100 Introduction and Background Information

Introduction

100.1 Auditing standards require the assessment of audit risk (the risk of material misstatement of the financial statements due to error or fraud) in audit engagements. This *Guide* provides the comprehensive tools and guidance that auditors need to effectively and efficiently apply risk assessment in their audit engagements. Risk assessment is an integral part of every audit and can significantly affect both audit efficiency and audit effectiveness. This *Guide* provides a complete package of risk assessment tools to assist in that process, including:

- detailed analysis of the risk assessment process and related standards, objectives, and requirements;

- practice aids for performing and documenting risk assessment; and

- practical guidance on applying risk assessment, including case studies, illustrated practice aids, and training materials, all aligned with the PPC audit approach.

100.2 Overall, risk assessment focuses on ensuring the effectiveness of financial statement audits. In applying risk assessment, auditors explicitly consider higher risk areas by focusing on what is most likely to go wrong that could affect the financial statements. Auditors assess the risk that the financial statements are materially misstated due to error or fraud and design and perform audit procedures to respond to those identified risks. The result is a targeted effort that considers the unique circumstances of each client.

What Is Risk Assessment?

100.3 The term *risk assessment* in this *Guide* refers to an audit approach in which the auditor:

• Obtains a sufficient understanding of the client and its environment, including internal control, to identify and assess the risks of material misstatement of the financial statements, whether due to error or fraud, at the financial statement and relevant assertion levels.

• Concentrates audit effort in areas of the financial statements where there is a higher risk of material misstatement. Such areas may have a high risk because either inherent or control risk, or both, is higher.

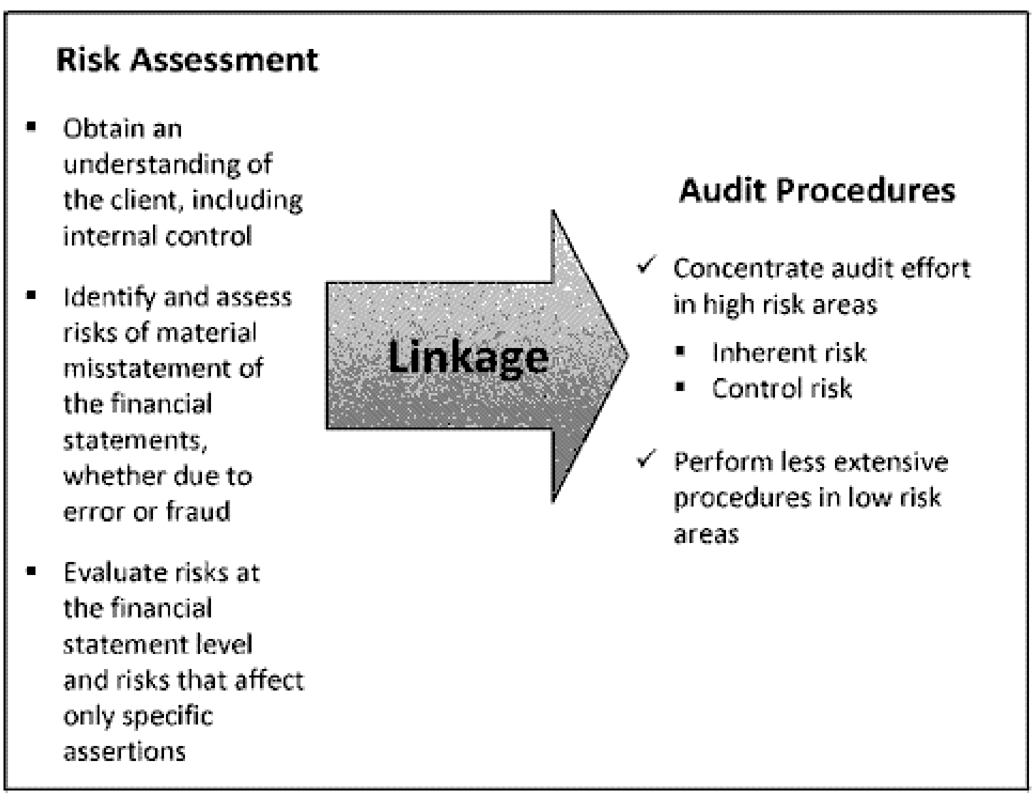
• Provides linkage between the identified risks and the resulting audit procedures.

• Identifies lower-risk areas in which to perform less extensive procedures.

An audit approach based on risk assessment provides methods to identify higher-risk areas and assertions so that audit effort can be focused on those areas. By focusing efforts in higher-risk areas and limiting procedures in lower-risk areas, the auditor is performing a more effective and focused audit. The risk assessment approach used in this *Guide* is illustrated in Exhibit 1-1.

