit Risk

The risk that we will issue the wrong audit opinion.



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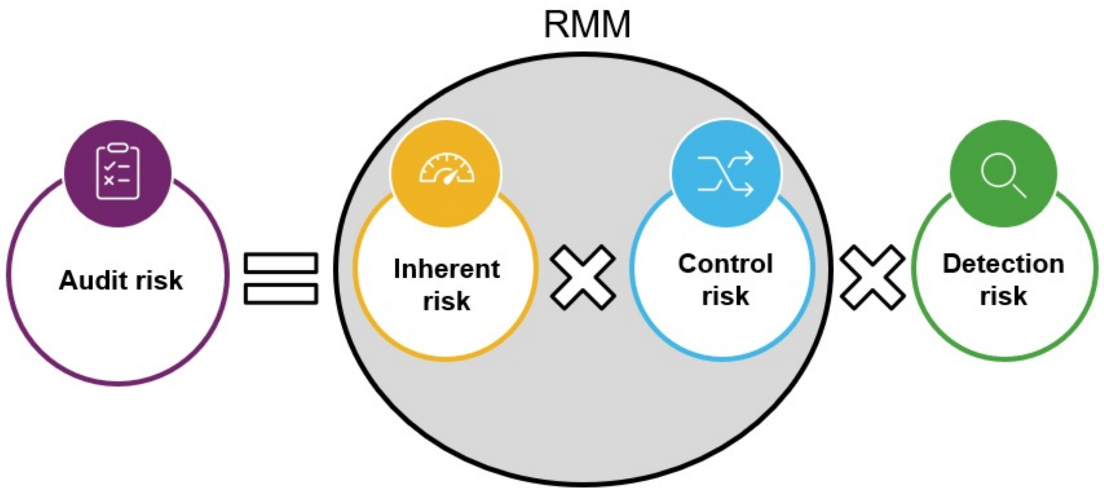
Inherent Risk

RoMM assuming that there are no related internal controls.



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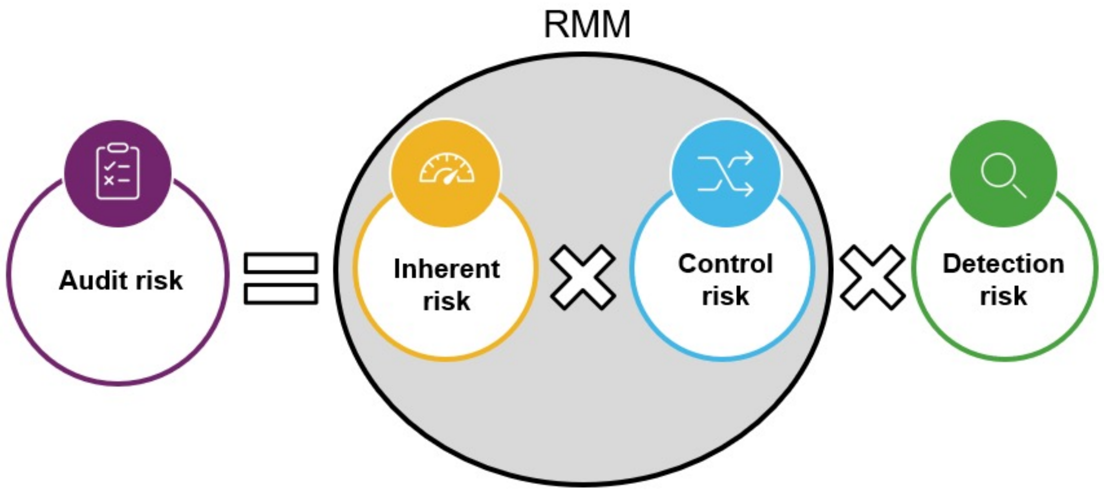
Control Risk

The risk that the client's controls will not prevent or detect a material misstatement.



