Discussant's response to "Assessing control risk: Effects of procedural differences on auditor consensus";

Richard W. Kruetzfeldt
Discussant’s Response to
“Assessing Control Risk: Effects of Procedural Differences on Auditor Consensus”

Richard W. Kreutzfeldt
Arthur Andersen

Statement on Auditing Standards No. 55 (SAS 55), “Consideration of the Internal Control Structure in a Financial Statement Audit,” is one of the “Expectations Gap” standards issued in 1988 that were intended to improve the effectiveness of audits. SAS 55 broadens the concept of internal controls, expands the auditor’s responsibilities with respect to internal controls, and revises and attempts to clarify a number of long-standing concepts. With such ambitious objectives, it is not surprising that questions are being raised about the meaning of the new standard, how to apply it in practice, and whether the new concepts themselves are sound. Morton and Felix [1989] express the concern in an earlier paper, “it appears that possibly confusing concepts are being replaced with concepts which we believe may be even more confusing, contradictory and ill-defined.”

I too have concerns about SAS 55. But I also believe that SAS 55 adds a number of fundamental enhancements to the auditing literature. What is needed now, in my view, is not a massive overhaul of SAS 55 but a continuing dialogue among practitioners, academicians and standard-setters aimed at improving the understanding and application of SAS 55 and leading ultimately to revisions or interpretations of the standard where necessary. This paper by Morton and Felix makes a significant contribution to this continuing dialogue.

SAS 55: An “Evidence-Based” Approach?

The focal point of this paper is the procedure to be followed in making control risk assessments. SAS 55 provides the following guidance:

29. Assessing control risk is the process of evaluating the effectiveness of an entity’s internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

30. Assessing control risk at below the maximum level involves—
• Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.

• Performing tests of controls to evaluate the effectiveness of such policies and procedures.

Figure 1

SAS 55 FLOWCHART
(Summary Version)

A simplified version of the SAS 55 flowchart is presented in Figure 1. This guidance is rather broad and conceptual and can lead to questions about implementation. The authors' interpretation of SAS 55 is that it requires an "evidence based" approach. An illustration of this approach is presented in Figure 2. While the authors did not actually include a flowchart of this or other models in their paper, I have attempted to represent their views in this manner for clarification and contrast with other models. The authors' principal concern with an evidence-based approach is that the "auditor's beliefs regarding the risk of a material error getting through the client's internal controls are ignored under some conditions." Ignoring these beliefs is inappropriate because they should have an effect on the design of substantive tests. While I
would share these concerns about an evidence-based approach as described by the authors, I do not believe that SAS 55 prescribes an evidence-based approach as illustrated in Figure 2. I believe the SAS 55 approach was intended to be more flexible. I will comment further on this later. But for now, let's explore the alternative control risk assessment procedure described by Morton and Felix.

**Figure 2**

EVIDENCE-BASED PROCEDURE FOR ASSESSING CONTROL RISK

1. Understand Internal Control Structure
2. Assess Control Risk (1)
3. Perform Tests of Controls
4. Assess Control Risk (2)
5. Design Substantive Tests

(1) This assessment should be at the maximum because no evidence has yet been obtained (assumes no tests were performed while obtaining the understanding).

(2) This assessment is lower reflecting evidence obtained through tests of controls.

**An Alternative: A “Belief-Based” Approach**

The authors describe a “belief-based” procedure for assessing control risk that addresses some of their concerns with an evidence-based approach. An initial depiction of a belief-based approach is presented in Figure 3. This initial depiction does not reflect all features of the belief-based approach described by the authors. These will be added later. However, it does provide a basis for contrast with the evidence-based approach. At first glance, some may question whether the differences between these two models are all that significant. After all, in both models, control risk is ultimately assessed after considering tests of controls performed. But, on closer review, there are differences in the impact on the design of substantive tests. In the evidence-based approach, the auditor cannot make an intelligent design of substantive tests until after the tests of controls are completed and an assessment of control risk is made. This is not logical and places undue constraints on the auditor. By contrast, in the belief-based approach, the auditor may design substantive tests based on his beliefs about control risk before any tests are performed. He may then make necessary revisions to the design after these beliefs have been confirmed. This is more logical and more reflective of what auditors do in practice.
BELIEF-BASED PROCEDURE FOR ASSESSING CONTROL RISK

(Initial Depiction)

(1) This assessment is based on the auditor's beliefs, regardless of whether evidence has been (or will be) accumulated to support this belief (example: "low").

