



SAS No. 145: Understanding the entity and its environment and assessing the risks of material misstatement

Special report

Risk assessment changes are coming. Are you ready?

When you live in a state with extreme heat in the summer, you learn to take advantage of the spring temperatures to get prepared for the hot summer days you know are coming soon. Preparation might include getting your air conditioner serviced, your pool cleaned, and your landscape established. **The same may be said about the new risk assessment standard: changes are coming soon, and you need to take advantage of the time you have now to get prepared.**

Changes are coming soon, and you need to take advantage of the time you have now to get prepared.

In broad terms, risk assessment is a filtering process that allows auditors to focus on potential material misstatements. While a business might have numerous transactions, the auditor's primary concern is whether material misstatements in the financial statements are present. Risk assessment draws the audit focus to potential problem areas using concepts such as significant audit areas, relevant assertions, inherent risk, and control risk.

Statement on Auditing Standards No. 145 (SAS 145), *Understanding the entity and its environment and assessing the risks of material misstatement*, updates the risk assessment standards, and supersedes AU-C 315A of the same name and other risk assessment and audit planning requirements in other AU-C sections. These changes give auditors more clarity on their responsibilities to accomplish their mission of conducting audits in accordance with generally accepted auditing standards; that is, to identify and assess risks of material misstatement, properly respond to those risks, and issue appropriate audit opinions. The standard is principles-based and audit methodology neutral. SAS 145, which is codified at AU-C 315, provides helpful guidance to improve risk assessment processes and related documentation without changing key audit risk concepts.

Practice monitoring programs consistently find that risk assessment problems occur frequently. For example, in recent peer reviews, common matters for further consideration (MFCs) were related to AU-C 315A.

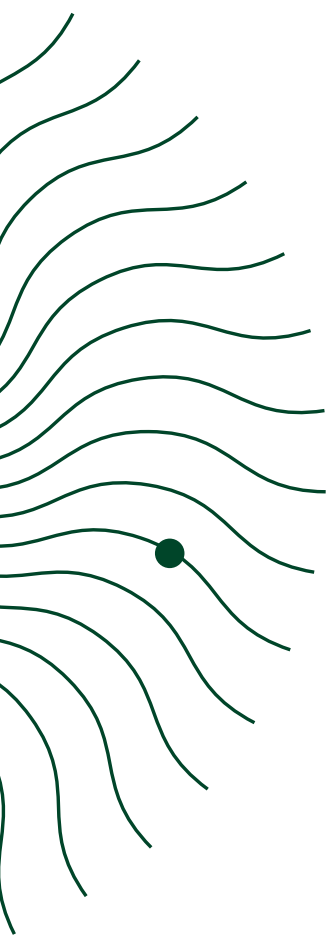
Executive summary

This special report provides insight into the risk assessment changes in SAS 145 and how they will affect your future audits using the PPC methodology.

Following are some of the key points to consider for SAS 145:

Defining key terms. SAS 145 revises and clarifies the definitions of several familiar terms, including *inherent risk factors*, *significant risk*, and *significant classes of transactions*, *account balances*, and *disclosures*. It also introduces new terms and concepts, including the *spectrum of inherent risk* and *identified controls*.

Separate inherent and control risk assessments. SAS 145 requires separate assessments of inherent risk and control risk by assertion. Previously, auditors could assess the combined risk of material misstatement. The PPC methodology continues to provide for separate assessments of inherent risk and control risk, just as it did before SAS 145.



2023 editions of your PPC guides and audit practice aids are updated to reflect requirements for periods ending on or after December 15, 2023.

Inherent risk factors and the spectrum of inherent risk. SAS 145 enumerates specific inherent risk factors to consider and introduces the concept of the *spectrum of inherent risk*. The PPC approach is unchanged upon implementation of SAS 145, using the familiar scale of low, moderate, and high risk to reflect where your assessment falls on the spectrum.

Significant risks. Previously, a significant risk was defined as one requiring special audit consideration, but the new SAS 145 definition highlights likelihood and magnitude of potential misstatements. So, while the previous definition focused on the auditor's planned response, the new definition relates directly to the degree of inherent risk.

Relevant assertions and significant audit areas. Incorporating SAS 145 concepts and terms with PPC audit methodology, a *significant audit area* is a class of transactions, account balance, or disclosure with at least one assertion for which there is assessed inherent risk (i.e., a relevant assertion). An audit area is significant even when that risk is assessed as low. This may present a change on your continuing engagements.

