Tax & Accounting

Spotlight on Risk Assessment

by Melisa Galasso

Wolters Kluwer

Melisa Galasso
Founder and CEO
Galasso Learning Solutions LLC

In 2019, the AICPA declared risk assessment an area of focus, even though the risk assessment suite of standards was issued nearly 14 years ago (that's over a decade!). The changes were sweeping to the requirements when performing an audit.

Typically, there is a one to two year ramp-up period when adopting a new standard to determine how to properly implement changes in an effective and efficient manner. However, a recent survey of peer reviewers found over half of 400 audits they reviewed didn't comply with the risk assessment standards.[1]

So why do we still have more than a 50% deficiency rate? Many believe the issue comes down to misinformation about the proper application of AU-C 315 and AU-C 330. An analysis of the most common audit deficiencies supports this theory.

[1] AICPA. "Enhancing Audit Quality," accessed January 2020.

Common Deficiency #1

40% of identified issues related to failure to gain an understanding of internal control when identifying the client's risks.[2]

Understanding the control environment helps identify material weaknesses and significant deficiencies in design, which in turn will help audit firms tailor their substantive procedures.

Why do nearly half of all audits fail to gain an understanding of internal control during risk assessment? A few reasons are obvious contributors.

First, many firms believe that it is more efficient to do a substantive procedure only audit. As a result, they do not intend to rely on controls and thus they do not feel that understanding controls will help their audit. This sentiment is factually incorrect. Even if you do not intend to rely on controls, understanding the control environment helps identify material weaknesses and significant deficiencies in design, which in turn will help audit firms tailor their substantive procedures.

Second, many firms indicate that their clients (particularly smaller clients) have no controls at all and therefore, there is nothing to understand or document. That is a very difficult statement to believe. That would imply that the client would have no passwords on their computers, no locks on their doors, and no required signatures on checks.

All entities have some controls and auditors should take the time to document these controls. The AICPA has compiled a list of the most common controls found in small entities. This practice aid provides examples of controls consistently found in smaller entities as a way to help jog the memory of auditors.

"While an entity may not have documented controls, some controls always exist."[3] Some of the more common controls identified include account reconciliations, strong tone at the top, passwords, and owner review.

Additionally, some firms believe they can simply assess control risk at high and then skip the requirement to understand controls. Prior to the creation of the risk assessment standards, this was a common methodology. However, the risk assessment suite of standards was issued to stop this behavior and require auditors to take the time to understand the entity's controls.

[2] Wolters Kluwer. "Overcome Risk Assessment Violations," accessed August 2018.

[3] AICPA. "Examples of Controls in Small Entities," accessed January 2020.

Risk assessments must be performed at the assertion level. Account-level risk assessments do not meet the standards set by the risk assessment suite of standards.

Common Deficiency #2

14% of issues related to incomplete or non-existent risk assessment.[4]

Another common deficiency occurs when firms do not perform any risk assessment. Many firms incorrectly believe that if they complete all the substantive procedures listed in the audit programs that they do not need to perform a risk assessment. This is also false. To ensure that all risks have been appropriately addressed, auditors are required to understand the entity and its environment.