Exhibit 1-1

The Risk Assessment Audit Approach



100.4 **Planning Is the Key** The key to successful risk assessment is planning. In general, the risk assessment process requires significant time spent in up-front planning. During the planning process, the auditor gains sufficient knowledge of the client to identify the risky audit areas and assertions and determine the procedures necessary to address identified risks. For lower-risk areas, the auditor determines what limited procedures will be necessary in light of the low assessed level of risk. The time spent during the planning process should ordinarily provide efficiencies from limiting procedures in lower-risk areas. And because the auditor is focusing his or her efforts on higher-risk areas, the audit approach is more effective. Also, the auditor's increased knowledge of the client's business and operations can add value to client service. The auditor may be able to provide the client with more insightful and practical comments and recommendations about matters that might benefit the client's business. Because of the increased emphasis on obtaining an understanding of the entity and the design and implementation of internal control as a basis for the auditor's assessment of risks, the auditor may identify control deficiencies that are required to be reported to management and those charged with governance. Control deficiencies are discussed in section 1814 of *PPC's Guide to Audits of Nonpublic Companies*.

100.5 Because risk assessments require significant judgment, auditing standards require that the engagement partner and other key members of the engagement team be involved in planning the audit. Normally it is more effective and efficient to have an experienced auditor make the risk assessments and prepare the planning documents. However, all levels of the engagement team ought to be involved in the risk assessment process.

100.6 **Integration of Fraud Risk Assessment** Auditing standards stress that the auditor's consideration of fraud is not separate from consideration of audit risk but is integrated into the overall audit risk assessment process. Although the requirements and guidance presented for risk assessment may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the financial statements in conformity with the applicable financial reporting framework that is used by the entity.[1] Therefore, risk assessment procedures are performed concurrently with other procedures, and the evaluation of risks, including fraud risks, occurs continuously throughout the audit. This *Guide* integrates the requirements for fraud risk assessment within the overall risk assessment process by addressing those requirements at relevant points throughout the *Guide*.

Risk Assessment Objectives

100.7 The overall objective of audit risk assessment is to understand the entity and its environment, including internal controls, to identify and assess the risks of material misstatement at the financial statement and relevant assertion levels in order to provide a basis for designing and implementing responses to those risks. Specific objectives and requirements related to the risk assessment procedures discussed in this *Guide* are summarized at the beginning of each chapter.

100.8 **Key Provisions of the Standards Relating to Risk Assessment** The following list presents some of the key elements of auditing standards with respect to risk assessment.

• *Emphasis on the Quality and Depth of the Required Understanding of the Entity and Its Environment.* In addition to the components of internal control, auditing standards specify aspects of the entity and its environment about which the auditor should obtain an understanding to identify and assess where material misstatements could occur.

• *Requirement to Assess Risks.* Auditing standards do not permit assessing control risk “at the maximum” without support. Risk assessment, at whatever level, should be supported by the auditor's understanding of the entity and its environment, including internal control. Auditors are required to identify significant risks that need special audit consideration, as well as other risks where the application of substantive procedures alone will not sufficiently reduce detection risk.

• *Emphasis on Evaluating and Testing Controls.* Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. In addition, control risk cannot be assessed at the maximum level without documenting the basis for that conclusion. As a result of the emphasis on understanding controls, testing of controls may frequently be considered. However, testing of controls is not required unless the auditor intends to rely on the operating effectiveness of controls to alter the nature, timing, or extent of substantive procedures, or the auditor concludes that substantive procedures alone will not sufficiently reduce detection risk.

• *Emphasis on Linkage between Assessed Risks and Resulting Audit Procedures.* Auditors are required to develop overall responses that address risks of material misstatement at the financial statement level as well as audit procedures that are clearly linked to assessed risks of material misstatement at the relevant assertion level. The risk assessment standards stress the importance of the nature of audit procedures in responding to assessed risks.

• *Guidance on Substantive Procedures.* Auditing standards indicate that substantive procedures should be applied to all relevant assertions related to each material class of transactions, account balance, and disclosure to detect material misstatements at the assertion level, regardless of the assessed risk of material misstatement. The standards also require the auditor to reconcile financial statements (and the accompanying notes) with supporting records, and to examine material journal entries and other adjustments that were made when preparing financial statements.

• *Emphasis on Testing of Disclosures.* Assertions about presentation and disclosure include completeness and understandability to users. Auditing standards emphasize that risks of material misstatement should be considered for disclosures.

• *Documentation Requirements.* Among other items, auditors are required to document overall responses to address the assessed risks of material misstatement at the financial statement level; the risk assessment at the relevant assertion level; the nature, timing, and extent of the further audit procedures; the linkage of audit procedures to assessed risks; and the results of the audit procedures.

