Eliminating Risks in Risk Assessment

FINANCIAL AND COMPLIANCE AUDITING UPDATE

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Watch Words from the Peer Review Process

Peer Review

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- NOT DOCUMENTED = NOT PERFORMED
- Vendor-obtained practice aids, checklists and forms are NOT audit evidence
- Sources of audit evidence
  - Books, records, data, etc. generated by the entity being audited
  - Information obtained from third parties who do business with the entity
  - Direct auditor knowledge

Audit Documentation

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- AU-C 230, Audit Documentation, requires the auditor to document the nature, timing, and extent of all audit procedures performed by recording –
  - The identifying characteristics of the specific items or matters tested;
  - Who performed the audit work and the date such work was completed; and
  - Who reviewed the audit work performed and the date and extent of such review.

Audit Documentation, continued

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- Factors to consider in determining the nature and extent of documentation:
  - Risk of material misstatement associated with account or class of transaction
  - Extent of judgment involved in performing the work and evaluating the results
  - Nature of the auditing procedures
  - Significance of the evidence to the assertion being tested nature and extent of exceptions
  - Need to document conclusion or basis of conclusion when not readily determinable

Audit Documentation, continued

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- Requires audit documentation to include abstracts or copies of significant contracts & agreements if needed to aid the experienced auditor in understanding work performed & conclusions reached
- Requires that documentation specifically identify items tested
- Requires documentation of any departures from auditing standards & the sufficiency of alternative procedures used to compensate for the objectives of the requirement

Audit Documentation, continued

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- AU-C section 230, *Audit Documentation*
  - Audit documentation should include audit plans, forms, checklists, and other practice aids.
- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
  - Tailoring of canned audit plans, forms and checklists is mandatory
- The audit plan ONLY supports the fact that the audit was planned, NOT that specific procedures were performed.

Audit Documentation, continued

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- Checklists and canned forms can be used to facilitate audit procedures, but, using them correctly requires that they be appropriately tailored for the specific audit.
  - However, they are NOT audit evidence.
- Checking off a step in an audit program or a checklist does not provide sufficient documentation about the nature, timing, and extent of audit procedures performed or the identifying characteristics of the specific items or matters tested.

Common Engagement Deficiencies

Professional Standards

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- Failure to appropriately document planning procedures, including:
  - Risk assessment (and linkage of risks to procedures performed)
  - Planning analytics
  - Understanding of IT environment
  - Internal control testing

Professional Standards, continued

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- Failure to appropriately address fraud considerations
- Failure to communicate and/or document required communications with those charged with governance
- Failure to include audit documentation that contains sufficient competent evidence to support the firm's opinion on the financial statements
- Failure to address the reason(s) accounts receivable were not confirmed
- Failure to adequately document sampling methodology
- Failure to document consideration of the group audit standard

Single Audit Peer Review Deficiencies

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Examples of the issues that arise that cause the team captain to consider whether a firm should perform additional audit procedures and reissue the prior year single audit reporting include the following:

1. Missed major program due to using preliminary expenditures when final numbers were higher.
2. Improper clustering of programs resulting in a missed major program
3. Failure to include and audit all programs with same catalog for domestic federal assistance (CFDA) number when determining major programs
4. Failure to properly perform Type A & B program risk assessments
5. Failure to properly compute the program type A/B threshold determination resulting in a missed major program or incorrect program selection
6. Improperly classifying an entity as a low-risk auditee resulting in missed major programs due to percentage of coverage audited as major (watch the 30 day rule)

Single Audit Peer Review Deficiencies, continued

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7. Inadequate testing of internal over compliance (for example, not testing to support a low assessed level of control risk, not testing controls relating to some direct and material compliance requirements, or inappropriate sample sizes or related documentation) or compliance (for example, failure to test compliance for all direct and material compliance requirements or inappropriate sample sizes or related documentation) to support the major program opinion
8. Failure to document an understanding of internal control over compliance of federal awards sufficient to plan the audit to support low assessed level of control risk for major programs, including consideration of risk of material noncompliance (materiality) related to each applicable compliance requirement and major program
9. Failure to document the adequacy of the planned sample size for test of controls over compliance to achieve a low level of control risk
10. Failure to document the testing of controls and compliance for the relevant assertions related to each applicable compliance requirement with a direct and material effect for the major program, including insufficient documentation and usage of dual-purpose testing.
11. Failure to document internal controls over the preparation of the Schedule of Federal Awards (SEFA).