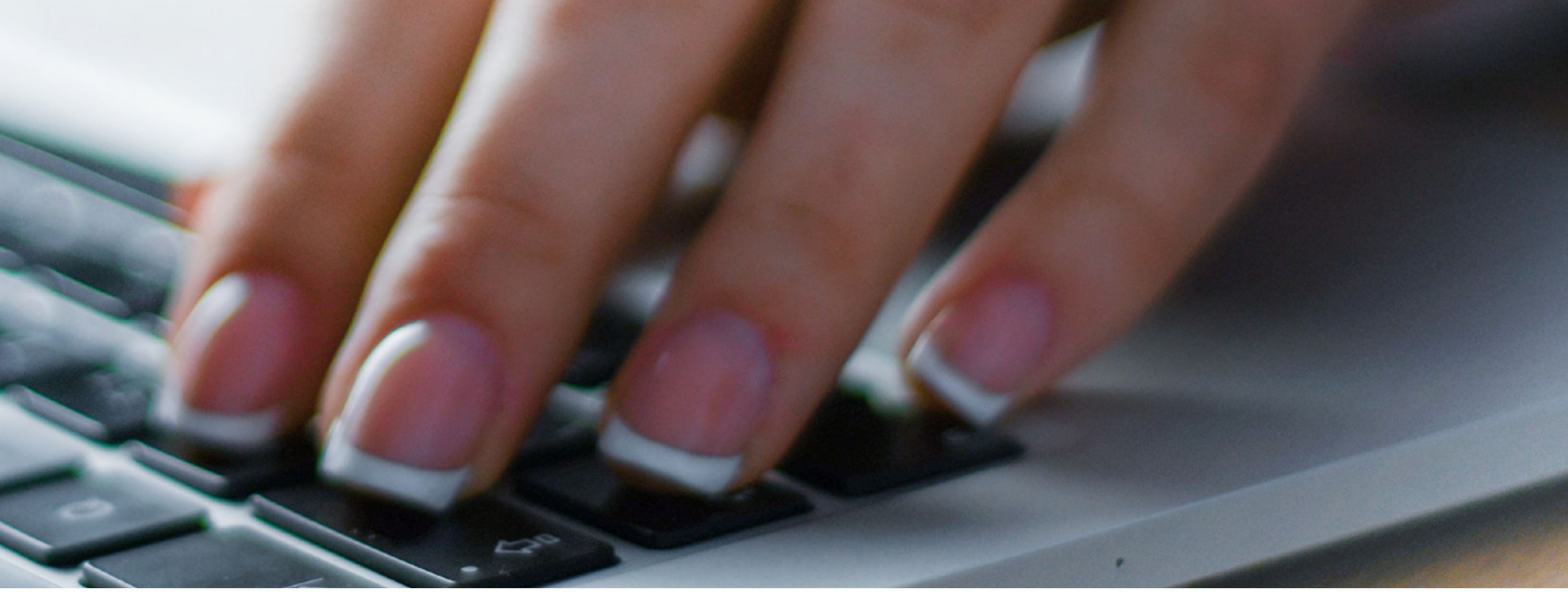
Without such understanding, an auditor cannot identify, assess, and respond to risks effectively. The only way to respond to a risk is to have first identified it. Audit programs need to be tailored to be responsive to the risks identified. Even if 100% of all procedures in an audit program are performed, there is no guarantee that those procedures address the specific risks found at a particular client.

Another common misunderstanding is the requirement to identify and assess both financial statement level risks as well as assertion level risks. Risk assessments must be performed at the assertion level. Account-level risk assessments do not meet the standards set by the risk assessment suite of standards.

Last, but not least, some firms use the same risk assessment for all entities in a particular industry without truly performing a risk assessment that is unique to a particular entity. Every entity has unique risks. Even two entities of similar size and in the same industry will have different systems, personnel, and capabilities.

The risk assessment must be unique to the entity as cookie-cutter risk assessments fail to take the time to truly understand the entity and to be responsive to the unique risks of each company.

[4] Wolters Kluwer. "Overcome Risk Assessment Violations," accessed August 2018.



Common Deficiency #3

4% of issues related to auditors not linking their risk assessment to their response.[5]

Another common deficiency found in audits today occurs when the auditor takes the time to do a risk assessment but then does not use the information gathered to identify audit procedures that respond to the risk. In other words, they perform the standard audit procedures identified in an audit program without considering the risks identified. As such, they do not link the risks at the assertion level to a procedure that is designed to test the assertion.

Interestingly, the existence of practice aids that walk an auditor through the requirements of a risk assessment, help firms to have excellent risk assessments. The issue is that they do not use them for the intended purpose — to design procedures responsive to the identified risk. Performing all the recommended procedures in a practice aid does not guarantee that a risk identified during the risk assessment phase has been appropriately handled in an audit. Auditors must take the time to link their procedures to each risk to ensure all risks have been appropriately addressed.

Another key issue relates to a failure to have specific procedures responding to a significant risk. By definition, a significant risk requires a specific audit response. This requires the tailoring or creation of an audit procedure designed specifically to respond to this significant risk and it is unlikely the procedure would be a standard audit procedure performed on all audits.