100.9 Appendix 1A presents key questions and answers on risk assessment. Appendix 1B is a diagnostic questionnaire that can be used to consider whether the requirements of the standards are being met, and how to meet the requirements effectively and efficiently, in an audit.

Terminology

100.10 Auditing standards use specific terminology to describe the auditor's responsibility for planning and performing an audit. Some of those terms, which are significant in the risk assessment process, are discussed in the following paragraphs.

100.11 **Audit Strategy** The *audit strategy* is the auditor's operational approach to achieving the objectives of the audit. It is a high-level determination of the audit approach by audit area. It includes the identification of audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the general approach to each audit area as being substantive procedures or a combined approach of substantive procedures and tests of controls. As part of risk assessment, the auditor should establish an overall strategy for the audit. Audit strategy is discussed beginning at paragraph 206.37.

100.12 **Audit Plan** The *audit plan* is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate evidence. The audit plan is commonly referred to as the audit program. The audit plan is discussed in section 305.

100.13 **Relevant Assertions** One of the terms of central importance in risk assessment is *relevant assertions*. The assertions that are relevant for a particular class of transactions, account balance, or disclosure are those that have a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for doubtful accounts.

100.14 Auditing standards related to risk assessment give prominent recognition to the idea of relevant assertions. References to “decisions made at the relevant assertion level” mean decisions made about the relevant assertions within a class of transactions, account balance, or disclosure. As discussed in Chapter 3, the auditor assesses risks of material misstatement at the relevant assertion level and designs audit procedures to mitigate those assessed risks.

100.15 **Significant Risk** Another term of importance in risk assessment is *significant risk*. A *significant risk* is an identified and assessed risk of material misstatement that, in the auditor's professional judgment, requires special audit consideration. The reference to “requires special audit consideration” indicates the basic idea. A risk is a significant risk if an analysis of inherent risk indicates that the likely magnitude of the potential misstatement and the likelihood of the misstatement occurring are such that they require special audit consideration. The determination of whether a risk requires special audit consideration is based on an assessment of inherent risk and does not include consideration of controls. Significant risks generally relate to nonroutine transactions (i.e., transactions that are unusual due to their size or nature) and complex or judgmental matters. Transactions that are routine, noncomplex, and subject to systematic processing have lower inherent risks and are less likely to involve significant risks. Identified fraud risks are always significant risks. Significant risks are discussed further in Chapter 3.

100.16 **Risk Assessment Procedures** *Risk assessment procedures* are a defined category of audit procedures performed near the beginning of an audit to obtain an understanding of the entity and its environment, including its internal control, for the purpose of identifying and assessing the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels. The risk assessment is used to determine the nature, timing, and extent of further audit procedures. Risk assessment procedures consist of inquiry, observation, inspection, and analytical procedures. Risk assessment procedures are discussed in section 201.

100.17 **Risk of Material Misstatement** The *risk of material misstatement* is the likelihood of having a misstatement in the financial statements of a material amount prior to the audit. When considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and that potentially affect many relevant assertions. The auditor should also assess the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. At the relevant assertion level, the assessment of risk of material misstatement is the combination of the auditor's assessment of inherent risk and control risk. *Inherent risk* is the susceptibility of an assertion about a class of transactions, account balance, or disclosure to a material misstatement before consideration of any related controls. *Control risk* is the risk that a material misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. The auditor can make a combined assessment of inherent and control risk or assess the component risks separately and then combine them. Considering the overall risk assessment at the financial statement level is discussed in section 206. Assessing the risk of material misstatement at the relevant assertion level is discussed in section 304.

100.18 **Further Audit Procedures** *Further audit procedures* are procedures an auditor performs in response to the assessed risks to reduce the overall audit risk to an appropriately low level. They consist of substantive procedures, tests of controls, and other procedures, sometimes referred to as general procedures. Further audit procedures are discussed in Chapter 4.

100.19 **Other Terms** Some other terminology relevant to risk assessment that is worth noting includes—

- Audit evidence.

- Reasonable assurance.

100.20 Audit Evidence. AU-C 500.05 states:

> *Audit evidence* is all the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both the information contained in the accounting records underlying the financial statements and other information.

The results of the auditor's risk assessment procedures provide evidence that contributes to forming an opinion on the financial statements.

100.21 Reasonable Assurance. The auditor's report includes a statement that generally accepted auditing standards (GAAS) require audits to be planned and performed to obtain *reasonable assurance* about whether the financial statements are free from material misstatement. That statement introduces the concept of materiality to the audit report and the auditor's responsibility for detecting errors or fraud. AU-C 200.06 clarifies that reasonable assurance is a high, but not absolute, level of audit assurance.

