

# New Audit Standards: How Will They Impact the Audit Process?

Presented by

**Robinson, Farmer, Cox Associates**

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# Presentation Objectives

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- Discuss background and reasons for enacting selected new Statements on Auditing Standards (SAS's).
- Review specific per-SAS requirements.
- Convey the impacts of the new requirements on localities.

# Risk Assessment Standards (SAS 104-111) - Overview

The AICPA's Auditing Standards Board has issued eight Statements on Auditing Standards (SAS) relating to the assessment of risk in an audit of financial statements:

- SAS No. 104, *Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")*
- SAS No. 105, *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- SAS No. 106, *Audit Evidence*
- SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*
- SAS No. 108, *Planning and Supervision*
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS No. 111, *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

# Why?

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- The Accounting Standards Board (ASB) believes these standards are significantly more strengthened and will lead to a more quality audit product.

# Objectives

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- Objective is to improve the audit's effectiveness by providing:
  - A more detailed entity-wide understanding of processes and controls
  - A more rigorous assessment of the risks of material misstatement (either by fraud or error) in the financial statement
  - A linkage between “assessed risks and the nature, timing, and extent of the audit procedures performed in response to those risks.

# Audit Benefits

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- Enhances the use of the audit risk model in practice by requiring:
  - A more detailed understanding of the entity, its processes, and controls
  - Ability to default to maximum control risk is removed
- Improved linkage between entity risk and the resulting audit procedures performed.

# Risk Assessment Standards

- Enhances the auditor's application of the audit risk model:

$$AR = [CR \times IR] \times DR$$
$$[CR \times IR] = RMM$$

AR = Audit Risk

CR = Control Risk

IR = Inherent Risk

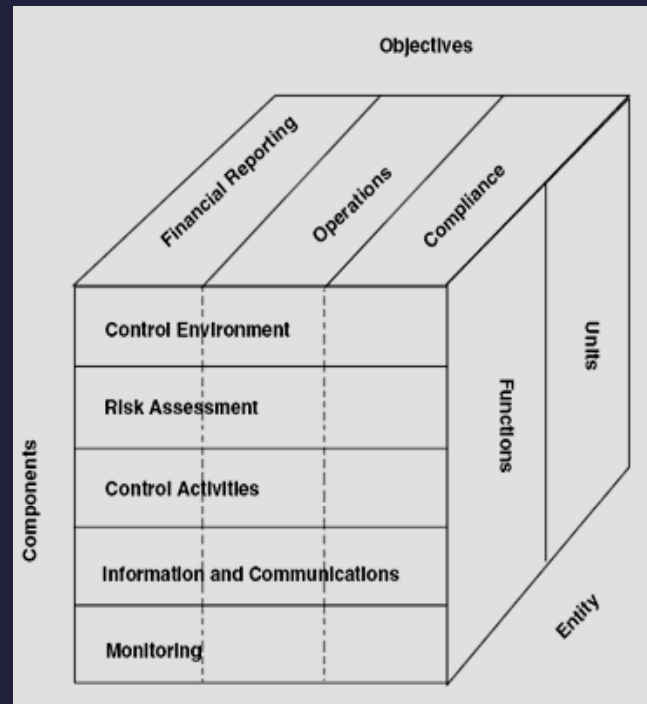
DR = Detection Risk

RMM = risk of material misstatement

*Source: AICPA Risk Assessment Standards Presentation*

# Risk Assessment Standards

- Retain the use of the Internal Control Framework:



# Risk Assessment Standards

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- Auditors must:
  - Assess internal control for strength and functionality
  - Assess whether or not these controls were in use
  - Assess the risk of material misstatement at both the financial statement level and at the assertion level.

# Risk Assessment Standards

## ■ New Assertion Framework

Classes of Transactions	Account Balances	Presentation and Disclosures
- Occurrence	- Existence	- Occurrence and Rights / obligations
- Completeness	- Rights and obligations	- Completeness
- Accuracy	- Completeness	- Classification and understandability
- Cutoff	- Valuation and allocation	- Accuracy and valuation
- Classification		

# Risk Assessment Standards

Audit Risk	Auditor's Response
Financial Statement	Overall responses
Account level	Further Audit Procedures (Tests of Controls and Substantive Tests)

- Testing of controls is encouraged.
- Enhanced requirement to link risks and audit procedures in response to those risks is improved.
- Risk assessment as a continuous process.

# Risk Assessment Standards

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- Summary of Significant Changes to Existing Practices
  - Identifying and assessing risks of material misstatement at the financial statement and the relevant assertion level.
  - Designing and specific audit procedures based on assessed risks at the relevant assertion level.
  - Linkage of audit procedures to the risk of material misstatement.

