



Governmental Audit
Quality Center

Risk Assessment for Audits of State and Local Governments

A Governmental Audit Quality Center Web Event

Today's speakers



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What we will cover

Audit Risk Model

Identifying Risk 

Assessing Risk 

Responding to Risk 

Resources

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Risk assessment is fundamental.



Non-conformity
persists

> half

of firms failed to comply with
AU-C Section 315 or 330.

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Misconception driving non-conformity

Auditors can perform a
quality audit without properly
considering their client's risk
of material misstatement.



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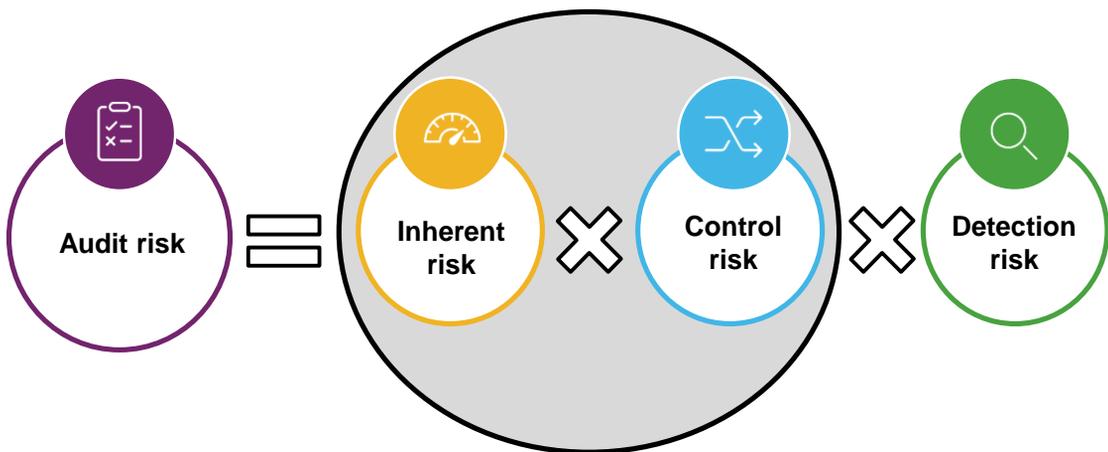
Panel discussion – What are you doing in your firms to focus on and address risk assessment?



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Audit risk model

Risk of Material Misstatement (RMM)



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What the audit is all about.



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Skipped a step? Non-conforming engagement

| Audit step | Impact if omitted |
|-------------------|---------------------------|
| Identifying RMM | Non-conforming engagement |
| Assessing RMM | Non-conforming engagement |
| Responding to RMM | Non-conforming engagement |

This is true regardless of amount and type of substantive testing performed!

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Same assertion, different procedures

**Inventory
existence**



Targeted selection



Random sample

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Same assertion, different procedures

**Investment
Valuation**



Targeted selection



Random sample or maybe
scope

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Identifying risk

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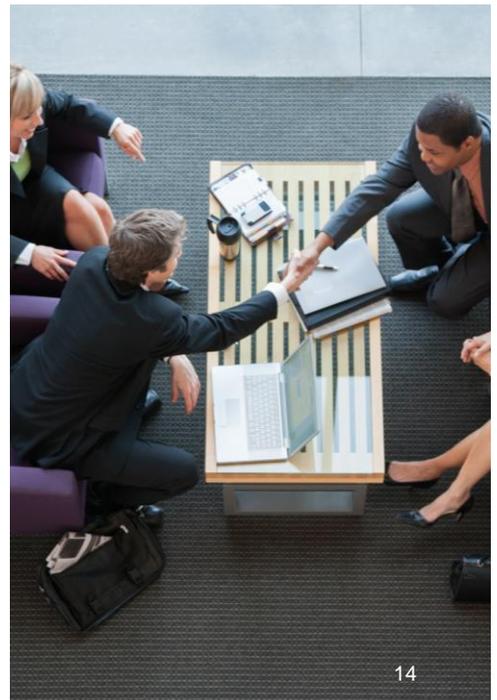
Understanding your client and their environment

What's the point?