100.22 In addition, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, includes a revised definition of fraud to converge with the ISAs, and AU-C 320, *Materiality in Planning and Performing an Audit*, introduces the term *performance materiality*. Performance materiality is an amount or amounts, set by the auditor, less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances, or disclosures. Performance materiality is to be distinguished from tolerable misstatement, which is reserved for audit sampling.

Authoritative Literature

100.23 The following standards establish requirements and provide guidance related to risk assessment:

a. AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, defines audit risk and the related risks of which it is a function, that is, the audit risk model.

b. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks, and for designing the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated.

c. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.

d. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance about the planned scope and timing of the audit.

e. AU-C 300, *Planning an Audit*, establishes requirements for audit planning, including development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether specialized skills are needed.

f. AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for performing risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement and requires obtaining an understanding of various specific matters, including the aspects of internal control relevant to the audit and, if there is one, the internal audit function. It explains the concept of assertions; provides guidance on identifying, assessing, and revising the risks of material misstatement at the assertion level; and discusses how the results of tests of controls may affect the preliminary risk assessment and planned audit procedures, and the use of analytical procedures in audit planning.

g. AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality for the financial statements as a whole and performance materiality for assessing the risks of material misstatement at the assertion level, and determining the nature, timing, and extent of further audit procedures.

h. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating Evidence Obtained*, addresses designing and performing audit procedures that are responsive to risks at the relevant assertion level and establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement. It provides guidance on (1) how the preliminary risk assessment affects the design of further audit procedures, including tests of controls, (2) determining when tests of controls may be appropriate, (3) the nature, timing, and extent of control tests, (4) selecting items for testing, (5) evaluating the sufficiency and appropriateness of audit evidence collected, and (6) documentation requirements.

i. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.

j. AU-C 500, *Audit Evidence*, establishes requirements for designing audit procedures that are appropriate for obtaining sufficient, appropriate evidence and describes audit procedures used to obtain audit evidence.

k. AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, establishes requirements for determining the completeness of litigation, claims, and assessments. It provides that the auditor's decision about whether to send a letter of inquiry to the client's lawyer is based on the auditor's risk assessment.

l. AU-C 520, *Analytical Procedures*, explains the use of analytical procedures as substantive tests to obtain sufficient appropriate audit evidence.

m. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements relating to identifying, assessing, and responding to risks arising from accounting estimates.

n. AU-C 550, *Related Parties*, establishes specific additional audit requirements relating to identifying, assessing, and responding to risks arising from related-party relationships and transactions.

100.24 In addition, the following standards also establish requirements and provide guidance related to risk assessment in certain situations:

- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides objectives and requirements that apply to an audit of group financial statements.

- AU-C 610, *Using the Work of Internal Auditors*, contains objectives and requirements that apply to audits of entities that have internal audit functions (as defined in the standard) when the auditor plans to use the work of that function or to use personnel from that function in a direct assistance capacity.

The objectives and requirements of AU-C 600 and AU-C 610 are primarily discussed in sections 207 and 208, respectively.

Generally Accepted Auditing Standards

100.25 Auditors of nonpublic entities should conduct their engagements in accordance with GAAS developed by the American Institute of Certified Public Accountants (AICPA). The AICPA *Code of Professional Conduct*[2] requires members to comply with SASs. This *Guide* is updated for changes in professional literature and includes guidance about how those changes might affect audits of nonpublic companies. However, even when using the material in this *Guide*, auditors are responsible for awareness and timely implementation of new pronouncements. The authors recommend that firms have a system in place to ensure staff members are informed about current authoritative literature.

100.26 **Defining Professional Responsibility** The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

- *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.

- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor *must* document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

100.27 **Use of the Terms *Must* and *Should*** Throughout this *Guide*, the authors use the terms *must* and *should* in accordance with AU-C 200.25. The authors also use the term *is required* interchangeably with *should*.

100.28 **Form and Structure of the Auditing Standards** Each auditing standard is divided into the following topics:

- *Introduction.* Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.

- *Objectives.* Establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.

- *Definitions.* Provides key definitions that are relevant to the standard.

- *Requirements.* States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.

- *Application and Other Explanatory Material.* Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the related application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

100.29 A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

100.30 **AU-C Section Organization** Within the AICPA Professional Standards, the auditing standards use "AU-C" section numbers. The organization of AU-C sections is as follows:

- Preface.
- Glossary.
- AU-C Section 200-299: General Principles and Responsibilities.
- AU-C Section 300-499: Risk Assessment and Response to Assessed Risks.
- AU-C Section 500-599: Audit Evidence.
- AU-C Section 600-699: Using the Work of Others.
- AU-C Section 700-799: Audit Conclusions and Reporting.
- AU-C Section 800-899: Special Considerations.
- AU-C Section 900-999: Special Considerations in the United States.

- Exhibits and Appendixes.