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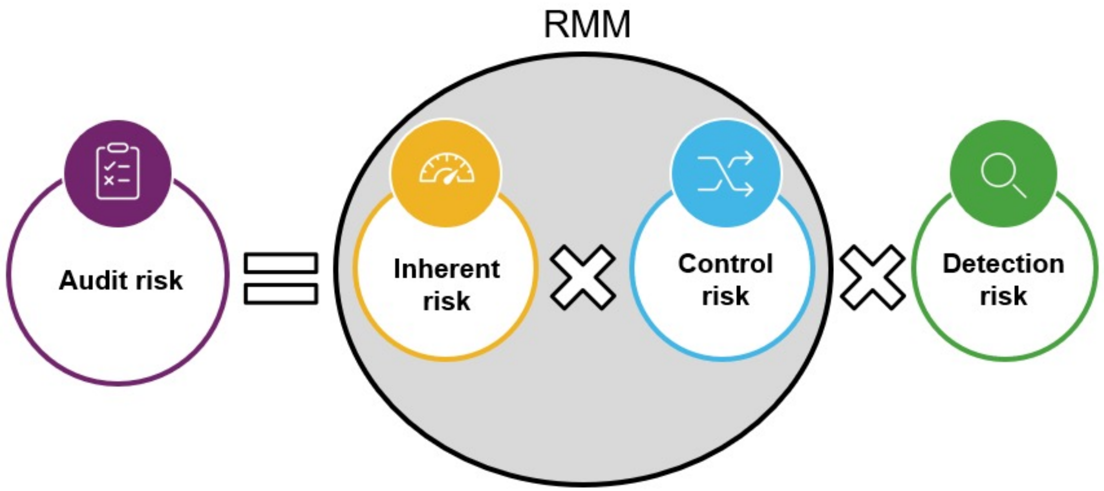
Detection Risk

The risk that WE will not detect a material misstatement.



The Risk Assessment Process

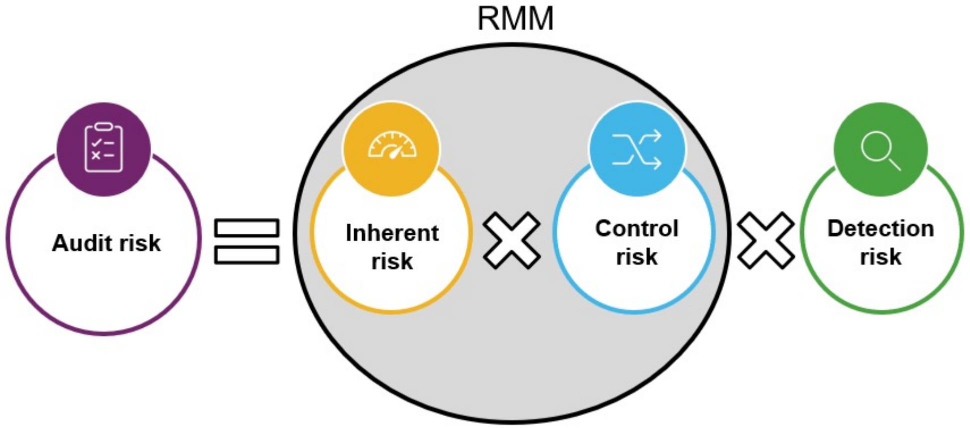
Key Observations about the Audit Risk Model

Inherent Risk and Control Risk combine to form RoMM.

– Exist independent of the auditor

– Cannot be reduced through substantive procedures

So if RoMM is anything other than low, how do we reduce audit risk to an acceptably low level?

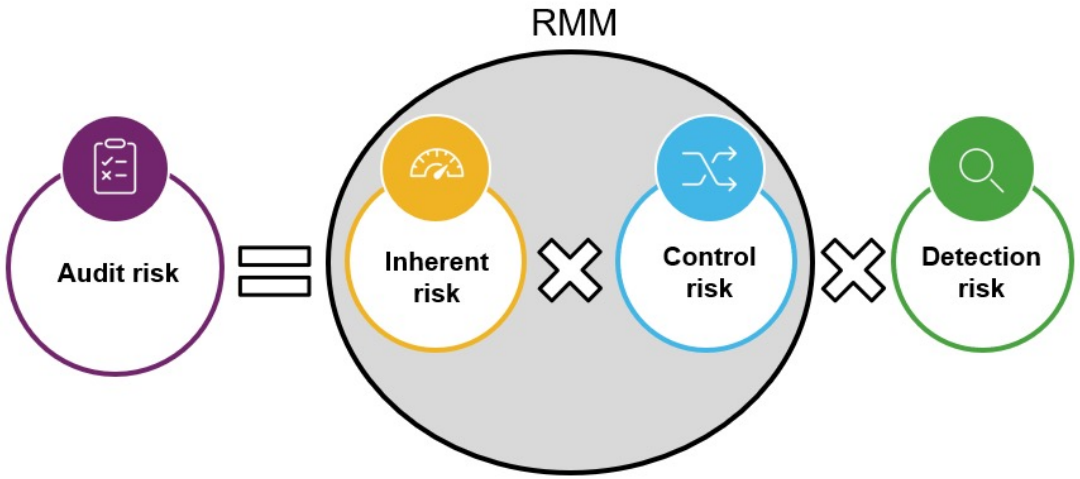


The Risk Assessment Process

Key Observations about the Audit Risk Model

We manipulate the only risk that we CAN control: **Detection Risk**

- Vouch transactions instead of analytics
- Perform procedures at year-end instead of during the interim
- Increase the extent of procedures (i.e., larger samples)



The Risk Assessment Process

Understand Your Client

- Nature of the client?
- External factors (industry conditions, environment, politics, etc.)?
- Organization strategies?
- Financial performance?