To assess and respond to RMM, you should:

- Understand the nature of the client's inherent risks, which means you should
- Understand the client and their environment

Same logic applies to internal control and gaining an understanding of the client's internal control structure



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Understanding industry, regulatory, and other external factors

General economic conditions

- How is economy around the government impacting it

Industry conditions

Competitive environment

- How there other governments near our client and what pressures, if any, does this put on the government

Supplier and customer relations

- Any specific pressures enacted by citizens

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Understanding industry, regulatory, and other external factors (cont).

- Technological developments

- Is the government utilizing IT systems appropriately
- Cybersecurity
- Using advanced IT functions (crypto-currency, etc.)

- Regulatory environment

- Always a big influencer on our government clients – federal, state requirements, regulations or mandates

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Understanding industry, regulatory, and other external factors (cont.)

- Legal and political environment
 - Similar to regulations, but could include impact of any local elections, or election cycles.
- Environmental requirements
 - Impact through GAAP – landfills, pollution remediation, asset retirement obligations

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Nature of the entity

- Operations
- Governance
 - How influential is the governing authority on day to day operations
- Types of investments
 - Aggressive? Or does state law keep them low risk?
- Structure
 - Reporting entity considerations, many component units, JVs, other related parties?

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Objectives & strategies & related risks

- Objectives are overall plans for the entity
- Strategies are operational approaches
 - Have there been any changes? Have conditions forced additional services?
 - Have seen more economic development by our governments.
- Business risks result from conditions that could adversely affect entity

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Measurement and review of entity's financial performance

- What does management measure in running the government?
 - Examples are budgets, variance analysis, key performance indicators
 - How is budget to actual performance measured?
 - How does management deal with the budget pressures?
- Understanding helps auditor in considering whether pressure to meet performance measures increase risk of material misstatement

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Internal control - The auditor should:

obtain an understanding of the five elements of internal control sufficient to...

assess risk of material misstatement of financial statements whether due to error or fraud to....

design the nature, timing, and extent of further audit procedures

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Depth of internal control understanding

- Auditor needs to evaluate design of control and determine whether it has been placed in operation
- Improperly designed control may represent material weakness and should be communicated
- Inquiry alone is not sufficient
- Obtaining understanding is not sufficient to serve as tests of operating effectiveness
 - i.e. – can 't reduce control risk below maximum

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What if I'm not testing controls, and control risk is high?

| Description | Understand level of control risk? | Understand nature of control risk? |
|------------------------------------|-----------------------------------|------------------------------------|
| Walkthrough | ✓ | ✓ |
| No walkthrough or other assessment | ✓ | X |

Should still assess design and implementation of controls to understand the nature of control risk.

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Using audit data analytics in risk assessment

▪ Five Basic Steps

1. Plan the audit data analytics
2. Access and prepare the data for the purposes of audit data analytics
3. Consider the relevance and reliability of data used
4. Perform the audit data analytics
5. Evaluate the results and conclude whether objectives have been achieved

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Using audit data analytics in risk assessment

Examples of ADA Risk Assessment Procedures

- Preliminary general ledger account balance analysis
- Sales tax collections trend by month
- Water fund receivables turnover
- Disbursements risk analysis
- Employees as vendor comparison

See AICPA Guide to Audit Data Analytics

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Identifying “significant audit areas”

- Relative materiality of the account balance
- Relative significance of the transaction class
- Susceptibility to fraud
- Audit areas that
 - for other reasons have a high assessed level of inherent risk
 - have traditionally required significant adjustments