100.31 **Preface** AU-C Preface—*Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards* contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

Related AICPA Guidance and Projects

100.32 **Audit Risk Alert** The Audit Risk Alert, *General Accounting and Auditing Developments—2014/15*, provides an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the entity's operations, risks, and financial reporting, which may in turn may affect the auditor's risk assessment and responsibilities in providing auditing services.

100.33 **Audit Guide** The AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (the AICPA Risk Assessment Audit Guide), provides implementation guidance and case studies illustrating the implementation of the risk assessment process. It includes guidance on performing further audit procedures, including tests of controls, and its guidance is incorporated in this *Guide*.

100.34 **Technical Questions and Answers** The AICPA periodically issues guidance in the form of questions and answers on selected practice matters. The Technical Questions and Answers [3] are not approved by any senior technical committee of the AICPA and are, therefore, nonauthoritative. A number of technical questions and answers, which are discussed at relevant points throughout this *Guide*, address risk assessment matters.

100.35 **AICPA Code of Professional Conduct** The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with an audit engagement. As noted in AU-C 220.A4, it sets forth the fundamental principles of professional ethics, including objectivity and independence. AU-C 200.16 also requires auditors to follow ethical requirements that are relevant to the engagement.

100.36 In May 2014, the AICPA issued a revised *Code of Professional Conduct* (revised Code). The revised Code was effective on December 15, 2014, with the exception of the two broad conceptual frameworks, one for members in public practice and one for members in business, that were given a one year delayed effective date. The revised Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The revised Code also establishes a new numbering system with the reference preface of “ET.” In addition, the revised

Code provides conceptual frameworks that set forth requirements in those situations where the member has identified a threat to compliance with the rules in the revised Code and the relationship or circumstance creating the threat is not covered in an interpretation within the revised Code. As noted previously, the conceptual framework guidance is not effective until December 15, 2015, but early implementation is allowed.

100.37 When applicable, this *Guide* provides references to the numbering system within the revised Code. *PPC's Guide to Audits of Nonpublic Companies* provides additional discussion of certain independence considerations in connection with client acceptance and continuance.

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[1] The *applicable financial reporting framework* is the set of accounting principles used by the entity to prepare its financial statements. This *Guide* assumes that entities are following U.S. generally accepted accounting principles (GAAP).

[2] In May 2014, the AICPA issued a revised *Code of Professional Conduct* (the revised Code). The revised Code has been reformatted to become more user friendly and results in a number of improvements and some substantive revisions while maintaining the substance of the existing AICPA ethics standards. See paragraphs beginning at 100.35 for further discussion of the revised Code. This *Guide* has been updated for the revised Code.

[3] The AICPA changed the name and reference of its AICPA Technical Practice Aids, “TIS,” to AICPA Technical Questions and Answers, “Q&A.” The numerical references remained unchanged. This *Guide* has been updated for the change.

END OF DOCUMENT -

101 The PPC Audit Process

101.1 Risk assessment requires auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are performed to obtain audit evidence to support the auditor's opinion on the financial statements.

The PPC Audit Process

101.2 The authors have developed a practical approach to the audit process to address the requirements for risk assessment and have designed practice aids to assist auditors in meeting those requirements. PPC's audit approach is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. The audit approach has been divided into the broad steps illustrated in Exhibit 1-2.

Exhibit 1-2

The PPC Audit Process

Step	Description
1	Perform procedures regarding acceptance/continuance of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.
2	Develop a preliminary audit strategy, establish planning materiality, and perform risk assessment procedures and gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements.
3	Gather information to understand and evaluate the design and implementation of the entity's internal control system.
4	Synthesize the information gathered, identify risks (both overall and specific) that could result in material misstatement of the financial statements, and finalize the overall audit strategy.
5	Assess the risks of material misstatement of the entity's financial statements.
6	Develop and perform appropriate responses (further audit procedures) to the assessed risks of material misstatement of the financial statements considering the overall audit strategy and planning materiality.
7	Evaluate audit findings and evidence.
8	Prepare required reports and communications.

101.3 Although the requirements and guidance may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client's financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

101.4 The PPC audit process outlined in Exhibit 1-2 is incorporated in all of PPC's audit guides, including specialized industry audit guides. This *Guide* focuses on Steps 2-6 of that process. Under the approach illustrated in this *Guide*, the auditor generally spends additional time on planning and risk assessment procedures to identify specific risks and develop targeted audit procedures. However, the efficiencies obtained by using this approach should offset the additional planning time required.