The system of internal control. SAS 145 clarifies certain testing requirements and adds guidance around scalability that may present opportunities for efficiencies.

Identified controls. While SAS 145 still requires an understanding and evaluation of each of the components of internal control, it specifies which controls, referred to throughout the standard and in PPC methodology as *identified controls*, the auditor is required to evaluate for effective design and implementation with procedures beyond inquiry.

General IT controls. SAS 145 enhances guidance around general information technology (IT) controls, clarifying the auditor's responsibilities around aspects of the IT environment that support identified controls, including the identification of related risks arising from the use of IT and the general IT controls that address such risks.

Assessing control risk. Under SAS 145, when you do not plan to test internal controls for operating effectiveness, control risk for the related assertions is assessed at the maximum. While this is unchanged from extant guidance, SAS 145 now specifies that in such cases, the combined risk of material misstatement is then assessed at the same level as the assessment of inherent risk. This last point is a clarification in SAS 145 that may affect your risk assessment on continuing engagements.

Other highlights. SAS 145 also addresses the increasing complexity of entities and audit tools, scalability, and professional skepticism.

SAS 145 and the related conforming amendments to other AU-C sections are effective for audits of financial statements for periods ending on or after December 15, 2023. The 2023 editions of your PPC guides and audit practice aids are updated to reflect these requirements.

Changes in key terms and concepts

SAS 145 revises the definitions of several existing terms and introduces new terms and concepts. Let us review some of these key terms in the following table before we jump into the requirements of the standard.

Control risk	<i>Control risk</i> , according to AU-C 315.04, is the risk that potential material misstatement in an assertion about a class of transactions, account balance, or disclosure, by itself or in combination with other misstatements, wouldn't be timely prevented, or detected and corrected, by the system of internal control.
Identified controls	<p>Certain internal controls for which SAS 145 requires the auditor to evaluate the design and determine implementation via procedures beyond inquiry. These <i>identified controls</i> include the following:</p> <ul style="list-style-type: none"> • Controls addressing significant risks • Controls over journal entries or similar adjustments • Controls for which the auditor plans to test operating effectiveness, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence • Other controls based on auditor judgment.
Inherent risk	SAS 145 places greater emphasis on the assessment of inherent risk. According to AU-C 315.04, <i>inherent risk</i> represents the susceptibility of an assertion about a class of transactions, account balance, or disclosure to misstatement that could be material, by itself or in combination with other misstatements. Inherent risk is determined before considering related controls.
Relevant assertion	A <i>relevant assertion</i> has an identified risk of material misstatement. AU-C 315.12 notes a risk of material misstatement occurs when there is a reasonable possibility (i.e., more than remote) of a misstatement occurring (likelihood) and, if it does occur, a reasonable possibility of it being material (magnitude). Relevant assertion determination only considers inherent risk; before considering related control risk.
Significant class of transactions, account balance, or disclosure	A class of transactions, account balance, or disclosure is significant if there is at least one relevant assertion. In PPC terminology, this is called a <i>significant audit area</i> .
Significant risk	<i>Significant risks</i> represent identified risks of material misstatement at the higher end of the spectrum of inherent risk, based on the degree of inherent risk factors impacting the likelihood and magnitude of potential misstatement. Significant risks also include certain other risks defined as such in the other sections of the auditing standards, such as fraud risks and related party transactions that are also significant unusual transactions.
Spectrum of inherent risk	The <i>spectrum of inherent risk</i> is the scale of the degree to which the level of inherent risk varies. It provides a frame of reference for determining the significance of the combined likelihood and magnitude of a misstatement.
System of internal control	The <i>system of internal control</i> is the system that those charged with governance, management, and other personnel designed, implemented, and maintained to provide reliable financial statements, effective operations, and compliance with laws and regulations.

Now that we have familiarized you with these key terms and concepts, let us look at the requirements of the new standard and how those changes may affect your audit.

PPC's audit methodology continues to provide a separate assessment of inherent risk and control risk to arrive at a combined risk of material misstatement assessment that assists you in determining audit procedures to respond to those risks.

Separate inherent and control risk assessments

SAS 145 requires separate assessments of inherent risk and control risk by assertion.