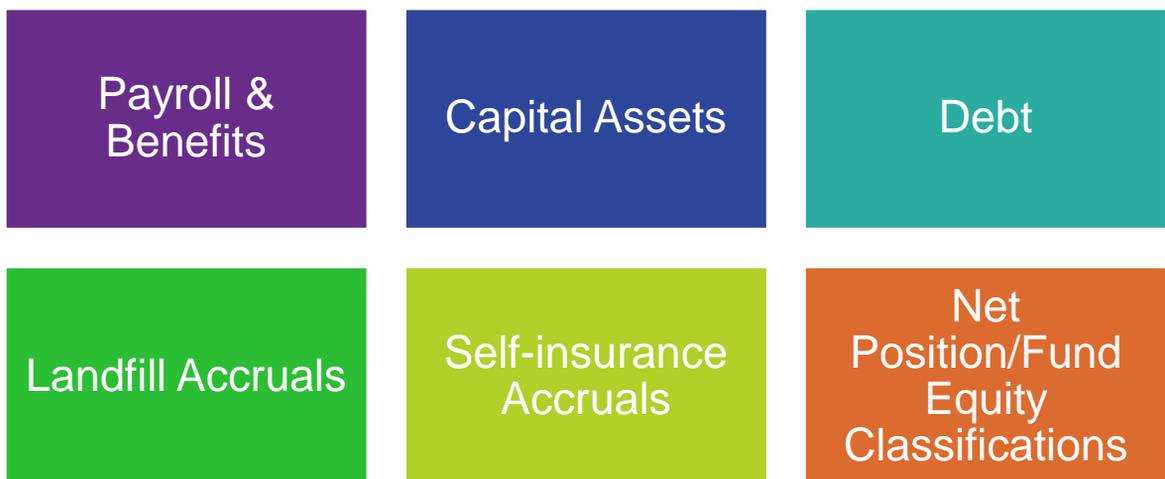
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Typical “significant audit areas” for SLG



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Typical “significant audit areas” for SLG



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Identifying “significant risks”



- Risks that require special audit consideration
- Based on inherent risk only
- Not always a fraud risk
- Often nonroutine transactions that require significant professional judgment
 - Complex calculations
 - Application of new/complex accounting principles
 - Related party transactions

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Typical “significant risks” for SLG



Budgetary pressure / cut-off

Lack of routine close outs

Significant estimates

- Pension/OPEB
- Landfills
- Donated infrastructure

New debt/financing transactions

Transactions with Component Units/JVs

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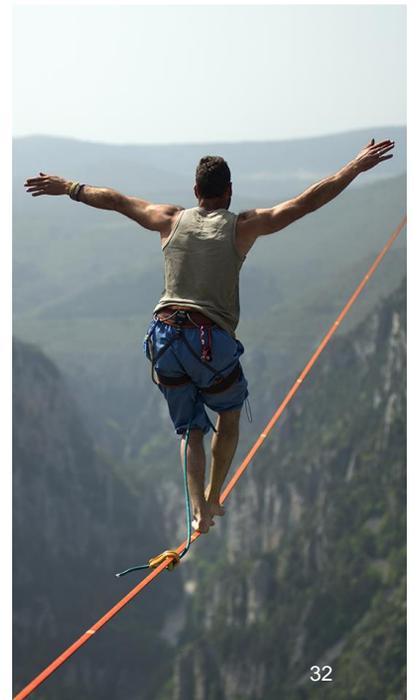


Assessing risk

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Objective of assessing risk

- Provide a basis for response
 - Nature
 - Timing
 - Extent
- Linked at the assertion (not account) level
- Assess risk at
 - Relevant assertion level
 - Financial statement level
(affecting many assertions)