We often find people identify the risks but then don't do anything with it. They do SALY, same as last year, this causes many firms to not truly incorporate the client-specific information that they obtain throughout the audit. As a result, under and over auditing occurs when audit teams complete procedures and fill out forms just because last year's audit teams did so. They really are just filling out forms for the sake of filling out forms, and that's not the approach that we need to take.

Another common deficiency found in audits today occurs when the auditor takes the time to do a risk assessment but then does not use the information gathered to identify audit procedures that respond to the risk.

[5] AICPA. "Examples of Controls in Small Entities," accessed January 2020.

Common Deficiency #4

13% of issues related to auditors assessing control risk as less than high without appropriate tests of controls.

The last deficiency identified is often the hardest to understand. The only way to reduce control risk below high is to test the operating effectiveness of controls. However, some firms are reducing control risk without testing the operating effectiveness — after only understanding controls or performing walkthroughs.

Walkthroughs of controls provide evidence that a control has been implemented, however, it does not provide evidence that a control is operating effectively. A walkthrough represents a point-in-time piece of evidence. When testing the operating effectiveness, auditors must obtain evidence that the control was in place over the financial statement period.

In addition, when performing a walkthrough, the client is keenly aware that they are being observed and thus they perform their controls with extra attention. That is not necessarily an indication that the client performs the procedures with the same level of diligence throughout the year. Instead, to reduce control risk, the audit firm would also need to select a sample to demonstrate the operating effectiveness through the audit period.

Wolters Kluwer's Audit Approach

Given the proliferation of these common deficiencies, many firms are looking for answers and ways to prevent themselves from becoming one of the statistics. Fortunately, the CCH® ProSystem *fx*® and CCH Axcess™ Knowledge Coach solutions are a valuable tool. The Knowledge-Based Audit (KBA) methodology that drives the Knowledge Coach solutions is a risk-based audit methodology that complies with the risk assessment standards.

Knowledge Coach provides a better way to comply with risk-based auditing standards through a structured, integrated, and innovative dynamic software solution. It enables auditors to work from constantly refreshed electronic audit documentation while also providing updated information in a dynamic software environment that leverages its KBA methodology.

This represents a significant improvement from the old checklist method of auditing. Knowledge Coach is an award-winning, patented and peer-reviewed solution that's an audit planning, risk assessment, and audit documentation tool all rolled into one. Tailored audit information flows from planning through completion, coaching auditors through the process while still allowing for professional judgment.

As a result, the explicit linkage of risks to program steps is formed, which helps auditors to follow a risk-based audit approach in an efficient and effective manner. Additionally, Knowledge Coach diagnostics help identify potential errors, inefficiencies and missing information to help streamline the review process.[6]

One of the foundational differentiators found in Knowledge Coach is the method by which it scopes the engagement. The tool forces an auditor to document materiality, significant risks, fraud risks, and the nature of transactions. When used properly, it forces auditors to understand their client's entity and properly scope the engagement. From there, the KBA methodology is going to continue to drive the risk assessment.

Since the software provides diagnostics and warnings, it won't let the auditor go any further until the engagement is properly scoped. If you tried to move forward without completing that work like risk assessment, it is going to give you diagnostics. For risk assessment, Knowledge Coach will walk you through the process of articulating what could go wrong and it will help you identify the risks. If you plan to reduce control risk, the software knows if the auditor has identified a lower control risk and will then determine if the audit plan includes a test of those controls. Diagnostics and warnings built into Knowledge Coach will identify any discrepancies caused and will produce diagnostic errors when control risk is reduced without having tests in place that address the controls.

Since the program effectively guides auditors throughout the process, they will be very aware of what needs to be done first before moving on. Even in the control assessment phase, the KBA methodology is a resource to help the auditor understand the design and implementation of controls. The systems make sure that walkthroughs take place, when needed, to evaluate the internal controls. They ensure that the client controls make sense, are in place during the audit period, and that they're being implemented.

