

This CICA publication is an “other auditing and assurance publication” under the hierarchy established in *Authority of Auditing and Assurance Standards and Other Guidance*, paragraph 5021.02(d). It has not been adopted, endorsed, approved, disapproved or otherwise acted upon by the Auditing and Assurance Standards Board (AASB), any CICA board or committee, the governing body or membership of the CICA, or any provincial Institute/Ordre. This publication has been prepared by the CICA Auditing and Assurance Standards staff to be included in the list of publications in Appendix B of Section 5021; consequently, it may be presumed to be appropriate. This publication may help practitioners understand and apply Recommendations and guidance issued by the AASB. Before applying the guidance in this publication, a practitioner should be satisfied that, in his or her professional judgment, it is relevant to the circumstances of the assurance engagement.

Staff contact

Previous issues of *Risk Alert* are available on the AASB's website (www.aasb.ca). Suggestions for and comments on *Risk Alert* are always appreciated and may be directed to:

Greg Shields, CA

The Canadian Institute
of Chartered Accountants
*Auditing and Assurance
Standards Department*
277 Wellington Street West
Toronto, ON M5V 3H2
Tel: (416) 204-3287
E-mail: greg.shields@cica.ca
Fax: (416) 204-3408



risk

ALERT

FOR CHARTERED ACCOUNTANTS PERFORMING AUDIT AND REVIEW ENGAGEMENTS

Implementing Audit Risk and Quality Control Standards

Anecdotal evidence suggests that some auditors, particularly those from small practice, have questions about how to more efficiently and effectively adapt their audit methodologies and processes to the new audit risk and quality control standards. The purpose of this *Risk Alert* is to put in perspective the key changes between the new audit risk standards and

those formerly in effect. It outlines matters that auditors may consider in adopting the new audit risk standards for audits of small entities when the auditor typically takes a substantive approach. This *Risk Alert* also provides some useful reminders for auditors as they continue to implement the quality control standards.



Audit risk standards

Background

In response to concerns raised about audit quality, the International Auditing and Assurance Standards Board (IAASB) developed new audit risk standards which the AASB adopted for use in Canada. The AASB released the following standards in August 2005 that became effective January 1, 2006:

- Section 5141, *Understanding the entity and its environment and assessing the risks of material misstatement*; and
- Section 5143, *The auditor's procedures in response to assessed risks*.

The “audit risk standards”, as they are commonly known, are based on the equivalent International Standards on Auditing (ISAs) issued by the IAASB. They are being used throughout the world by auditors with large and small public accounting practices. The standards are founded on the premise that all audits should be conducted in accordance with the same high quality auditing standards — “an audit is an audit”. However, the standards are designed to allow the auditor sufficient flexibility to respond to the particular circumstances of the entity whose financial statements are being audited. Applying the new standards, the audit of a small, less complex organization can continue to require a lot less time and effort than the audit of a larger, more complex organization.

In the context of the audit of a small entity, the following are the key changes resulting from the new audit risk standards.

Understanding the entity and its environment in assessing risk of material misstatement

The Handbook formerly contained a separate Section 5140, *Knowledge of the*

entity's business, that required the auditor to obtain sufficient knowledge of the entity to provide a basis for assessing risk, designing audit procedures and assessing the appropriateness of audit evidence obtained.

It appeared, however, that this standard was not being implemented as intended. Auditors were regarding it as somehow a separate and distinct part of the audit, not strongly linked to assessing risk and designing appropriate substantive procedures.

In the new standards, more specific guidance is provided regarding the auditor's required understanding of the entity and its environment. The new standards are also clearer in requiring this understanding be integrated into the auditor's risk assessment process.

Understanding internal control in assessing risk of material misstatement

The former standards, particularly Section 5205, *Internal control in the context of an audit — understanding internal control for audit planning purposes*, contained Recommendations (requirements) regarding the need for the auditor, even when taking a substantive approach to the audit, to obtain an understanding of the entity's control environment and its control systems that collect, record and process data and report the resulting information. When the auditor was planning to rely on the effectiveness of internal controls, that understanding had to be expanded to include control systems that enhance the reliability of data and information.

It appeared that some auditors, particularly those of smaller entities, were often taking a checklist approach to designing and performing substantive procedures.

They seemed to be paying relatively little attention to assessing control risk and taking it into account in determining the nature, timing and extent of substantive procedures appropriate to the audit being performed.

The new standards focus on requiring the auditor to obtain an understanding of internal control relevant to the audit. This includes evaluating the design of a control and determining whether it has been implemented. Regarding the required understanding of internal control, the new standards do not distinguish between an audit where the auditor does not intend to rely on the effective operation of controls (for example, take a “substantive approach”, which is still permitted) versus an audit where the auditor does plan on such reliance. The new standards focus on the concept of “internal control relevant to the audit” and provide greater breadth and depth of guidance on what that means.