# Risk Assessment Standards – SAS 104

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- SAS 104, Amendment to SAS 1
  - Expands the definition of “reasonable assurance” to “high level of assurance.”

# Risk Assessment Standards – SAS 105

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- SAS 105, Generally Accepted Auditing Standards

- Amends SAS 95
- Update of older terminology (e.g. “Audit Evidence” replaces “Evidential Matter”, “The entity and its environment, including internal control” replaces “internal control”).

# Risk Assessment Standards – SAS 106

- SAS 106, Audit Evidence (amends SAS 31)
  - States that the auditor must obtain significant audit evidence *by performing audit procedures* to give a reasonable basis for an opinion
  - Evidence includes accounting records, confirmations, minutes, industry reports, audit procedures such as inspections and inquiries, etc.

# Risk Assessment Standards – SAS 106

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- Audit Procedures
  - Risk Assessment Procedures
    - Inquiries
    - Analytical procedures
    - Inspection and observation
  - Further Audit Procedures
    - Test of controls
    - Substantive procedures
      - Test of details
      - Substantive analytical procedures

# Risk Assessment Standards – SAS 106

## ■ Assertions

- The use of assertions in obtaining audit evidence – these are management’s implicit or explicit assertions regarding the recognition, measurement, presentation and disclosure of information in the financial statements and related disclosures.

## ■ Types of Assertions

- a. Classes of transactions
- b. Account balances
- c. Presentation and disclosure

# Risk Assessment Standards – SAS 107

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- SAS 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.”*

# Risk Assessment Standards – SAS 107

- Risk must be assessed at the financial statement level
  - Fraud
  - Incompetent management
  - Related party transactions
- Risk must also be assessed at the assertion level:
  - a. Combined risk assessment, which consists of:
    1. Inherent risk
    2. Control risk
  - b. Detection risk

# Risk Assessment Standards – SAS 107

## ■ Materiality

- Is assessed using professional judgment
- Is determined in order to
  - Perform risk assessment procedures
  - Identify and assess risk
  - Design/perform further audit procedures
  - Evaluate the fair overall presentation of financial statements
- Is assessed using benchmarks such as total revenues and net assets
- Is used to create tolerable misstatement, which is the amount of acceptable error.

# Risk Assessment Standards – SAS 108

- SAS 108, Planning and Supervision
  - Amends SAS 1 and SAS 22
  - *“The auditor must adequately plan the work and properly supervise all assistants.”*
  - Involves
    - Appointment of an independent auditor
    - Preliminary engagement activities
    - The overall audit strategy and audit plan
    - The planning of any specialist involvement.
    - Any necessary additional considerations

# Risk Assessment Standards – SAS 109

- SAS 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 the design the nature, timing, and extent of further audit procedures.”*

# Risk Assessment Standards – SAS 109

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

# Risk Assessment Standards – SAS 109

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- Inquiries of management may be directed toward:
  - External parties – for example, legal counsel, bankers, valuation experts, etc.
  - Internal – for example those charged with governance, internal audit, employees other than accounting personnel, in-house counsel, etc.

# Risk Assessment Standards – SAS 109

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- Analytical Procedures
  - Use guidance of SAS 56, Analytical Procedures
  - Helpful In identifying unusual transactions or events
  - Assist in determining amounts, ratios, trends in the financial statements

# Risk Assessment Standards – SAS 109

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- Observation and Inspection of
  - Documentation and manuals
  - Internal reports and minutes
  - Transaction tracing through systems

# Risk Assessment Standards – SAS 109

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- Attempting to develop an understanding the entity and its environment, including its internal control.
  - Industry, regulatory, and other external factors
  - Nature of the entity
  - Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
  - Measurement and review of the entity's financial performance
  - Internal control

# Risk Assessment Standards – SAS 109

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- Internal Controls

- Evaluate the design of controls relevant to the audit
- Determine whether or not the standards are actually in use

- Controls are tested using observation, inspection, or walkthroughs

- Inquiry alone is insufficient to evaluate control design and implementation.