Understand Internal Control

- Control environment: what is the tone at the top?
- Control activities for ALL material classes of transactions, account balances, and disclosures.

RoMM Drives Detection Risk

- Nature, timing, and extent of your audit procedures; MUST be responsive to the RoMM identified.

The Risk Assessment Process

What are significant risks and why should auditors focus on them?

Significant risks are defined as those risks of material misstatement that require special audit consideration. Significant risks often relate to significant nonroutine transactions and matters that require significant judgment; routine noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks.

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What are significant risks and why should auditors focus on them?

In exercising professional judgment to determine whether a risk is significant, auditors need to consider:

- **The nature of the risk**
- **The likely magnitude of potential misstatement, including the possibility that the risk may give rise to multiple misstatements**
- **The likelihood of the misstatement occurring**

Remember! Significant risks are required to be communicated in writing (engagement letter or as an addendum) by SAS 134.

The Risk Assessment Process

Common Deficiencies Noted by the AICPA

Many auditors of smaller clients appear to be documenting their risk assessment in accordance with AU-C 315 but performing audits with little regard to the results of that assessment. This is often due to overreliance on standardized, third-party practice aids.

While standardized practice aids can be valuable tools, they must be used as intended to be effective. Even if an auditor uses standardized aids, they are still required to link the procedures they perform back to their risk assessment.

Reviewers should consider the linkage between the risk assessment and the auditor's procedures, and they should determine whether the procedures are responsive to the client's financial statement- and assertion-level risks. If the auditor's procedures are not responsive to one or more risks, the auditor has failed to comply with AU-C 330.06.

Internal Controls

AU-C 315.14 states, ***"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 the inquiry of the entity's personnel."***

- ❑ Consider what could go wrong as the client prepares their F/S.
- ❑ Identify the controls meant to mitigate those RoMMs.
- ❑ Evaluate the likelihood that the controls are capable of effectively preventing or detecting and correcting material misstatements.

Internal Controls

Common Deficiencies Noted by the AICPA

Some auditors may indicate that the requirements of AU-C 315.14 do not apply to their client because their client has no controls. This is a false assumption. While an entity may not have documented controls, some controls always exist. Examples for smaller entities include monitoring of financial results by management; reconciliation of accounts, such as cash, accounts receivable and accounts payable; computer log-in credentials; and limitation of physical access to cash and inventory.

Other auditors may suggest that they did not evaluate the design and implementation of controls relevant to the audit because they are not relying on the operating effectiveness of the controls. Regardless of whether the auditor is relying on operating effectiveness, the nature of control risk can only be ascertained by evaluating the design and implementation of the control. Without understanding the nature of the risk, the auditor cannot design an appropriate response.

Internal Controls

Common Deficiencies Noted by the AICPA

- ❑ We documented an internal control, but did we verify implementation?
- ❑ Internal control documentation not addressing the five elements of internal control (COSO): Control environment, risk assessment, control activities, information & communication, and monitoring.
- ❑ Did our risk assessment properly consider the results of any deficiencies, significant deficiencies or material weaknesses reported in the prior audit?

Internal Controls

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Common Deficiencies

- ❑ Did we document a control or a control feature to reduce inherent risk?
- ❑ Did we document the WHY behind our risk assessments?

Linkage to Audit Testing

Overall, auditors should:

- **Assess the risks of material misstatement at both the financial-statement and relevant assertion levels.**
- **Determine which risks are significant and the assertions affected.**
- **Design specific procedures that are responsive to significant risks; where client controls likely would mitigate significant risks, consider whether those controls should be tested as part of further audit procedures.**
- **For non-significant risks, design further audit procedures where the nature, timing and extent of those procedures are responsive to the assessed risks of material misstatement; these risks often are addressed through standard audit work program procedures.**
- **Provide a clear linkage between the risk assessments and the nature, timing and extent of the further audit procedures.**

Linkage to Audit Testing

A couple of key questions auditors should ask themselves about their current audit methodology:

- ❑ Does the audit methodology used require completion of a series of checklists that do not seem to add any value to the audit?

- ❑ Do engagement team members have a lack of understanding as to why checklists that are utilized need to be completed?