(2) This is to update the auditor's belief about control risk based on evidence obtained. Ordinarily, this would be the same as the initial assessment unless contrary evidence has been obtained. In this case, the design of substantive tests may need to be revised.

(3) This approach allows flexibility to design and perform substantive tests either simultaneously with, or subsequent to, tests of controls.

What Does SAS 55 Really Require?

Now that the rudiments of each approach have been described, let's explore what SAS 55 actually requires. Does it really prescribe an evidence-based approach and preclude a belief-based approach? Based on my experience with the Task Force that developed the Audit Guide [AICPA, 1989], "Consideration of the Internal Control Structure in a Financial Statement Audit," the answer is "no." The evidence-based approach described by the authors is a too literal and too sequential an interpretation of SAS 55. Indication of a sequential view is provided by the following comments [p. 113]:

It follows, then, that AFTER obtaining an understanding of the internal control structure but PRIOR TO any tests of controls, the control risk assessment should be at the maximum level (emphasis added).

Ultimately, AFTER all testing has been completed, the final (evidence-supported) assessed level of control risk is used, along with the assessed level of inherent risk, to determine the . . . substantive tests to perform (emphasis added).

These literal descriptions of a sequential process cannot be found in SAS 55. The SAS only requires that the auditor "consider results of any tests of controls" in the design of substantive tests. It does not require that the tests of controls be completed before the design of substantive tests can begin. It does not preclude the auditor from anticipating the results of tests of controls (i.e., from considering his beliefs about the level of control risk that will be supported by the planned tests of controls) in designing substantive tests.
The Audit Guide: A Clarification of SAS 55

The above statements reflect more than just my personal view of SAS 55. They reflect the approach taken in the Audit Guide. A summarized version of the flowchart included in the Audit Guide is presented in Figure 4. As depicted here, the Audit Guide adds a useful concept not included in SAS 55 – the preliminary audit strategy.

Figure 4
AUDIT GUIDE FLOWCHART
(Summary Version)

(1) This is the level of control risk that the auditor believes can be supported by the tests of controls he plans to perform.

(2) This is to update the auditor’s belief about control risk based on evidence obtained. Ordinarily, this would be the same as the initial assessment unless contrary evidence has been obtained. In this case, the design of substantive tests may need to be revised.

(3) This approach allows flexibility to design and perform substantive tests either simultaneously with, or subsequent to, tests of controls.

The above concept is described in the Audit Guide as follows [AICPA, 1989, paragraphs 2.2 and 2.3]:

. . . . the auditor often will be able to choose between several possible audit approaches . . . .

When considering a preliminary audit strategy . . . ., the auditor considers knowledge of the entity’s business, the industry in which it operates, the nature and materiality of different account balances, prior experience with the industry, and other factors.

The preliminary audit strategy is not a detailed design of audit procedures. Rather, it represents preliminary judgments about an audit approach that are updated as necessary during the conduct of the audit as the auditor confirms initial judgments or obtains evidence to the contrary.

The preliminary audit strategy includes, among other things, a planned assessed level of control risk – the level of control risk that the auditor believes can be supported by tests of controls that he plans to perform. The
belief-based approach and the Audit Guide approach have many similarities. Both allow, at least in part, a belief-based control risk assessment for audit planning purposes. Both allow flexibility in the design of substantive tests. In noting the similarities of the Audit Guide approach to the belief-based approach, it is also important to note that the approach taken in the Audit Guide should not be viewed as a revision of the SAS 55 approach. The Audit Guide is intended only to provide guidance in the application of SAS 55. The Auditing Standards Board did not consider it necessary to issue a revision or interpretation of SAS 55 as a result of the issuance of the Audit Guide. Thus, the procedure covered in the Audit Guide may be viewed as representing the intent of SAS 55. Therefore, to conclude, as the authors do, that SAS 55 prescribes an evidence-based approach and precludes a belief-based approach is inappropriate. This is not to say that the authors' discussion of the belief-based approach is without merit. It is only to say that characterizing SAS 55 as an evidence-based approach is not appropriate.

Assessing Control Risk at the Maximum

At this point, I would like to pursue further some of the additional features of the belief-based approach. One of the most interesting questions raised by this approach is: What if the auditor does not intend to validate his beliefs about control risk through tests of controls? A related, and more troublesome, issue involves the assessment of control risk at the maximum for efficiency reasons even though the auditor believes controls are strong. The authors contrast this case with one where control risk is assessed at the maximum because of weak controls and ask whether the maximum assessed level of control risk has the same meaning in both cases. This example is illustrated in Figure 5.