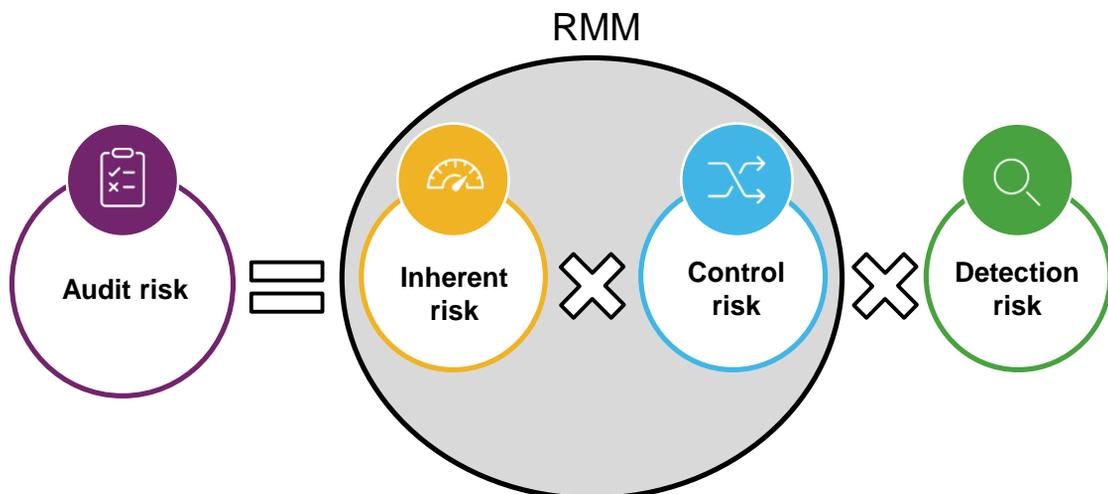
Process of assessing risk

- Identify any general risk assessment factors
- Determine those audit areas that are significant
- Describe the specific significant risks of material misstatement
- **Assess the risk of material misstatement at the relevant assertion level**



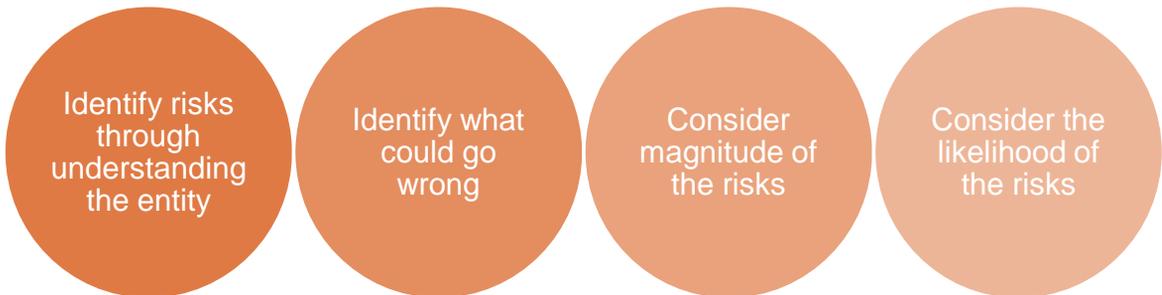
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Audit risk model



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Identifying RMM for relevant assertions



Assess the risk of material misstatement at the relevant assertion level

Keep in mind your Opinion Units

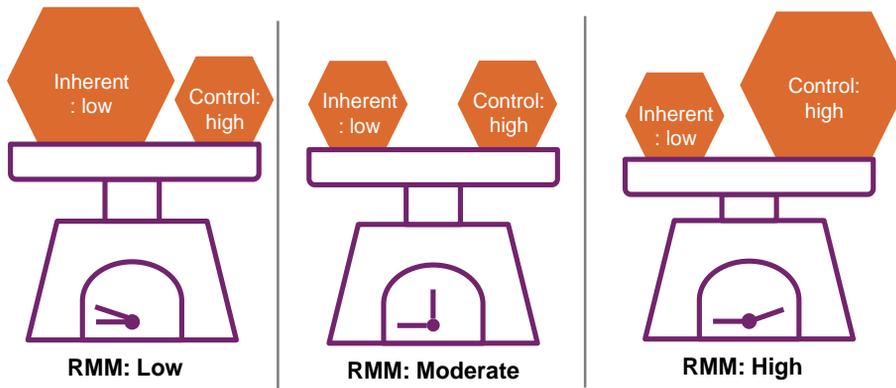
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Panel discussion – Which of the steps in the process just highlighted are most challenging for your staff?