Practice Aids

101.5 This *Guide* reproduces the practice aids from *PPC's Guide to Audits of Nonpublic Companies*, which guide the auditor through the risk assessment process. The auditor completes the risk identification process using the practice aids CX-3.1, “Understanding the Entity and Identifying Risks,” CX-3.2, “Engagement Team Discussion,” CX-3.3, “Fraud Risk Inquiries Form,” CX-3.5, “Documentation and Analysis of Group Components (when applicable),” CX-4.1, “Understanding the Design and Implementation of Internal Control,” CX-4.2, “Financial Reporting System Documentation Forms,” and CX-4.3, “Walkthrough Documentation Forms.” The practice aids at CX-6.1, “Entity Risk Factors,” and CX-6.2, “Fraud Risk Factors,” provide examples of risk factors to consider when identifying financial statement risks using the practice aids at CX-3.1 and CX-3.3. Another practice aid, CX-7.1, “Risk Assessment Summary Form,” is then used to summarize the auditor's risk assessments and document the auditor's response to those assessments. Practice aids are also included to assist the auditor in efficiently documenting control testing procedures if the auditor chooses or needs to test controls.

101.6 Because the audit process requires significant judgment on the part of the auditor when making risk assessments and determining the nature of audit procedures to be performed, the practice aids are designed to be flexible. For example, “Understanding the Entity and Identifying Risks” (CX-3.1) consists of open-ended questions supplemented by “factors to consider” listed on “Entity Risk Factors” (CX-6.1) versus a “checklist approach.” Also, the “Risk Assessment Summary Form” (CX-7.1) provides a snapshot of the auditor's risk assessments and the effect on the audit approach. Checklists and practice aids used in risk assessment are discussed in Chapters 2 and 3 and illustrated in the case studies at Appendixes A-C.

101.7 **PPC's Industry Audit Guides** All of PPC's industry audit guides contain similar forms. A common numbering scheme is used so that the practice aids in all of PPC's audit guides have similar references. However, the prefix to the practice aid reference differs among the guides. For example, the practice aid referred to in this *Guide* as CX-3.1, “Understanding the Entity and Identifying Risks,” can be found at ASB-CX-3.1 in *PPC's Guide to Audits of Nonpublic Companies*. The equivalent practice aid can be found at NPO-CX-3.1 in *PPC's Guide to Audits of Nonprofit Organizations* for a nonprofit organization, at ALG-CX-3.1 in *PPC's Guide to Audits of Local Governments* for a governmental entity, and similarly for other industry audit guides. The practice aids in the industry guides are tailored for specific industry requirements.

101.8 All of the practice aids mentioned in paragraph 101.5 are discussed and illustrated throughout this *Guide*. In addition, blank copies of those practice aids are included in the appendixes to Chapters 2, 3, and 4. PPC's *SMART Practice Aids—Risk Assessment* is an innovative audit tool that automatically generates audit programs based on the auditor's risk assessments. Also, PPC's *SMART Practice Aids—Internal Control* provides a top-down, risk-based approach for efficiently and effectively evaluating internal control over financial reporting.

Applying the PPC Audit Process in Continuing Engagements

101.9 The PPC audit process illustrated in this *Guide* is based on practitioner input and is designed to help simplify the auditor's documentation and application of risk assessment. Auditors ought to carefully assess the results of their risk assessment efforts and determine how the firm's audit process might be improved. The following paragraphs provide the authors' suggestions for improving the efficiency and effectiveness of applying risk assessment on continuing engagements.

101.10 As more fully discussed in Chapter 2, the auditor performs risk assessment procedures to gain an understanding of the entity and its environment, including internal control, to assess the risks of material misstatement. In many cases, considerable effort may have been spent in performing risk assessment procedures to obtain and document the necessary understanding during the initial year of implementation. In subsequent engagements, the auditor still performs risk assessment procedures to understand the entity and its environment; however, the focus shifts slightly to determining whether changes have occurred that may affect the relevance of the information obtained in prior audits. Thus, auditors often focus their efforts in continuing engagements on inquiries and walkthroughs to determine the extent of changes to prior year information and the impact of those changes on their risk assessment.

101.11 The authors suggest the following when planning for continuing engagements:

- Consider best practices.

- Focus on changes in the entity and its environment since the prior engagement.

- Consider final risk assessments and the results of further audit procedures performed during the prior audit.

- Reconsider internal control testing.

- Look for efficiency opportunities.

101.12 **Consider Best Practices** If the firm has formed a best practices team to assess practice issues and improvement opportunities, the team should consider where the firm's audit processes might be modified for both initial and recurring engagements. If a best practices team has not been formed, firm leadership may consider assigning key audit personnel to perform an assessment to determine where improvements could be made.

101.13 The team may want to consider matters such as the following:

- What inefficiencies were encountered? How can those inefficiencies be eliminated? Were extensive risk assessment or further audit procedures performed and documented in areas that were not significant or had a relatively low level of inherent risk? Did teams have to modify initial risk assessments based on the results of further audit procedures? If so, why?