SAS 55 indicates that control risk may be assessed at the maximum in both cases. The authors argue, effectively I believe, that the assessments do not have the same meaning in both cases and that using the same assessment could be misleading [p. 114]:

In the first case [weak controls], the assessed level of control risk is . . . a reflection of the auditor’s beliefs regarding the risk of material error getting through the client’s internal control structure. In the second case, however, the auditor’s beliefs are not reflected at all. The assessed level of control risk is arbitrarily set for the purpose of planning the audit. It would seem, however, that a key factor in audit planning would be the auditor’s actual expectations regarding material error, yet these expectations are not reflected in the control risk assessment in the second case.

Of even greater significance is whether the substantive tests would be the same in both cases. If one believes the substantive tests should be the same, then it should not matter that the control risk assessments are the same. However, if one believes the substantive tests should be different, then having the same control risk assessment may be a greater concern. SAS 55 does not specifically address this issue, but because the control risk assessments are the
same, the implication is that the substantive tests would also be the same. The authors argue persuasively, however, that they should not be the same [p. 114]:

In the first case [weak controls], the auditor has identified areas of weakness in the client's internal control structure and should direct additional audit effort to searching for material error where he believes the risk of error is high. In the second case, however, no material weaknesses in the internal control structure have been identified by the auditor. The course of action indicated in this case may be quite different than the first, yet because the assessed level of control risk is the same for both cases, this suggests that the nature, timing, and extent of substantive testing would not differ between the two.

SAS 55 actually provides the conceptual foundation to deal more effectively with this issue through the guidance provided in paragraph 16. This paragraph indicates that knowledge about the internal control structure should be used to –

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

It is the first two bullet points that provide the means to differentiate between the two cases discussed above. In the case of weak controls, there may
be one or more types of potential misstatements that present a significantly
greater risk than where controls are strong. There may also be a number of
additional factors affecting the risk of misstatement. These conditions would
probably warrant an expansion of substantive tests. For example, the audi-
tor may make additional inquiries or perform additional substantive tests in
response to these added areas of risk. These risk conditions may be incon-
sequential in the case of good controls and not warrant any additional response
beyond the “basic” procedures. Some may assert that the procedures should
be the same because the risk is assessed at maximum. While this may be
true in some cases, I would not agree with it as a general assertion. This as-
sertion would seem to suggest that the myriad of risk factors present in any
given situation can be reduced to a single-word expression of risk and that
the audit procedures should be driven by this singular expression. I believe
such an approach would be overly mechanical, limiting, and unrealistic.
Clearly there is value to an explicit assessment of risk. But I do not view it
as the sole determinant of audit procedures. Auditors also consider the com-
plexities and subtleties of the risk factors present in determining the substantive
tests to be performed. Any “model” of the auditing process should accom-
modate such an approach. I believe SAS 55 would accommodate this if one
considers its emphasis on control risk assessments together with its discussion
of risk factors in paragraph 16. With such an approach, I believe auditors could
draw the appropriate distinctions between the strong controls and weak con-
trols cases described earlier.

Some effort was made in the Audit Guide to distinguish between these
cases. The following discussion is included in paragraph 3.5:

The auditor should recognize that, although the level of assurance
needed from substantive tests remains the same whether control risk
is assessed at the maximum because of efficiency reasons or because
of ineffective policies and procedures, the fact that the auditor concludes
that policies or procedures are ineffective may raise concerns about
auditability and other questions. Assuming that the auditor is able to
overcome auditability concerns, he or she may respond by heighten-
ing the degree of professional skepticism, assigning more experi-
enced staff, and changing the nature, timing and extent of substantive
procedures.

While this is an attempt to recognize the differences, some auditors may
find it confusing, particularly the apparent inconsistency between “level of
assurance needed from substantive tests remains the SAME” and “CHANG-
ING the nature, timing and extent of substantive procedures (emphasis
added).” No further explanation is provided in the Audit Guide. Thus, I be-
lieve this is an area for further guidance and clarification by the Auditing Stan-
dards Boards.

**How Do the Alternative Models Handle “Maximum”
Control Risk Cases?**

But how well do the models presented earlier address the two cases
where control risk is assessed at the maximum? Let us first consider the be-
belief-based approach, the initial depiction of which is presented in Figure 3. This model would not be a logical approach for the strong controls case. Here, the auditor’s “initial” control risk assessment would be “low” and this would be reflected in the initial design of substantive tests. However, this would result in under-auditing because the auditor does not plan to validate his control risk assessment belief through tests of controls. This under-auditing would be corrected later when the auditor makes his “final” control risk assessment. Such an approach is not logical or efficient.