# Risk Assessment Standards – SAS 110

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- SAS 110, Performing Procedures

- *“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.”*

# Risk Assessment Standards – SAS 110

- SAS No. 110 provides guidance on:
  - Determining overall responses
  - Designing and performing further audit procedures
- Overall responses may include:
  - Exercising professional skepticism
  - Assigning more experienced personnel
  - Changing the timing and extent of audit procedures
  - Using specialists
- Leads to the design of additional procedures as necessary and deemed adequate (considering the timing, nature and extent of procedures)

# Risk Assessment Standards – SAS 110

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## ■ Testing Procedures

- Control tests may be rotated but each control should be tested at least once every three years.
- Controls over areas of significant risks should be tested in the course of each audit

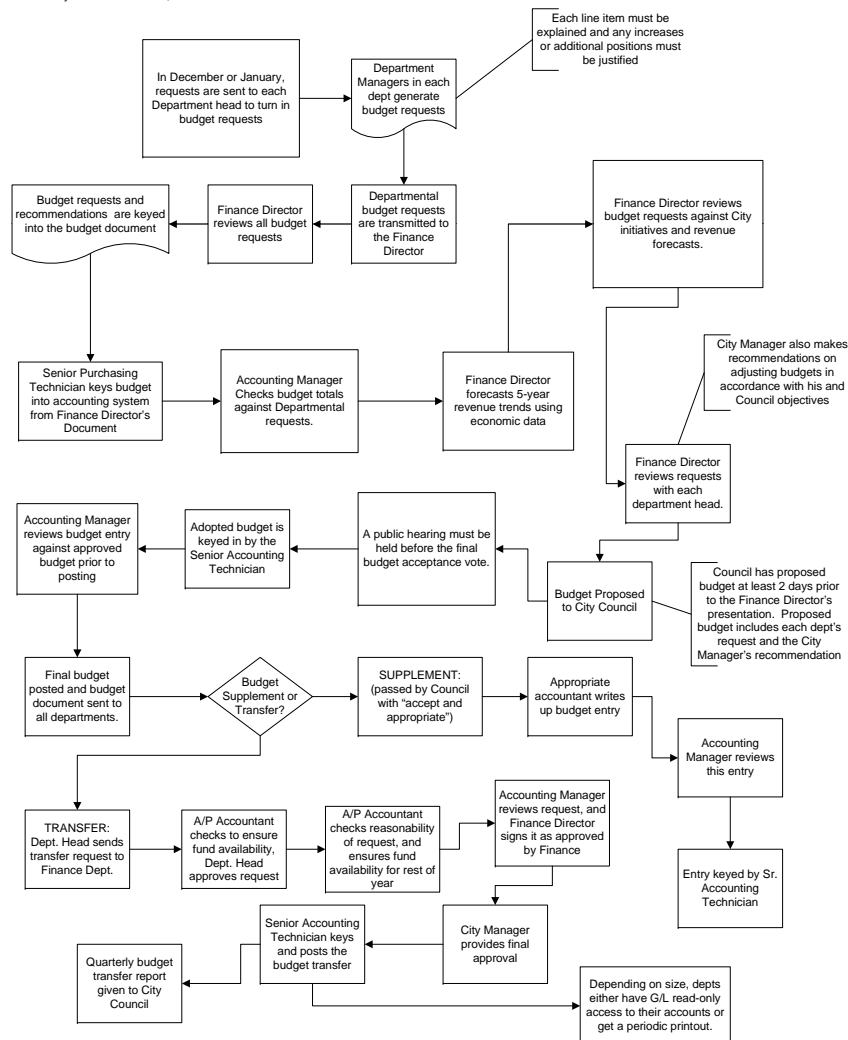
# Risk Assessment Standards – SAS 110

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- Evaluating audit evidence sufficiency and appropriateness
  - Auditors should not assume that fraud or errors are isolated
  - Auditors will need to determine whether tests are adequate from a reliance standpoint
- Documentation necessary for
  - Procedures performed
  - Inquiry and testing results
  - Evidentiary conclusions

# Risk Assessment Standards – SAS 110

City of Westfield, Virginia  
Documentation of  
Budget Development Process  
For the fiscal year ended June 30, 2007



## Documentation – Flowcharting example

# Risk Assessment Standards – SAS 111

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- SAS 111 – Provides additional guidance regarding tolerable misstatement
  - Should generally be less than materiality
- The use of sample sizes should be chosen on a statistical basis.

# SAS 114 – Auditor’ Communication With Those Charged With Governance

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- Who is Charged with Governance?
  - Person(s) with responsibility for overseeing and approving the financial reporting process
  - Management

# SAS 114 (cont'd)

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- What is to be communicated (before)?
  - Overview of the planned scope and timing of the audit, significant audit findings / difficulties etc.
- When to communicate (after)?
  - In a timely manner

# Conclusions

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- New audit standards significantly change the processes and requirements necessary for the audit process
- Change the methods by which audits are both planned and executed
- Create a need for additional preparatory efforts and preliminary fieldwork
- May create additional preliminary demands on client staff

*Thank you very much.  
Questions?*