- What improvements can be made in the firm's documentation process? If PPC practice aids are used by the firm without modification, do they need to be further modified to reflect firm policies?

- Did the firm take a primarily substantive approach in many of its engagements? Is that the most effective approach? Is it possible to design efficient tests of controls that can increase overall audit effectiveness while reducing substantive procedures?

- What efficiencies were gained using a risk-based approach? Which of the approaches and methods used by different engagement teams could be considered best practices for others to follow?

101.14 In addition, auditors may want to consider best risk assessment practices of other audit firms, for example, by enrolling in best practices training opportunities. Thomson Reuters Tax & Accounting offers a number of in-house training courses and conferences that focus on best practices. For more information, contact Thomson Reuters at (800) 431-9025 or visit the website at **https://checkpointlearning.thomsonreuters.com**.

101.15 **Focus on Changes in the Entity and Its Environment** In subsequent audits where the auditor uses information about the entity and its environment obtained during the previous audit, the auditor's focus when performing risk assessment procedures is on determining whether changes have occurred that may affect the relevance of the prior information. Therefore, the auditor ought to consider whether the nature and extent of risk assessment procedures need to change in the subsequent period. Usually, the auditor will make inquiries of relevant and knowledgeable key personnel and perform walkthroughs to identify and evaluate changes. In some cases, the auditor may determine that the extent of inquiries needed in a subsequent engagement might be less than what was needed during a prior engagement. However, the auditor needs to use care in determining the nature and extent of risk assessment procedures in subsequent audits. There may be new information or factors that suggest an element of change necessitating performance of more robust risk assessment procedures to obtain a sufficient understanding.

101.16 **Consider Final Risk Assessments and the Results of Further Audit Procedures from the Prior Audit** If the auditor's assessment of the risk of material misstatement was revised during the previous audit as additional audit evidence was obtained, the auditor ought to determine what impact that may have on risk assessment procedures in the current audit. For example, if an assertion for an audit area was deemed to have a higher level of risk of material misstatement based on the results of substantive procedures, and the initial risk assessment was consequently revised (and documented), it may be appropriate to modify the risk assessment procedures relating to that assertion during the planning phase of the subsequent audit to ensure an appropriate understanding of the risks. Likewise, if the final assessed risk in the prior audit was lower than initially planned, the auditor might consider reducing the extent or changing the nature of risk assessment procedures in the current year. In other words, the extent and nature of procedures will generally go hand-in-hand with the degree of risk for an audit area or assertion.

101.17 **Reconsider Internal Control Testing** In continuing engagements, auditors need to take a fresh look at the selection of further audit procedures applied in the previous audit. In some cases, the auditor might have decided that performing substantive procedures alone was effective and more efficient than a combined approach consisting of tests of controls and substantive procedures. For the subsequent audit, as part of the planning process, the auditor will reevaluate that decision considering both the current year risk assessment and the efficiency and effectiveness of the procedures performed in the prior audit. In some cases, as the auditor gains more experience in understanding controls, designing efficient and effective control tests, and reducing substantive procedures based on the results of those tests, he or she may decide that internal control testing is the most effective and efficient strategy. Chapter 4 discusses internal control testing.

101.18 **Look for Efficiency Opportunities** When appropriate, some auditors ask clients to review and update the documented understanding of the entity and its environment, including internal control, from the previous audit. When doing this, auditors normally only provide the client with those portions of the workpapers that reflect the documented understanding. Typically, auditors ought not provide the client with sections of the workpapers that describe the auditor's risk assessment procedures and conclusions. If the auditor decides that certain of the “Activity and Entity-level Control Forms” at CX-5 will be used in the current engagement, the client might be asked to perform a self-assessment regarding the existence and implementation of the controls listed on one or more of those forms. Chapter 2 discusses those forms in further detail.

101.19 Auditors may wish to emphasize to their clients the importance of self-assessing their financial reporting risks and internal control systems. As discussed in Chapter 2, management's risk assessment is a key component of internal control. Appendix 2B provides a PowerPoint client presentation that can be used to educate clients on how they can identify and assess risks related to financial reporting and their internal control systems. Also, Appendix 2C provides a PowerPoint client presentation that emphasizes the importance of entity-level controls, which are discussed in Chapter 2. A documented client self-assessment of risks and internal control procedures can jump-start the auditor's risk assessment process, contribute to audit efficiency, and help minimize audit fees for the client.

101.20 If the client is asked to review and update the documentation of the auditor's understanding of the entity and its environment, including internal control, or performs and documents a self-assessment of financial reporting risks and the internal control system, the auditor still needs to perform sufficient risk assessment procedures, based on his or her judgment, to confirm any changes and to evaluate the design and implementation of controls that the client indicates are in place.