Previously, auditors could assess the combined risk of material misstatement and were not required to assess inherent risk and control risk separately. **The PPC methodology continues to provide for separate assessments of inherent risk and control risk, just as it did before SAS 145.** PPC's audit methodology continues to provide a combined risk of material misstatement assessment to assist you in determining audit procedures to respond to those risks.

SAS 145 clarifies a point regarding the determination of the combined risk of material misstatement. As in previous guidance, when the auditor elects not to test internal controls for operating effectiveness, SAS 145 requires the auditor to assess control risk at the maximum. **However, the standard now specifies that in such cases, the combined risk of material misstatement is to be assessed at the same level as the assessment of inherent risk.** With this new clarification, in the PPC methodology when inherent risk is assessed as Low, and you do not intend to test operating effectiveness of controls, the result will be a combined risk of material misstatement of Low to match the inherent risk level. This is discussed further when we delve into assessing control risk later in this special report.

Consequently, the inherent risk assessment is vital in determining audit responses. Assessing inherent risk higher than necessary means you will likely plan and perform unnecessary work. Setting it lower than is merited means your planned response may not provide sufficient appropriate audit evidence.

Practical consideration: The combined risk of material misstatement calculations presented in PPC's Risk Assessment Summary Form at CX-7.1 are intended as a guide. Risk assessment is ultimately based on the auditor's professional judgment and may vary based on the facts and circumstances unique to each engagement. Use your judgment in determining the combined risk of material misstatement for your audits.

Next, let's break down how the auditor assesses inherent and control risk under SAS 145.

Inherent risk factors and the spectrum of inherent risk

Inherent risk at the assertion level for a particular risk of material misstatement is evaluated in terms of degree. The degree of inherent risk may range from lower to higher on what SAS 145 refers to as the *spectrum of inherent risk*. The evaluation of where in the range the assessment falls (i.e., where on the spectrum of inherent risk), considers the likelihood and magnitude of the misstatement and the relevant inherent risk factors. The PPC audit methodology uses low, moderate, and high to reflect where your assessment falls on the spectrum of inherent risk. This approach is unchanged upon implementation of SAS 145. **A key point to remember is that inherent risk is assessed before considering any related controls.**

The inherent risk factors enumerated in SAS 145 include:

- Complexity
- Subjectivity
- Change
- Uncertainty
- Susceptibility to fraud

These are common risk factors that inherently affect the probability of misstatement. Appendix B of SAS 145 explains each of these characteristics and provides examples of events and conditions that may indicate risks of material misstatement at the assertion level. For example, an estimate calculation may be complex, subjective, and easily manipulated, putting it close to the upper end of the spectrum of inherent risk. Moreover, the estimate could be a significant risk, as discussed below.

Practical consideration: The optional “Inherent Risk Assessment Form” at CX-7.2 has been revised to address these inherent risk factors and is a useful tool to assist you in evaluating how these factors affect your inherent risk assessment and determinations of significant audit areas and significant risks.

Significant risks

SAS 145 modifies the definition of and requirements relating to significant risks. **Previously, a significant risk was defined as one requiring special audit consideration, but the new SAS 145 definition highlights likelihood and magnitude of potential misstatements.**

In other words, the old definition of a significant risk focused on the auditor’s planned response to the risk rather than the risk itself. Under the new definition, significant risks are identified risks with an assessed inherent risk near the upper end of the spectrum of inherent risk. The standard also clarifies that the significant risk determination is based on the inherent risk assessment, which does not consider control risk.

The definition of significant risks also includes those required to be treated as a significant risk in other AU-C sections, such as fraud risks, related-party transactions that are also significant unusual transactions, and any other risks expressly defined as significant in other sections of the auditing standards.

Another change in SAS 145 is that auditors are no longer required to determine whether an overall financial statement level risk is a significant risk. Even so, financial statement level risk can affect an auditor’s determination of significant risks at the assertion level. For example, management override of controls, which is treated as a fraud risk, and therefore a significant risk, per AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, could also affect the risk assessment related to assertions for a number of transactions, account balances, and disclosures.

Often, multiple inherent risk factors are in play, but even one inherent risk factor can create a significant risk. For example, estimation uncertainty as a single inherent risk factor can result in inherent risk close to the upper end of the spectrum of inherent risk for the valuation assertion, resulting in a significant risk.