What is needed is a model that enables the auditor to design substantive tests based on both his control risk assessment beliefs as well as his plans for validating these beliefs. The model presented in the Audit Guide — and summarized in Figure 4 — provides one approach for doing this. The “planned assessed level of control risk” combines, in a single expression, the auditor’s belief about control risk and his intent to validate this belief.

Where the auditor plans to validate his belief (or where no validation is necessary because the auditor believes risk at the maximum), the planned assessed level of control risk is the same as the auditor’s belief about control risk. However, where the auditor believes risk is low but does not plan to validate this belief, the planned assessed level of control risk would be at the maximum. Thus, this is not a purely belief-based approach. It is subject to the same concerns expressed earlier about treating the two maximum control risk assessment cases in the same manner.

The authors’ belief-based approach includes additional features (not reflected in Figure 3) that would enable the auditor to consider separately his plans for validating his control risk beliefs. They discuss the “reliance” concept which was dropped from the standard because of “perceived confusion over its meaning” and replaced with the control risk assessment concept. However, the authors do not agree that the control risk assessment concept should be viewed as a substitute for the reliance concept. In fact, they see complementary roles for a belief-based control risk assessment and the reliance judgment. Certainly the auditor’s control risk belief is relevant for audit planning. The authors argue that the auditor should also consider whether he plans to rely on this belief (i.e., the reliance judgment). This enhancement of the belief-based approach is illustrated in Figure 6.

The belief-based approach is an appealing model because it enables the auditor to separately consider his control risk beliefs as well as his plans for validating these beliefs. This model provides a better way of dealing with the two control risk assessment cases noted earlier. Using the evidence-based or Audit Guide models, control risk would be assessed at “maximum” in both cases, which does not recognize the differences in these situations. Using the model in Figure 6, however, there are differences in the assessments made. While both would place “no reliance” on internal controls, the control risk assessment in one case would be “maximum” while in the other it would be “low.” These different assessments provide a direct, explicit means to recognize the differences between these cases and to produce a design of substantive tests that recognizes these differences. In my view, this “marriage” of the control risk assessment concept with the reliance concept is the most significant contribution of this paper and warrants serious consideration by
Figure 6
BELIEF-BASED PROCEDURE FOR ASSESSING CONTROL RISK
(Including Reliance Judgement)

Understand Internal Control Structure

Assess Control Risk (1)

Determine Reliance on Controls (2)

Perform Tests of Controls

Assess Control Risk (3)

Design Substantive Tests (4)

Perform Substantive Tests

(1) This assessment is based on the auditor's beliefs, regardless of whether evidence has been (or will be) accumulated to support this belief (example: "low").

(2) This decision is the degree to which the auditor intends to rely on, and obtain evidence to support, his belief. Thus, while the auditor may believe control risk to be low, he may decide to obtain evidence to support only a "moderate" or "slightly below maximum" level. This decision is based on the relative effectiveness and efficiency of alternative audit procedures.

(3) This is to update the auditor's belief about control risk based on evidence obtained. Ordinarily, this would be the same as the initial assessment unless contrary evidence has been obtained. In this case, the design of substantive tests may need to be revised.

(4) This approach allows flexibility to design and perform substantive tests either simultaneously with, or subsequent to, tests of controls.

The Auditing Standards. Unlike other discussions, it does not require an "either-or" choice between the concepts, but recognizes their complementary relationship between the two.

The "Evidence Sufficiency" Judgment

The authors' belief-based approach has one additional feature not reflected in Figures 3 or 6. They believe it is also important for the auditor to evaluate the sufficiency of evidence obtained in performing tests of controls. They make the following arguments:

Ideally, a risk model should accommodate separate assessments of risk and evidence sufficiency [p. 115].

Although professional standards do not explicitly 'model' separate belief assessments and evidence sufficiency assessments, this basic concept was nevertheless reflected in the old standards [p. 115].

The control risk assessments should be based on the auditor's beliefs and a separate assessment made regarding the sufficiency of the evidence collected to rely on those beliefs [p. 118].