They also emphasize the following:

- The auditor exercises professional judgment in determining the extent of understanding of internal control required in the context of the particular audit. However, the auditor must always evaluate the design and implementation of internal control related to a risk of occurrence of a material misstatement that the auditor has assessed as significant (“a significant risk”).
- The way in which internal control is designed and implemented varies with the size and complexity of the entity. For example, the components of internal control may not be clearly distinguished within smaller entities.

Documentation

The former standards contained few requirements regarding documentation. Practice inspectors often voiced concerns about the poor quality of documentation in audit files of the auditor’s risk assessment and responses to assessed risk.

The new standards provide more specific requirements covering matters such as documenting the auditor’s understanding of the entity and its environment, internal control, risk assessment and responses to assessed risk at the assertion level.

How the new standards may impact the audit of a small entity

Auditors using a substantive approach for small entity audits will likely need to make some changes in order to comply with the new standards. Main areas of change for some auditors are likely to relate to the knowledge required of the entity and its internal control and the need to better document the linkages between risk assessments and the procedures the auditor plans to perform. Auditors who have been conducting audits using best practice may not see any substantive change in the extent of audit work and documentation under the new standards. Others may find the changes significant. However, matters including the following might be considered when implementing the new standards.

Understanding the entity and its internal control

In a small entity, the accounting process is usually uncomplicated with few, if any, personnel solely engaged in record keeping

and with limited segregation of duties.

Under the new standards, understanding the information system may often simply involve:

- evaluating the design of the controls by learning what accounting package is being used, how input is organized and how output is used, what controls are in place in using the software (including to what extent programmed controls have been “turned off”) to effectively prevent, or detect and correct, misstatements; and
- drawing a conclusion on whether the relevant controls have been implemented, for example by performing a walk through of the system to determine that the controls exist and the entity is using them.

Also, basic policies and procedures (control activities) are likely to exist for the main transaction cycles such as revenues, purchases and employment costs. Management may have direct involvement in control activities relevant to the audit. Management’s direct control over key decisions and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances are often important positive features of internal control in a small entity. On the other hand, management’s dominant position may be abused and can result in an override of controls and inaccurate accounting records. Auditors have always needed to consider both of these scenarios of management’s dominant position in a small entity when designing procedures to obtain an understanding of control activities.

Some auditors using a substantive approach when auditing the financial statements of a small entity use a standardized audit program (checklists) that has not been adapted to address assessed risks in the specific circumstances of that entity. Under Section 5141, auditors must identify and assess the risks of material misstatement at the financial statement level and the assertion level, including significant risks that require special audit consideration. The auditor must evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.

Further, the auditor must design procedures that are specifically responsive to that risk. Substantive analytical procedures will need to be combined with tests of details and involve use of procedures designed to obtain more reliable audit evidence such as external confirmations. As a result, the auditor may need to spend more time performing procedures in higher-risk areas. On the other hand, the auditor may need to spend less time auditing low risk areas.

Auditors may therefore wish to reconsider whether a substantive audit approach is the most effective audit approach in every circumstance in which it is currently used. One consideration is that Section 5143 permits the auditor to use the

results of prior audit tests of controls in the current engagement (for risks other than significant risks). In some cases, it may therefore be more efficient to use an audit approach that involves reliance on the effectiveness of certain controls, even when auditing a small entity.

Documentation under the audit risk standards

Many smaller entities have a limited range of products or services and operate from a limited number of locations. As a result, their processes and structures are uncomplicated. In these cases, the documentation of the auditor's understanding of the entity's operations and of the relevant industry, regulatory and other external factors required under Section 5141 is likely to be simple in form and relatively brief. The understanding may be documented by free-form narrative notes or by completing structured forms. Whatever form the understanding takes, it should indicate those elements that impact the auditor's assessment of the risks of material misstatement in the financial statements.

Auditors may also find that much of their current documentation can be used to meet the requirements of Section 5141, although it may need to be reorganized and refocused to make it more useful within the context of assessing risks of material misstatement. For example,

the extent and nature of management's involvement in internal control in a smaller entity is typically a key aspect of the documentation of the auditor's understanding of the entity and assessment of risk.

Those auditors who have relied on the use of standardized checklists for all of their audits of small entities may find that they need to improve their documentation of how the substantive procedures they performed link to their risk assessments at the assertion level. Tools are available to assist auditors with such documentation, including the CICA's Audit Technique Study, "Audit of a Small Entity," the Professional Engagement Manual (PEM) and related materials.

Increased time and effort in documentation to respond to Section 5141 may largely be concentrated in the year of transition to the new standards. For example, when there is no significant change in the entity's operations and internal control, the documentation will continue to be relevant from year to year, requiring relatively little effort to appropriately update.