Peer Reviewer Focus – Inherent Risk

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- ***Guidance***
  - In large, major accounts and audit areas, the inherent risk is rarely low. Low risk may come from a relatively small balance or it may be low on a specific assertion (for example, currency valuation risk when only one currency is involved). Note: Unless controls are tested and determined to be effective, the risk of material misstatement is, essentially, equivalent to inherent risk, even though they may be assessed as required in AU-C sec. 315.
- ***Question***
  - *Revision for 2016*: Where RMM for any relevant assertions or significant accounts is indicative of an IR assessment set at less than high, is there a reasonable basis for that assessment? [AU-C sec. 315.03 and AAG-ARR sec.3.23 and 5.70] Consider: discussions amount the engagement team, key elements of their understanding obtained regarding each aspect of the entity and its environment, and any significant decisions reached or a separately documented IR assessment, if applicable.

AU-C 315 Paragraph 26

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- To determine the further audit procedures the auditor should identify the risks of material misstatement at:
  - The financial statement level and,
  - The relevant assertion level for classes of:
    - Transactions
    - Account balances
    - Disclosures

AU-C 315 Paragraph 27

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- For the risk assessment the auditor should:
  - Identify risk throughout understanding of the entity and its environment, including controls by considering classes of transactions, account balances and disclosures in the AFS
  - Assess the identified risks and evaluate whether they relate more pervasively to the AFS as a whole and potentially many assertions
  - **Relate the risks to what can go wrong at the relevant assertion level**
  - Consider the likelihood of material misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in material misstatement

AU-C 315 Paragraph 28

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- As part of the risk assessment described in paragraph .26, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk. In exercising this judgment, the auditor should exclude the effects of identified controls related to the risk.

AU-C 315 Paragraph 29

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- In exercising professional judgment about which risks are significant risks, the auditor should consider at least:
  - Whether there is a risk of fraud
  - Whether the risk is related to recent significant economic, accounting or other developments
  - Complex transactions
  - Involves significant related party transactions
  - Degree of subjectivity in the measurement of financial information related to the risk, especially those related to uncertainties
  - Significant transaction outside the normal course of business

Peer Reviewer Focus – Control Risk

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Guidance

An assessment of control design and implementation is required on every audit, whether or not controls are tested and relied on. Specifics regarding the account being reviewed should consider the inherent risks and whether specific controls exist to address the inherent risk by assertion.

Question

Consider the relevant assertions and risks related to the account or audit area. Did the auditor evaluate the design and implementation of relevant controls in this area? [AU -C sec. 315] Consider the following:

- Documentation includes actual controls and **not just process descriptions**
- In addition, are all the following present in the documentation:
  - Who performed the procedure and when
  - Who in the client organization was interviewed
  - What evidence regarding the control was examined during the procedure

Peer Reviewer Focus – Control Risk, continued

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Question

If control risk is assessed at less than high, has evidence been obtained to support the level of reliance planned, as follows:

- If the auditor is relying on a service auditor's report, did the auditor substantively meet professional requirements regarding internal control, including those detailed at AI35 of this checklist? [AU-C sec. 402)
- For controls where sampling is planned, is the level of testing sufficient to support the level of planned reliance (considering the parameters of risk, tolerable rate, expected rate, and population size) [AU-C sec. 330.07-.10] [AAGARR sec. 5.69]
- For controls not involving sampling (for example, governance assessments) has sufficient evidence been gathered to support the level of planned reliance? [AUC sec. 330.07-.10, AAG-ARR sec. 5.70]

Internal Control per the Yellow Book Documentation and Testing

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- Compliance with laws, regulations, contracts, and agreements
  - Controls to ensure compliance with Federal, state, and local laws and regulations, both general and specific to the industry and operations of the entity
  - Controls to ensure compliance with specific provisions of contracts and agreements
  - Monitoring of compliance with LRCA
  - Personnel, systems, and technology competent and accountable for compliance with LRCA
  - Controls document compliance with specific provisions of contracts and agreements

Peer Review Sampling Issues

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- Sampling issues appearing in “deeper dive” peer reviews
- Methods of defensible sample size determination
  - Critical issues
    - Sample Size – control, substantive, compliance
    - Sufficient evidence for low-risk opinion
    - Consequences
  - Second level issues
    - Documentation issues
    - Confusion on Single Audit and HUD
    - Applications
  - Effects in Quality and Peer Reviews

Sampling In Single Audit/HUD

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- Sampling is mandatory in both the Single Audit Compliance Supplement and the HUD Audit Guide
  - Samples in both include
    - Tenant files
    - Cash disbursements
    - R4R releases
    - A few others
  - HUD Audit Guide may also include
    - Work orders
    - Cash receipts
    - Releases from the wait list
- Follow AU-C 530, Audit Sampling

Objectives in Sampling

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- Dual purpose sampling
  - Controls over compliance
  - Determining compliance
- Attempting to detect known questioned costs >$25,000 **($10,000 HUD/DEC Limit**) mandatory reporting
  - Required to report known questioned costs,
  - However, likely questioned costs affect the overall report
- Generally it is not possible to combine compliance testing with financial statement testing