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Calculating RMM



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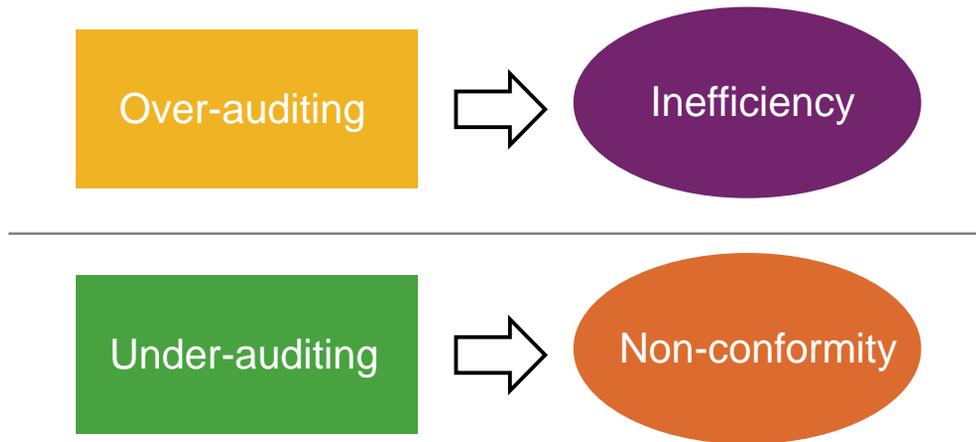
Documenting risk assessment

Auditor must document basis of risk assessment set at **any** level (AU-C 315.33)

| RMM Assessment | Required to document basis of risk assessment? |
|----------------|--|
| 1. High | YES |
| 2. Medium | YES |
| 3. Low | YES |

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Defaulting to high RMM without understanding the client



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Reducing inherent risk

Inherent risk:

- Risk of a material misstatement assuming no related controls
- **Cannot** be reduced based on competency of accounting staff

Control risk:

- Risk that a misstatement would not be prevented or detected and corrected by an entity's internal control

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Control Risk < Maximum



Must test controls

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SLG transactions/assertions that can lead to higher RMM

Existence and/or Cut-off of Cash

- in decentralized cash handling functions

Cut-off of AR/Revenue

- budgetary pressures, recording unbilled receivables in enterprise fund

Cut-off and/or Completeness of A/P & Expenses

- budgetary pressures, lack of routine cut-off

Classification of Revenue

- bond covenant requirements

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SLG transactions/assertions that can lead to higher RMM

| | |
|---------------------------------------|---|
| <p>Completeness of Capital Assets</p> | <ul style="list-style-type: none"> • record all the additions in the governmental activities • capture all donated infrastructure |
| <p>Valuation of Receivables</p> | <ul style="list-style-type: none"> • allowance for doubtful accounts in enterprise funds |
| <p>Valuation of Investments</p> | <ul style="list-style-type: none"> • with harder to value investments (level 3, etc.) |

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SLG transactions/assertions that can lead to higher RMM

| | |
|---|---|
| <p>Valuation of Capital Assets</p> | <ul style="list-style-type: none"> • depreciation kept in excel prone to error • judgement involved in valuing donated infrastructure |
| <p>Valuation of Debt</p> | <ul style="list-style-type: none"> • complex, non-routine transaction, especially refundings in the year of issuance |
| <p>Valuation of Significant Estimates (Liabilities)</p> | <ul style="list-style-type: none"> • pension or OPEB liabilities • estimate plus complex accounting • landfill liability • self-insurance IBNR |

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Responding to risk

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No linkage between risk and planned responses



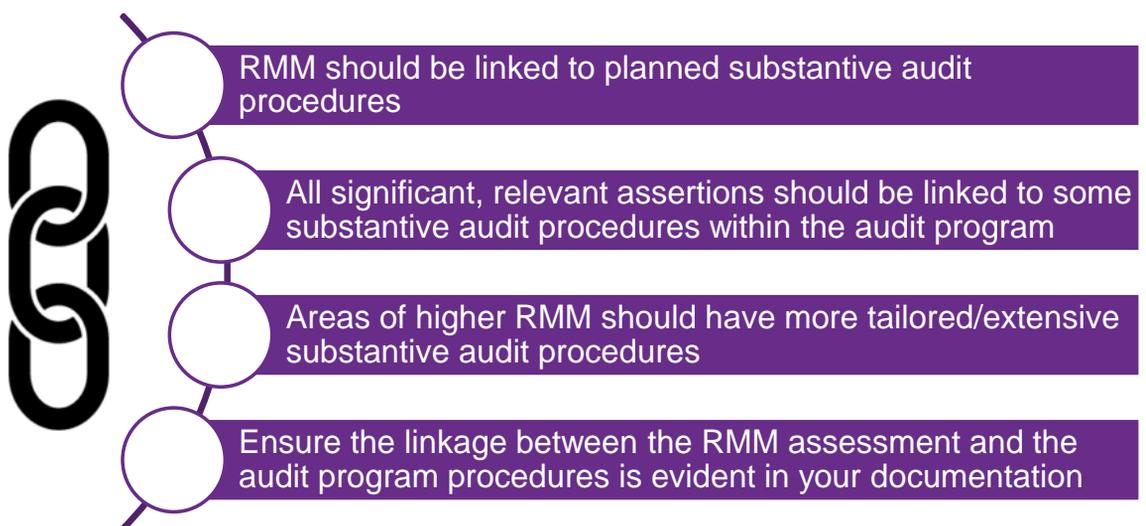
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No two audits are exactly the same.