Quality control standards

In 2005, the AASB issued standards on quality control:

- GSF-QC, *General standards of quality control for firms performing assurance engagements*; and



- Section 5030, *Quality control procedures for assurance engagements*.

GSF-QC requires firms to develop a system of quality control policies and procedures. The deadline for initial implementation was set at December 1, 2005. Section 5030 applies to assurance engagements with years beginning on or after December 1, 2005.

Since the release of the standards, questions have been raised by practitioners in smaller practices, particularly with respect to the engagement quality control review process and monitoring of quality control.

Engagement quality control review

GSF-QC requires the firm to establish policies and procedures regarding engagement quality control review of certain assurance engagements. This review has often been referred to in practice as an independent partner review, second review or concurring review. GSF-QC requires that an engagement quality control review be done on all audits of public enterprises. For other assurance engagements, it requires the firm to establish criteria against which the engagement can be assessed to determine if this review should be done. GSF-QC provides examples of criteria the firm may consider and suggests that, normally, engagements that

would be subject to engagement quality control review would be those engagements to report on financial statements of large private companies, of companies contemplating a securities offering, of organizations of broad public interest or those subject to filing with federal or provincial regulatory agencies.

However, GSF-QC does not specify any criteria: each firm can exercise discretion in specifying the criteria it uses. It seems likely that the criteria would result in an engagement quality control review for the audits of financial statements of, for example, organizations whose financial statements are likely to be relevant to a broad segment of the community, or of those organizations for which the risks of continuing the engagement are assessed as high.

The CICA's Quality Assurance Manual (QAM) was developed specifically to assist practitioners in smaller practices in developing their system of quality control. It provides a checklist of potential risk factors against which a firm may assess its assurance engagements. Firms using the QAM should note, however, that the list may not be an exhaustive list of factors that could affect their engagements. On the other hand, factors may be included on the list that may not be applicable to their engagements.

Once an assurance engagement has been identified as being subject to an engagement quality control review, the assurance team would follow the firm's policies and procedures to ensure that this review is appropriately carried out. GSF-QC establishes requirements and provides guidance with respect to the timing and extent of such a review. GSF-QC also requires the engagement quality control review to include an objective evaluation of the significant judgments made by the assurance team, the conclusions reached in formulating the report and other significant matters identified by the engagement quality control reviewer during this review.

The extent of this review is normally determined by the complexity of the engagement. For example, a review would be more detailed in cases where there are complex accounting issues, significant differences of opinion with management or with those consulted, or when the risk of material misstatement has been assessed as high. In other circumstances where the accounting is straightforward and unchanged from the previous year, when there has been no consultation with others or when the risk of material misstatement has been assessed as lower, the engagement quality control review would likely be less detailed. In any case, the engagement quality control

review is not intended to replace the review by the partner-in-charge of the engagement or to reduce the responsibilities of the partner-in-charge. Further, this review would not normally entail a detailed review of all working papers.

Engagement quality control reviewer

GSF-QC requires the firm to establish criteria setting out the eligibility of persons who may complete an engagement quality control review. This review would be performed by one or more persons who are objective and have sufficient experience and authority, and the capability of fulfilling that role. For example, there is no requirement for the reviewer to be a partner (or equivalent). However, the reviewer must have sufficient experience and authority to be able to understand the significant issues and question, when necessary, the conclusions of the assurance team, including the partner-in-charge of the engagement. GSF-QC also stresses that it is important that the reviewer have sufficient time to perform this review.

Monitoring

There are two aspects to the monitoring requirements in GSF-QC. The firm is required to review the quality control policies and procedures it has established to determine whether they remain appropriate. The firm is also required to inspect a selection of completed assurance engagements to ensure that they have been completed in accordance with the standards. GSF-QC does not prescribe how often the monitoring is to be performed. However, it does require, at a minimum, an annual communication

of the results of the monitoring process. This implies that the overall firm monitoring would be done annually. Since the firm's system of policies and procedures was required to be in place by December 1, 2005, the first annual monitoring of the system would, in most cases, have occurred towards the end of 2006.

Annual monitoring is done to ensure that the firm's policies and procedures are updated to reflect both changes in standards and changes in the firm (for example, the firm's operations or structure). Inspection of individual assurance engagements, however, can be done on a cyclical basis. Depending on the size of the firm and the number of assurance engagements, some files may be reviewed every year. A longer period may be selected, but would ordinarily not span more than four years. In the case of a large firm, a number of assurance engagements may be selected for inspection every year, although an individual practitioner may not have an engagement selected every year. Of course, in a smaller practice with fewer assurance engagements, a practitioner may have such engagements inspected more frequently.

The objective of the inspection process is to ensure that the firm's policies and procedures are being followed and that assurance engagements are completed in accordance with assurance standards. Regular inspections are expected to decrease the risk of inappropriate reports being issued and enhance a firm's ability to perform engagements in accordance with the firm's and the profession's, standards.

