

# The Audit Risk Assessment Standards

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In March 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued eight Statements on Auditing Standards (SASs), (which are collectively referred to as the Risk Assessment Standards). These Risk Assessment Standards will greatly impact the auditor's process of assessing risk in an audit of a privately-held entity. Many of the concepts in the new standards are similar to the Public Company Accounting Oversight Board's auditing standards, which are applicable for audits of public companies, and the standards more closely align the auditing standards of privately-held entities to those of public companies. Additionally, these standards are very similar to International Standards on Auditing. These new SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006.

The Risk Assessment Standards are meant to improve the quality and effectiveness of financial statement audits by requiring, among other things, (i) that the auditor obtain a deeper, more in-depth understanding of the client, its environment and its internal control; (ii) that the auditor performs a more rigorous assessment of the risk of material misstatement to the financial statements based on the understanding of the client, its environment and its internal control; and (iii) that the auditor improves the linkage between the assessed risk and the nature, timing and extent of audit procedures performed in response to those risks.

These new standards represent some of the most dramatic changes to the audit profession in years. They are long and complex and will require significant additions and modifications to existing audit procedures. The following is a brief summary of all eight new standards and certain key elements of each standard.

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**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")**

- Clarifies the meaning of "reasonable assurance" used in the audit report as it relates to whether the financial statements are free of material misstatements to mean a high, but not absolute, level of audit assurance.

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## **SAS No. 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards**

- Requires the auditor to obtain an understanding of the entity and its environment, including its internal control. This is an expansion of previous standards, which required the auditor to gain an understanding of the entity's internal controls. Under previous standards, the understanding obtained was primarily for planning purposes, but this amendment is intended to extend the purpose to assessing the risk of material misstatement of the financial statements whether due to error or fraud.

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## **SAS No. 106, Audit Evidence**

- Provides guidance about the concepts underlying the audit requirement that "the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." Such guidance defines "audit evidence" defines "relevant assertions," and discusses their use in assessing risk and designing appropriate further audit procedures; discusses qualitative aspects that the auditor considers in determining the sufficiency and appropriateness of audit evidence; and describes various audit procedures and the purpose for which they may be performed.

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## **SAS No. 107, Audit Risk and Materiality in Conducting an Audit**

- Provides guidance on the auditor's consideration of audit risk and materiality when performing an audit. Materiality is a matter of auditor professional judgment and is based on the needs of the users of the financial statements. Users are assumed to have an

appropriate knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements; understand that financial statements are prepared and audited to levels of materiality; recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and consideration of future events; and make appropriate economic decisions on the basis of the information in the financial statements.

- Provides that the auditor communicate to management all known and likely misstatements identified during the audit other than those the auditor believes are trivial. The auditor should request management to record the adjustments needed to correct all known misstatements, including the effect of prior period misstatements, other than those deemed trivial by the auditor. The auditor should request management to evaluate likely misstatements in order to identify and correct misstatements.

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#### **SAS No. 108, Planning and Supervision**

- Provides a requirement that the auditor obtain an understanding with the client regarding the services to be performed and that the understanding be documented through a written communication with the client. (This is generally done through an engagement letter.)
- Provides guidance on the development of an overall audit strategy and an audit plan.

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#### **SAS No. 109, Understanding the Entity and its Environment and Assessing the Risk of Material Misstatement**

- Explains the audit procedures that the auditor should perform to obtain an understanding of the entity and its environment, including its internal control, and provides that the audit team discuss the susceptibility of the entity's financial statements to material misstatement.
- Provides guidance to the auditor in understanding specified aspects of the entity and its environment, and the components of its internal control, in order to identify and assess risks of material misstatements, and in designing and performing further audit procedures.

- Provides guidance on assessing risk at both the financial statement and relevant assertion level.
- Provides guidance on matters that should be documented, including the required discussion among the audit team regarding the susceptibility of the entity's financial statements to material misstatements; key elements of the understanding obtained regarding the entity and its environment, including the component of internal control; the assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level; and the risks identified and related controls evaluated.

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#### **SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained**

- Provides guidance to the auditor in determining overall responses to address risks of material misstatement at the financial statement level and provides guidance on the nature of those responses.
- Provides guidance to the auditor in designing and performing substantive testing and testing of controls.
- Provides guidance to the auditor on documentation, including the documentation of the linkage between the procedures performed and the assessed risks at the relevant assertion level.

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#### **SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling**

- Enhances guidance relating to the auditor's judgment about establishing tolerable misstatements for a specific audit procedure and on the application of sampling to tests of controls.

The Risk Assessment Standards will have significance to audit clients in the following ways:

- Serves as a reminder that an audit provides a high level, but not absolute, assurance that the financial statements are free of a material misstatement;
- Auditors may do more inquiries or research to gain a better understanding of the client's environment as part of their risk assessment procedures, which is more extensive than obtaining an understanding of the client's internal controls as previously required.

- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected;
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

Significant deficiencies or material weaknesses identified by the auditor must be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and which have not yet been remediate.

As the surrounding environment in which the industry operates comes under increased scrutiny from investors and regulators, the pressures on management to provide transparency and a strong control environment are ever increasing. Management of all entities must be cognizant of emerging reporting requirements and ensure that the strongest feasible safeguards and controls are being utilized and monitored for effectiveness.