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102 Scope of This *Guide*

102.1 This *Guide* is designed for audits of nonpublic companies. The text discussion and practice aids illustrated in this *Guide* are designed for audits of commercial business entities and may also be applied to an industry-specific audit engagement. This *Guide* is not intended to provide guidance for audits of public companies nor for auditors performing an integrated audit (an examination of internal control over financial reporting that is integrated with the audit of the financial statements [4]). Auditors of public companies should use *PPC's Guide to PCAOB Audits*, while auditors performing an integrated audit of financial statements for a nonpublic entity should use *PPC's Guide to Nontraditional Engagements* or *PPC's Guide to Audits of Financial Institutions*. Those guides may be ordered by calling (800) 431-9025 or by visiting **tax.thomsonreuters.com**.

Generally Accepted Auditing Standards

102.2 Although a brief instruction to the generally accepted auditing standards is included in section 100, this *Guide* assumes that the auditor has an understanding of the professional audit standards, and it therefore does not provide a comprehensive discussion of those requirements.

How to Use This *Guide*

102.3 This *Guide* can be used in a variety of ways. For example, a firm may use the *Guide* as a quick reference tool to address questions about specific topics. Appendix 1A presents key questions and answers on risk assessment and references to the *Guide's* discussion of the topics. This *Guide* is also designed as a package of tools—technical guidance, best practices, and workflow tools—developed to give firms everything necessary to effectively apply risk assessment. This *Guide* illustrates completion of the related practice aids and, with its detailed guidance on every aspect of risk assessment, provides an excellent source of reference material when questions arise. Also, some firms might use portions of the *Guide* as a training resource for staff. Appendix 1B is a diagnostic questionnaire on audit risk assessment that can be used to determine whether the risk assessment procedures required by professional standards were performed in a particular audit engagement. Appendixes A through C provide case studies that illustrate the use of PPC practice aids in the risk assessment process. Appendix 1C presents a PowerPoint presentation on Understanding Audit Risk Assessment, which can be used as the basis for an in-house training session. These materials can assist new staff in understanding the risk assessment process and how various risk assessment forms can be used and completed.

Overview of This *Guide*

102.4 Chapter 2 discusses risk assessment procedures, which include obtaining an understanding of the entity and its environment, including internal control, and planning decisions and judgments made by the auditor. Chapter 2 also discusses audits of group financial statements and use of internal audit. Chapter 3 discusses assessing and responding to identified risks. That chapter includes a discussion of performance materiality, risks of material misstatement at the relevant assertion level, and preparing the detailed audit plan. Chapter 4 discusses further audit procedures and other matters, and focuses on tests of controls, making a control risk assessment, and substantive procedures. Appendixes A through C include three case studies that illustrate completed practice aids and walk the auditor through various aspects of the risk assessment process for different types and sizes of entities, further discussed beginning at paragraph 102.5. Appendixes 2B and 2C provide PowerPoint presentations, along with scripts, that explain how clients can self-assess their financial reporting risks and internal control systems, including maintaining an effective control environment.

102.5 **Appendix A** Appendix A presents a case study of a midsized nonpublic manufacturing entity in the technology sector. The auditors document their risk assessment (and other audit matters) by completing the PPC forms illustrated in this *Guide* (as well as certain other forms used in the PPC audit process). The auditors use a combined approach consisting of tests of the operating effectiveness of internal controls and substantive procedures. This case study illustrates the PPC checklists that are required in every audit to comply with professional standards. A completed audit program for accounts receivable and sales is also illustrated in Appendix A.

102.6 **Appendix B** Appendix B presents a case study of a small, privately-held manufacturing entity. The auditors document their risk assessment by completing some of the PPC forms illustrated in this *Guide* and writing memos. A primarily substantive audit is performed (that is, a further understanding of internal controls is not obtained and controls are not tested for operating effectiveness). Completed audit programs for inventory and accounts payable are illustrated in Appendix B.

102.7 **Appendix C** Appendix C presents a case study of a privately held employment services entity. The objective of this case study is to illustrate the use of various PPC forms for documenting the understanding of internal control. Furthermore, the case study illustrates how the “Activity and Entity-level Control Forms” at CX-5 (as discussed in section 205 and in Chapter 4) might be used when documenting internal control.

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4 As of the date of this *Guide*, the guidance for performing an integrated audit is found in AT 501, *An*

Examination of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of its Financial Statements. However, at its July 2015 meeting, the AICPA's Auditing Standards Board approved to ballot for final issuance a new SAS, *An Audit of an Entity's Internal Control Over Financial Reporting That is Integrated With an Audit of its Financial Statements*, which would move the guidance on performing integrated audits to the auditing standards and supersede AT 501. The new SAS is expected to be issued by the end of 2015 and be effective for integrated audits for periods ending on or after December 15, 2016.

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