The risk-based methodology in Knowledge Coach works like a GPS for audits. It prompts the auditor to consider what program steps address the risk assessment, prompting the user to create a direct linkage with the help from a robust diagnostic series — some diagnostics identify unaddressed risks or risks addressed incorrectly, which is designed to prevent the most commonly identified audit deficiencies (instances where a risk was identified but nothing was done about it).[7]

This powerful and time-saving solution allows financial and assertion level risks to be identified and entered from any workpaper, and consolidates risks and related program steps into an engagement risk summary. If you are performing further audit procedures and identify a risk that was not identified during the risk assessment phase, it will automatically update the risk assessment. Information and answers flow through all the workpapers dynamically. When responding to risks, it links program steps to identified risks and allows the addition of custom audit areas and program steps to existing templates. These features make it easy to tailor your audit programs and to adjust to new information.

Plus, with the dynamic solution, newly entered data flows within and across workpapers in all appropriate locations, ensuring accuracy and efficiency. The system automatically updates workpapers when you need to add or change a related workpaper. This will ensure that changes made to the audit approach are not lost. The software is also smart as it provides contextual help in a "tips pane," as well as "answer effect" tips that explain how your answers will impact recommendations, workpapers, and information flow.

[6] Wolters Kluwer. "ProSystem *fx* Knowledge Coach's Audit Software Technology Granted U.S. Patent," accessed April 28, 2014.

[7] AICPA. "CCH ProSystem *fx* Knowledge Coach," accessed January 2020.

An Integrated Approach

Wolters Kluwer offers solutions to help their customers meet the standards in the most efficient and effective manner.

View All the Solutions →

The extensive diagnostics, featured both inside and outside of workpapers, helps to identify missing steps, incomplete workpapers or unaddressed risks throughout the audit.

Knowledge Coach walks an auditor through from the beginning (gaining an understanding of the entity, starting to identify the risks, looking at the client controls) through to performing audit procedures. It assists the auditor by guiding them through sound methodology and by alerting them when things are not being done correctly. The system helps tailor the engagements so that you're doing the proper amount of work the first time to avoid costly over auditing or under auditing. It will look to make sure that that risks are linked to the audit procedures at the assertion level. If it's not done properly, it will alert the auditor by popping up those items if they are not being done. The program walks the auditor through, step-by-step, what needs to take place to properly identify controls, test controls, identify the risks, and then properly make sure they're included in the audit plan.

Additionally, CCH Axcess Knowledge Coach is the cloud-based solution with all the audit practice aids for planning, risk assessment, and review in the cloud, improving access to information and team collaboration.

While many firms select Knowledge Coach because of its risk assessment methodology, it is also important to understand that this solution is part of an entire suite of CCH® audit solutions designed to make your audits even more efficient.

For example, TeamMate® Analytics is a suite of more than 150 Audit Data Analytics (or ADAs) that allows auditors to easily perform powerful data analysis to deliver significant value for their team and their clients. Accessed from within Excel®, TeamMate Analytics includes powerful analytical tools such as gap and duplicate detection, Benford's testing, Monetary Unit Sampling, and stratification.[3]

It produces results numerically and graphically, which makes it an ideal way to review complex information with clients in an easier to understand visual way. Since everybody loves a good picture, you can use this tool to illustrate what's been going on this year, help identify things to do better or what went well, and freshen up existing reports with engaging and visually appealing graphs. TeamMate Analytics is integrated so well with Knowledge Coach that an indicator will inform those working on an audit program step if a specific test can be run efficiently in TeamMate Analytics. The integration between the solutions is seamless!

Conclusion

Don't skip steps! Due to the significant number of risk assessment problems found, the AICPA has updated the peer review process to focus on risk assessment. A new section to the Peer Review Program Manual — Evaluation of Noncompliance with the Risk Assessment Standards was added and is effective for reviews commencing on or after October 1, 2018, through reviews commencing on or before September 30, 2021.

If any step is missing from the risk assessment process (risk identification, assessment or response), the issue will be documented and the firm will be required to take action. After September 30, 2021, if any of these issues are found, the engagement will be deemed to be nonconforming. This is true regardless of the amount and type of substantive testing performed! Given the focus of peer review, using Wolters Kluwer's Knowledge Coach solutions to document your risk assessment and response will help reduce your risks when it comes time for your peer review!

Contact information:
Wolters Kluwer
2700 Lake Cook Road
Riverwoods, IL 60015
United States

Visit **EngageTax.WoltersKluwer.com/Software4CPAs** for more information.

05/23 2023-0285