The new SAS 145 definition highlights likelihood and magnitude of potential misstatements.

Practical consideration: In addition to SAS 145, the 2023 editions of your audit guides and practice aids also incorporate the requirements of SAS No 143, *Auditing Accounting Estimates and Related Disclosures*. Both standards address risk assessment requirements related to accounting estimates, which have been incorporated in the “Estimates Identification and Retrospective Review” at CX-3.6.

Because auditors evaluate risk in relation to assertions within each significant class of transactions, account balance, or disclosure, we need to know how SAS 145 addresses these.

Relevant assertions and significant audit areas

An entity makes certain assertions when it includes classes of transactions, account balances, and disclosures in its financial statements, such as the assertions that transactions occurred (Occurrence), the amounts in account balances exist (Existence), and those amounts are appropriately valued (Valuation). But only some assertions are *relevant*, and those relevant assertions indicate a significant class of transactions, account balance, or disclosure (or *significant audit area* in PPC terminology) for purposes of your audit. Incorporating SAS 145 concepts and terms with PPC audit methodology, a *significant audit area* is an audit area with at least one assertion for which you have assessed inherent risk, even if that risk is assessed as low. This may present a change on continuing engagements. Let’s discuss each of these concepts further.

Relevant assertions. A relevant assertion is an assertion about a class of transactions, account balance, or disclosure with an identified risk of material misstatement. The determination of whether an assertion is relevant is made *prior* to considering any related controls. In other words, the determination is based on inherent risk.

The SAS 145 definition of a relevant assertion emphasizes likelihood and magnitude of a potential misstatement. In the context of SAS 145, *likelihood* means there is reasonable possibility of a misstatement occurring. *Magnitude* means that if the misstatement were to occur, there is a reasonable possibility of it being material. For example, the existence assertion for cash is relevant if there is a reasonable possibility (likelihood) of a material (magnitude) misstatement. SAS 145 states that *reasonable possibility* means *more than remote*. So, identified risk is present when the likelihood of risk of material misstatement for a particular assertion is more than remote.

As previously stated, the inherent risk determination is made before consideration of control risk. When assessing the inherent risk of the existence assertion for cash, the preparation and review of monthly bank reconciliations is not considered. Instead, you would consider inherent risk factors, such as complexity and subjectivity, of the account balance.

For an identified risk of material misstatement, documentation is required of the rationale for significant judgments related to the inherent risk, especially when such judgments are not otherwise apparent. Documentation of the rationale for such judgments is a new requirement of SAS 145. So, how much detail is required? As always, the documentation should be sufficient to enable an experienced auditor with no experience with the audit to understand the reasons for the judgment.

Significant classes of transactions, account balances, and disclosures. Now that we know how a relevant assertion is defined in SAS 145, let's look at which classes of transactions, account balances, and disclosures you need to address in your audit. Pre-SAS 145 auditing standards did not define this term. SAS 145 states that a class of transactions, account balance, or disclosure is significant when there are one or more relevant assertions.

The PPC audit methodology calls classes of transactions, account balances, or disclosures *audit areas*, a term familiar to PPC users. So, incorporating the concepts discussed thus far with PPC methodology, a *significant audit area* is an audit area with at least one assertion for which you have assessed inherent risk (a relevant assertion), even if that risk is assessed as low.

For PPC users, a significant audit area is an audit area with at least one assertion for which you have assessed inherent risk (a relevant assertion), even if that risk is assessed as low.

For PPC users, a *significant audit area* is an audit area with at least one assertion for which you have assessed inherent risk (a relevant assertion), even if that risk is assessed as low. This may present a change from pre-SAS 145 practice and auditors will likely need to re-evaluate this on continuing engagements.

Practical consideration: Auditors will likely need to revisit their determination of significant audit areas for continuing engagements. After implementation of SAS 145, any audit area for which there is at least one assertion with assessed inherent risk is a *significant audit area* using the PPC methodology.

