



PCPS BRIEF

The Risk Assessment Standards: Key Points to Remember

*This Brief is based on “**The Risk Assessment Standards: A High Level Overview,**” a PCPS Practice Management Forum given in September by CPA Chuck Landes, AICPA Vice President of Professional Standards and Services.*

In the coming busy season, practitioners will be working for the first time with Statements on Auditing Standards Nos. 104 through 111, which are effective for audits of financial statements for periods beginning on or after December 15, 2006. These risk assessment standards emphasize the importance of returning to the basics of good audit procedure, so in many ways they simply emphasize existing audit practices. Much of the theory used in the risk assessment standards is the same as that used in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, for example.

Practitioners should be aware, however, that, in achieving their goals, the new standards do contain significant changes for audit practice. Among them:

- The auditor will have to gain a deeper understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- Auditors will have to perform a more rigorous assessment of the risks of material misstatement. It is necessary to identify and assess the risks of material misstatements at both the financial statement level and the relevant assertion level by performing risk assessment procedures.
- The risk of material misstatement refers to control risk and inherent risk, which are two independent variables. They are the client’s risks, not the CPA’s. Audit risk, on the other hand, is the risk that the firm will issue a clean opinion when the financial statements contain a material misstatement. CPAs want to express a reasonable (or high) level of assurance, and therefore it is important to reduce audit risk to a low level. The only way for CPAs to control audit risk is to drive detection risk—the risk that our audit procedures will not detect misstatement—to a low level. Generally, the higher the risks of misstatement, the more work needs to be done to reduce detection risk.
- Auditors will have to link audit procedures—the nature, timing and extent of what they do—to the risk of material misstatement. Since default to the maximum level is no longer allowed, CPAs will have to use their judgment, based on their risk

assessment procedures, to tailor their audit to the risks identified.

- Auditors will have to design and perform tailored audit procedures that respond to assessed risks at the relevant assertion level. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, required auditors to have an understanding of the internal control system sufficient to plan the audit, but it allowed auditors to default to maximum. Under the new standards, it is no longer acceptable to default to a maximum level of control risk, based on assumptions or initial observations. As a result, practitioners will have to develop a greater understanding, which includes assessing the strength of design of internal control.

As firms begin preparing to implement the new risk assessment standards, they should remember these suggestions:

Consider COSO. The COSO Framework is the foundation for understanding the clients' internal control system. Before implementing the standards or training staff on them, be sure that the partners and staff understand this framework (to learn more, go to www.coso.org). Auditors can't draw conclusions about the strength of the design of a client's internal control unless they are familiar with the requirements of an effective system, which is what the Framework describes. As part of the audit process, auditors will have to assess how COSO's five components of internal control relate to the entity.

The auditor cannot be a part of the client's internal control system. This requirement has already been established under SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*. It will be important to remember as firms plan to implement the new standards.

Resources Available

PCPS and the AICPA have created a number of tools for members to use in implementing the new standards. The [PCPS Risk-Based Auditing Toolkit](#), which is free to PCPS members, includes an overview of the standards; FAQs; a glossary; and an archived version of the PCPS Practice Management Forum on the standards. It also features a client communications letter and a talking points document that CPAs can use to introduce clients to the new requirements.

In addition, CPAs can learn more about the standards and about the following tools at www.aicpa.org/risk:

- An AICPA audit guide, "Assessing and Responding to Audit Risk in a Financial Statement Audit."
- An audit risk alert, "Understanding the New Auditing Standards Related to Risk Assessment."
- Two CPE self-study courses and new technical practice aids.

The Risk Assessment Standards

- 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.

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