The addition of this "evidence sufficiency judgment" is reflected in the illustration in Figure 7. While I agree that this is a judgment that should be and is made by auditors, I do not agree with including it explicitly in the model. The reliance judgment that comes earlier in the model provides the auditor's initial assumption about the sufficiency of evidence he plans to obtain. Fur-
ther, the revised control risk assessment made later in the model would reflect what the auditor actually found with respect to the sufficiency of evidence. Thus, I do not believe an additional explicit judgment is necessary and would merely add additional complexity to the model.

Figure 7
BELIEF-BASED PROCEDURE FOR ASSESSING CONTROL RISK
(Including Reliance and Sufficiency Judgments)

(1) This assessment is based on the auditor's belief, regardless of whether evidence has been (or will be) accumulated to support this belief (example "low").
(2) This decision is the degree to which the auditor intends to rely on, and obtain evidence to support, his belief. Thus, while the auditor may believe control risk to be below, he may decide to obtain evidence to support only a "moderate" or "slightly below maximum" level. This decision is based on the relative effectiveness and efficiency of alternative audit procedures.
(3) This decision is to evaluate whether the intended degree of reliance has been supported by evidence obtained through tests of controls. If not, the auditor may need to revise his belief about control risk and revise the design of substantive tests.
(4) This is to update the auditor's belief about control risk based on evidence obtained. Ordinarily, this would be the same as the initial assessment unless contrary evidence has been obtained.
(5) This approach allows flexibility to design and perform substantive tests either simultaneously with, or subsequent to, tests of controls.

What About Inherent Risk?

An important area that is not addressed by the authors is the consideration of inherent risk. The authors recognize the importance of this issue but do not deal with it in this paper:

SAS 55's expansion of factors to be considered in obtaining an understanding of a client's internal control structure may lead to increased confounding of the inherent risk and control risk assessments. This issue (albeit critical) is beyond the scope of this paper [p. 113, footnote 5].

By "confounding," the authors refer to the overlap of inherent risk and control risk factors. Because the standards provide little guidance on defining inherent risk factors, SAS 55 has included a number of control risk factors which many would say are inherent risk factors. An equally serious or perhaps more serious concern is with the risk assessments. SAS 55 discusses almost exclusively the control risk assessment, as if that assessment alone is responsible for driving the scope of substantive tests. However, the control risk assessment can be very misleading if not considered together with the inherent risk assessment. To illustrate, let's review two cases where inherent risk is substantially different. See the illustration in Figure 8.
In each of the illustrated cases, control risk would be assessed at the maximum using the SAS 55 procedure. But it is very evident that the design of substantive tests would not be the same because of the differences in inherent risk. These cases illustrate that the design of substantive tests should be driven not just by the assessment of control risk but by assessment of both inherent risk and control risk. SAS 55 actually refers to such an approach in paragraph 37:

The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions.

While this appears to provide the appropriate guidance, no further guidance or examples are provided. The SAS 55 guidance with respect to inherent risk is reflected in a simple model in Figure 9. This model reflects the limited guidance in the standards on inherent risk factors and inherent risk assessments. Any future attempts to improve upon the SAS 55 or Audit Guide models should also consider inherent risk.

One approach would be to provide additional, essentially separate, guidance on the identification of inherent risk factors and the assessment of inherent risk. However, I would propose a more integrated approach. Under this approach, rather than making separate assessments of inherent risk
and control risk, the auditor would make a single combined risk assessment. This single assessment would represent the level of risk that remains after considering the level of risk that is created by inherent risk factors and reducing this by the effect of the internal control structure. A single model reflecting this “remaining” risk assessment is presented in Figure 10. Making a combined assessment has several advantages over separate assessments of inherent risk and control risk. In practice, it is difficult if not impossible to separate the consideration of control risk from inherent risk. These considerations are inextricably linked. Making separate assessments is more an exercise in theory than in reality. Further, a combined model would encourage direct consideration of inherent risk factors, rather than assuming the risk to be irrelevant or at the maximum.

Summary

The following is a summary of my remarks. First, SAS 55 can be difficult to understand and apply. While it makes some significant conceptual improvements in the literature, it is rather complex and it will take time before
it is well understood. Papers such as this that contribute to understanding and improving this standard are appreciated. Second, literal interpretations of SAS 55 can be misleading. This SAS should be viewed more as a conceptual document rather than one that can be read literally. The Audit Guide is more useful for understanding the procedures to be followed. Third, the belief-based approach introduced by the authors is a very good model particularly in its separation of the control risk assessment from the reliance judgment. Finally, any effort to improve the SAS 55 model should also integrate the consideration of inherent risk.

References