The SAS 145 concept of significant classes of transactions, account balances, or disclosures (i.e., significant audit areas) provides a basis for the scope of the auditor's work. The following procedures should be performed for significant audit areas:

- Gain an understanding of the entity's system of internal control, including information-processing activities
- Identify and assess the risks of material misstatement
- Plan and perform audit procedures to respond to those risks

Practical consideration: You may notice that in some of your 2023 audit guides and practice aids, certain pre-populated audit areas have been disaggregated to allow for more robust risk assessment. For example, the inherent risk associated with an entity's goodwill and intangibles assets would likely be significantly different than that of prepaid expenses and other assets. This disaggregation is not intended to create additional audit effort, as the nature and extent of procedures for each area remain the same. It may, however, result in efficiencies by encouraging more precise risk assessment and audit response.

As always, in the PPC methodology, a limited approach — that is, limited to preliminary and final analytical procedures, as well as other risk assessment procedures — is *not* appropriate for a significant audit area. Let's look at why that is the case.

In connection with this change, SAS 145 includes a new provision at AU-C 315.40 requiring an evaluation of whether the significant audit area determinations are complete.

Significant audit areas and the stand-back requirement. A significant change in the conforming amendments to SAS 145 is that AU-C 330.18 now requires substantive procedures for each relevant assertion for each *significant* class of transactions, account balances, and disclosures (i.e., each significant audit area), regardless of the assessed level of control risk. In other words, risk assessment procedures and control testing cannot provide sufficient appropriate audit evidence for a relevant assertion. Before SAS 145, the auditor was required by AU-C 330.18 to perform substantive procedures for all relevant assertions for each *material* class of transactions, account balances, and disclosures, regardless of the assessed risk of material misstatement. This means that while you may have more audit areas designated as significant under the amended guidance, you may also be able to eliminate substantive testing on a material audit area if that area has no relevant assertions (i.e., there is no identified inherent risk for any assertion).

In connection with this change, SAS 145 includes a new provision at AU-C 315.40 requiring an evaluation of whether the significant audit area determinations are complete. After identifying significant audit areas (i.e., those with relevant assertions), you are required to “stand back” and consider whether the determination that a material audit area is not significant remains appropriate. To do this, you will evaluate the assessed risk of material misstatement and the appropriateness that a material audit area is not a significant audit area. Let’s look at an example.

Consider an entity that has a material account balance for property and equipment, as well as material depreciation expense. Under the previous standards, the auditor would be required to perform some form of substantive testing on this material audit area. However, under the new standard this may not be necessary. In this example, the auditor has performed the following risk assessment procedures:

- Inquiries of management, which indicate that there have been no significant additions or disposals during the year. Furthermore, they are not aware of any indicators of impairment, such as idle equipment.
- Review of board meeting minutes, significant contracts, and the interim financial statements, which corroborate this.
- Preliminary analytical procedures that indicate that the account balance only changed by the depreciation expense amount, which is consistent with both the prior year and with the auditor’s expectations.

In this example, the procedures performed during risk assessment provide sufficient appropriate audit evidence to indicate that the likelihood of material misstatement for this audit area is remote. As such, the auditor could determine that this is *not* a significant audit area, and no further audit response is required.

Practical consideration: The authors recommend using the linkage/comments fields in the “Risk Assessment Summary Form” at CX-7.1 to document the rationale for material audit areas deemed not significant as an efficient way to meet the requirements of the stand-back provision. We have also added a procedure to the Audit Program for General Planning Procedures at AP-10 for this new requirement.

So far, we have focused on inherent risk, but SAS 145 also has quite a bit to say about your responsibilities regarding internal controls.

The system of internal control

SAS 145 replaces the term *internal control* with *system of internal control*. AU-C 315.12 enumerates the components of the system of internal control as follows:

1. Control environment
2. The entity's risk assessment process
3. The entity's process to monitor the system of internal control
4. The information system and communication
5. Control activities

While SAS 145 does not prescribe the use of a particular internal control framework, the five components identified by the standard are essentially the same as the five components of COSO's 2013 Internal Control – Integrated Framework (COSO framework) and will already be familiar to PPC users. SAS 145 explains that management or the auditor may use COSO, another internal control framework, or no framework at all, as long as all the five components are addressed.

Consistent with previous guidance, the auditor is still required to obtain an understanding of each internal control component to evaluate the system of internal control. The auditor is also still required to evaluate the design and determine implementation of certain controls; however, SAS 145 provides more clarity regarding which controls are subject to this requirement. These are referred to as *identified controls*, and we will discuss these further later.

Practical consideration: In the PPC methodology, the “Understanding and Evaluating the System of Internal Control” form and the other Internal Control Documentation forms (located in the CX-4 series), are still used for these requirements and have been updated to reflect the requirements of SAS 145.