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Linking to substantive audit procedures



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Responding to significant risks

- Special audit consideration = beyond the norm
- Often requires
 - Modifying standardized procedures or
 - Adding additional procedures
- One or more arise on most audits

Key point

If you aren't tailoring your practice aids to address significant risks, you're probably not complying with AU-C 330.

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Improper use of third-party practice aids

“Basic” approach \neq auto-pilot

“Extended” approach

- Pick the right procedures to address the client's specific risks
- May need to tailor procedures or design your own
- Especially true with significant risks



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Panel discussion – What are the most important participant takeaways from today’s presentation?



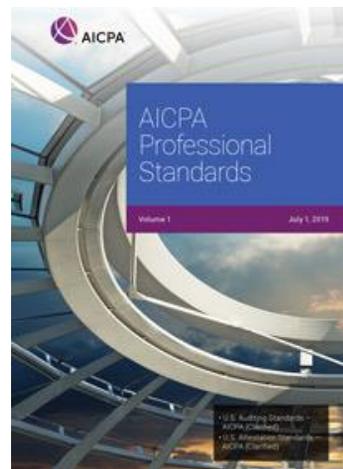
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Resources

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Relevant Guidance

- AU-C section 300, *Planning an Audit*
- AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*
- AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*



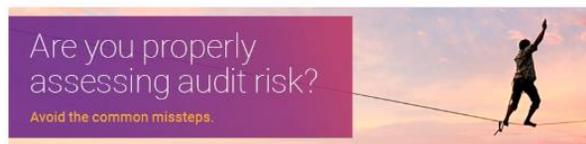
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Risk assessment toolkit

Free resources available at aicpa.org/riskassessment, including:

- Audit risk assessment tool
- Staff training workshop
- Internal inspection aid
- Aid for identifying and testing controls at smaller entities

AICPA Risk Assessment Resources



Identifying, assessing and responding to risks of material misstatement are at the core of every audit. However, a recent survey of peer reviewers found over half of 400 audits they reviewed did not comply with the risk assessment standards. Follow the advice in this risk assessment infographic to avoid common missteps.

The resources below will help you perform more effective risk assessments, appropriately link your risk assessments to your audit procedures and comply with the standards.



Audit Risk Assessment Tool



Risk Assessment Deep Dive: How to Avoid Common Missteps



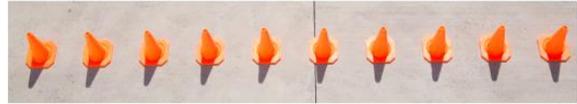
Internal inspection aid

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Internal control toolkit

Free resources available at aicpa.org/internalcontrol, including:

- Internal control over financial reporting tool template
- Process memo template
- Staff training workshop
- Internal inspection aid



AICPA Internal Control Toolkit

Obtaining an understanding of a client's internal control is a necessary step in every audit. However, a 2018 Peer Review Program survey found over 40% of audits didn't comply with AU-C 315 or AU-C 330 because auditors did not properly identify the risks of material misstatement through obtaining an understanding of their client's controls.

To help you comply with requirements associated with internal controls, we've developed resources to help. Check this page often, as new resources will be posted.



Internal control over financial reporting tool template



Process memo template



Aid for identifying controls at smaller entities

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- If you need assistance with locating your certificate, please contact the AICPA Service Center at 888.777.7077 or service@aicpa.org.

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Thank you

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