Known versus Likely Questioned Costs
(Single Audit Only)

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UG 200.516

- (3) **Known questioned costs that are greater than $25,000 for a type of compliance requirements for a major program**. Known questioned costs are those specifically identified by the auditor. *In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs).* **The auditor must also report known questioned costs when likely questioned costs are greater than $25,000 for a type of compliance requirement for a major program.** In reporting questioned costs, the auditor must include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

Preparing for An Adequate Sample

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- Analytical review procedures
- Scanning
- Applying procedures to entire population
- Testing key items
  - May use judgment in determining
  - Focus on materiality
  - May eliminate sample altogether due to reduced detection risk
  - May not be effective when using to test multiple attributes
- Procedures to clarify understanding of IC over compliance is not sampling

Sampling – Define Population

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- Sampling unit and population should be consistent with the objective
  - For example payroll testing may very based on whether costs are direct or indirect
- Focus on transactions of interest (may be subset of original population)
- Representative – Sample may be revisited if it does not contain sufficient sample items
- Sampling Unit –defined by the individual items constituting the population, eg., tenant file or cash disbursements (Attributes of each item being testing are not sampling units)

Multiple Organizational Units (Single Audit Only for Compliance) paragraph 21.45

21.45

If controls over compliance or compliance procedures at the various organizational units vary significantly, it may be necessary for each location to be considered a separate population. When transactions relating to types of compliance requirements are processed in organizational units using the same controls [fn 9] or compliance procedures are performed under common oversight and monitoring, it may be feasible for the auditor to obtain sufficient appropriate audit evidence about controls and compliance for major programs by selecting one overall sample across the organizational units (for example, selecting from centralized locations or visiting all organizational units). When it is not feasible to obtain the evidence centrally or to visit all the organizational units, and controls or compliance procedures, or both, are the same across organizational units, the auditor generally will select some organizational units from which to obtain audit evidence. In this case, the auditor may consider (*a*) testing the minimum sample size at each location of significance (or more than the minimum sample size depending on the results of risk assessment procedures preceding sampling) or (*b*) varying the selection of the less significant organizational units included in the testing from year to year. Appendix E, "Multilocation Sampling Considerations," of the AICPA Audit Guide *Audit Sampling* provides useful guidance in determining the appropriate organizational unit to visit, as well as implications on sample size.

Sample Sizes

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- Size of population has little impact on sample sizes, except for smaller populations
- Controls Testing
  - Identify characteristics indicating performance of control
  - Deviation is a departure from the expected performance of the control (departure from Federal rules or contract conditions
  - Defined for each audit objective
- Compliance Testing
  - Determine whether deviations constitute a finding and its effect on compliance opinion

Dual Purpose Sampling

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- Covers both testing of effectiveness of internal control over compliance and whether auditee complied with relevant compliance requirements
- Same sampling unit
- Size will generally be the larger of the two required samples
- Failure of a control may not lead to noncompliance
- Findings evaluated separately
- Documentation clearly distinguishes between controls and compliance testing

Combining Compliance and AFS Samples
(paragraph 21.56)

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21.56

Another example of using a sample for multiple purposes is when auditors wish to use a single sample for testing for both Uniform Guidance compliance audit objectives and financial statement audit objectives. Such an approach may present additional complexities to consider because often there are different characteristics, and even different appropriate populations, for single audit and financial statement audit tests. Although many auditees record federal award transactions within their general ledgers, populations used for financial statement purposes often do not align well with sampling populations for testing in a Uniform Guidance compliance audit. The same principles described previously for a dual purpose sample apply when a single sample is used to achieve both Uniform Guidance compliance audit and financial statement audit objectives.

Combining Compliance and AFS Samples
(paragraph 21.56), continued

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21.57

Although it is challenging to select samples that achieve both Uniform Guidance compliance audit and financial statement objectives, they do occur. An example of a sample that achieves both Uniform Guidance compliance audit and financial statement audit objectives is a sample of transactions inspected to determine the following:

- Indications of compliance with relevant federal statutes, regulations, and compliance requirements over allowable costs and cost principles
- Indications of performance of internal controls over both allowable costs and cost principles and appropriateness of the expense for financial reporting
- Evidence that the recorded amount, account, and period are correct for financial reporting

Controls Sample Size

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- Planned to a low assess level of risk
- Accordingly, a 90-95% confidence level
- High level of assurance
- Appropriate for populations of greater > 250

Significance of Control and Inherent Risk of Compliance Requirement 0 deviations expected	*Minimum Sample Size*
Very significant and higher inherent risk	60
Very significant and limited inherent risk or Moderately significant and higher inherent risk	40
Moderately significant and limited inherent risk	25