Linkage to Audit Testing

PROGRAMS AND RISK ASSESSMENTS

Make sure you are considering links with programs

FRAUD MEMO / INQUIRIES

Any identified risks

↓

Risk Assessment

↓

Program

Linkage to Audit Testing

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For each audit area (e.g., cash, accounts receivable, etc.), auditors should <u>document:</u>

- **Any identified significant risks**
- **The assertions affected**
- **Assessments of inherent risk and control risk and the RoMM for relevant assertions**
- **Audit procedures beyond the standard work program procedures needed to mitigate the risks identified**
- **Linkage of the audit procedures in the work program to these risks**

Linkage to Audit Testing

Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Indicate If Significant Risk (S=Significant, F=Fraud)	Assertions	I/R (H,M,L)	C/R (H,M,L)	Assessed RMM (H,M,L)[b]	Audit Approach (L,B,E,S)[c]
Cash	✓							B
				E/O	L	H	L	
				C	L	H	L	
				R/O	L	H	L	
				V	L	H	L	
				A/CL	L	H	L	
				CO	L	H	L	

Comment[d]	For cash accounts with a decentralized process, inherent risk for cutoff is considered high due to increased risk of misappropriation. All other inherent risks (including cutoff for centralized cash) are low because there are: no significant or complex accounting issues; no prior audit adjustments; and no judgment required or involved. For all relevant assertions with low risk of material misstatement, we believe the low inherent risk of the assertion (as documented above) is of such significance that it leads to the low risk of material misstatement.
CO	Decentralized Cash - Cut off should be assessed at high inherent risk

Linkage to Audit Testing

Revenue SECTION

- **We still have our normal risks with grants –**
  - **Cut-off and completeness**
  - **Existence**
- **Now may have issues with CARES money which may be reported as liabilities if Cash is received.**

		Risks of Material Misstatement		Risk Assessment				Response
Audit Area	Significant Audit Area? (✓=Yes)	Identified Risks/ Assertions Affected	Indicate If Significant Risk (S=Significant, F=Fraud)	Assertions	I/R (H,M,L)	C/R (H,M,L)	Assessed RMM (H,M,L)[b]	Audit Approach (L,B,E,S)[c]
Grant and Similar Programs	✓							B
				E/O	H	H	H	
				C	H	H	H	
				R/O	L	H	L	
				V	L	H	L	
				A/CL	L	H	L	
				CO	H	H	H	

Comment	Inherent risk related to completeness, existence and cutoff is considered high due to the past misstatements and complex accounting. All other assertions are considered low due to there being no auditing issues, lack of judgment required, and the nature of the items. For all relevant assertions with low risk of material misstatement, we believe the low inherent risk of the assertion (as documented above) is of such significance that it leads to the low risk of material misstatement.

Revenue rollforward – make sure client is rolling grants
- Prior Year Unavailable Revenues
- Current Year Receipts
- Current Year Receivables
- Current Year Availability

Thoughts to keep in mind:
- If a in a grant fund – watch for "net income" and "deficits"
- Make sure we look at grant agreements for reimbursement rates
- Watch for Clean Water / Drinking Water Loans

Linkage to Audit Testing

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Common Issues in Analytical Procedures:

Are we developing an appropriate expectation OR are we just comparing to the prior year?

Is our expectation / precision for the analytic consistent with our risk assessments?

If the results of the analytic are outside of our expectation, have we done appropriate ADDITIONAL procedures to respond?

Linkage to Audit Testing

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Common Deficiencies

- ❑ Inconsistency between entity-wide or significant risks identified in our planning documentation that does not make its way into our risk assessments.
- ❑ Significant risks identified but no documentation of communication with management / those charged with governance.
- ❑ Neglecting to consider the impact of prior year audit adjustments.

Linkage to Audit Testing

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Common Deficiencies

- Inconsistency between risk assessments and audit procedures performed:
  - Sampling
  - Scoping and remaining untested balances
  - Following up on risk assessments throughout the audit process

Risk Assessment in Single Audits

AU-C 935.15 establishes a requirement to perform risk assessment procedures. It states the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and related internal control over such compliance requirements for each program and compliance requirement selected for testing.

Risk Assessment in Single Audits

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The GAS / Single Audit Audit Guide, Paragraph 6.31 and AU-C 935.A13 explain that the nature and extent of risk assessment procedures may vary for different entities and are influenced by factors such as:

- **The newness and complexity of the compliance requirements subject to audit**
- **The entity's internal control over compliance**
- **Services provided and how external factors affect the services**
- **The amount of oversight by the grantor or pass-through entity**
- **Management's responses to findings / corrective action plans**

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QUESTIONS?

- **Tim Lyons**
  Partner
- **tlyons@mjcpa.com**
- **(803) 799-5810**
- **www.mjcpa.com**