

Risk Assessment Q & As

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Statements on Auditing Standards (SAS) Nos. 104 -111, commonly referred to as the **risk assessment standards**, are effective for audits of financial statements for periods beginning on or after December 15, 2006, which means they are effective for calendar year 2007 audits.

AICPA members have submitted questions about the new risk assessment standards since they were issued in March 2006. The AICPA staff has collected these inquiries and developed responses in the form of Q & As. Here are some of the Q & A's that have been compiled so far.

Q. Last year our auditors assessed internal control risk at “maximum”. Should they still default to that?

A. No. The standards require that your auditors obtain a sufficient understanding of your internal control to assess control risk. As your auditors obtain that understanding, they may identify material weaknesses in the design of controls and, as a result, end up assessing control risk at maximum for some financial statement accounts and relevant assertions. Additionally, your auditor might initially assess control risk at less than maximum only to find out later, after testing controls, that controls were not effective and would then reassess control risk at maximum.

Q. Does a control have to be documented for it to be tested?

A. No. However it is recommended that you document your controls so that your auditors can efficiently test them for operating effectiveness and reliance thereon. If you do not document a control, and it is an important control, the auditors will need to document the control as part of their assessment of internal control. Inquiry, observation, and re-performance are the types of tests that are performed when determining whether a particular control has been placed in operation. However, the auditors may consider it to not be practical to test the operating effectiveness of controls throughout the audit period without some level of documentation of the control by the client. So when in doubt, document!

Q. Our auditors refer to an Audit Risk Alert for SAS Nos. 104 -11. After reading it I have a question related to walkthroughs. How often do walkthroughs need to occur? For example, for the cash disbursement process, do they need to occur every year, once every three years, or some other frequency? Please let me know your thoughts.

A. Under SAS No. 109, your auditors are required to obtain an understanding of internal control to evaluate the design of controls and to determine whether they have been implemented. To do that, performing a walkthrough would be a good practice. Accordingly, your auditors will probably perform a walkthrough of significant accounting cycles every year. In some situations, the standards allow the auditors to rely on audit evidence obtained in prior periods. In those situations, the auditors are required to perform audit procedures to establish the continued relevance of the audit evidence

obtained in prior periods, for example, by performing walkthroughs. So, your auditors will most likely perform walkthroughs every year.

Q. If our auditors know in advance that controls over our financial reporting are nonexistent or ineffective, could the evaluation and documentation of such controls (including the walkthrough) be skipped? If this is a scope limitation, can an unqualified opinion still be issued?

A. No. SAS No. 109 requires your auditors to obtain a sufficient understanding of the five components of internal control to evaluate the design of controls and determine whether they have been implemented. Secondly, SAS No. 109 requires your auditors to assess the risks of material misstatement at the assertion level as the basis for designing and performing further audit procedures. It is not a scope limitation if your auditors skip the audit procedures. A scope limitation exists only if you (the client) impose the limitation. However, failure to perform a required procedure would be a violation of generally accepted auditing standards ... so expect the auditors to perform more robust procedures in the area of internal control in particular.

Q. When our auditors perform a walkthrough of our controls, may they suggest improvements we should make in internal control?

A. Absolutely! A byproduct of obtaining an understanding of internal control is making suggestions for improvement to the client. That brings value to your audit process.

Q. If the auditor decides not to test controls, does that mean there is a significant deficiency that must be communicated?

A. No, not necessarily. It depends on why the auditors decide not to test the control. The auditor's decisions about the nature, timing, and extent of further audit procedures are based on the assessment of the risk of material misstatement. Communications under SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, are based on control deficiencies that the auditors have identified. If your auditors decide not to test a control because it is non-existent or is not properly designed, then that would represent a control deficiency that would need to be assessed as to severity to determine whether it is a significant deficiency or material weakness. If the design of the control is appropriate, but your auditors decide not to test it for another reason (for example, because the control is redundant), then your auditors have not identified a control deficiency.