SAS 145 explains that management or the auditor may use COSO, another internal control framework, or no framework at all, as long as all the five components are addressed.

SAS 145 also provides useful application guidance, promoting scalability and recognizing that while some systems of internal control may not be well defined, they may still be sufficient. Less complex entities might use simple or less structured internal controls to achieve their control objectives. As such, the nature, timing, and extent of the auditor's procedures that would be necessary to understand and evaluate the components of the entity's system of internal control will vary based on the entity's complexity, size, nature of controls, the use of IT, and documentation of controls.

When addressing scalability, SAS 145 focuses on complexity of an entity rather than its size because small entities may be complex, while large entities may have simple accounting systems. So, the entity's size may not correlate with complexity. Regardless, complexity is what drives the scalability of the auditor's internal control documentation. More complex accounting systems will generally require more internal control documentation. Let's look at an example.

The accounts payable process at a less complex entity may not be optimal, but the controller's daily review of that department's activities (a control activity) may lower the risk of material misstatement. Though the entity might not have written accounts payable procedures, the auditor can understand the system of internal control with inquiries, observations, and inspections.

Identified controls

Not all controls are equal. While SAS 145 still requires an understanding and evaluation for each of the five components, it specifies which controls, referred to throughout the standard and in PPC methodology as *identified controls*, the auditor is required to evaluate for effective design and implementation via procedures beyond inquiry.

Identified controls include the following:

- Controls addressing significant risks
- Controls over journal entries or similar adjustments
- Controls for which the auditor plans to test operating effectiveness, including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence
- Other controls based on auditor judgment

For each identified control, you also need to consider risks arising from the entity's use of IT and identify general IT controls that address those risks.

Practical consideration: PPC's audit tools include a new practice aid, "Internal Control Documentation—Evaluation of the Design and Implementation of Identified Controls," to guide auditors through the related requirements. In addition, the "Internal Control Documentation—IT Environment and General IT Controls" practice aid has been updated to address new SAS 145 requirements for IT applications and other aspects of the IT environment that support identified controls, the identification of related risks arising from the use of IT, and the general IT controls that address such risks.

SAS 145 requires documenting the evaluation of the design and determination of implementation of identified controls.

Identified controls are direct controls, i.e., those that address risk of material misstatement at the assertion level; they are most often identified as information-processing controls, or controls relating to the processing of information in IT applications or manual processing found in the information system component of the system of internal control. However, you may also identify controls within the entity-level components that address risk at the assertion level. SAS 145 requires documenting the evaluation of the design and determination of implementation of identified controls. So, keep this in mind as you perform walkthroughs or other reviews of the system of internal control.

Additionally, SAS 145 highlights the potential for identifying control deficiencies while performing risk assessment procedures. Why? Because significant deficiencies or material weaknesses identified at this stage directly affect the auditor's risk assessment and response.

IT controls

SAS 145 addresses risks that arise from the use of IT and general IT controls. *Risks arising from the use of IT* refers to the risk that information-processing controls are improperly designed or ineffectively operating, or that the integrity of information in the entity's information system is compromised, due to ineffective design or operation of IT controls.

Risks arising from the use of IT increase with the complexity of the IT application.

Risks arising from the use of IT increase with the complexity of the IT application. For example, stand-alone “off-the-shelf” software is often lower risk, while customized, interfaced applications increase the risk of material misstatement. Risks arising from the use of IT may also increase with emerging technologies, such as blockchain and artificial intelligence. Therefore, when applicable, you need to consider the risk of material misstatement in light of more complex IT applications.

Additionally, you are required to identify general IT controls and evaluate their design and implementation for those that address risks arising from the use of IT related to other identified controls. General IT controls exist related to the processes to manage access, manage program or other changes to the IT environment, and to manage IT operations. Examples of general IT controls related to these processes include the provisioning and deprovisioning of users; change management processes to design, program, test, and migrate changes to the end user environment; and backup and restoration procedures.

For example, suppose you determined that an automated three-way match is an identified control in accounts payable, addressing the accuracy assertion. You would be required to identify risks arising from the use of the application for the three-way match, such as inappropriate access to the application, or inappropriate changes to the program logic. You would then consider whether existing general IT controls are in place to address such risks, such as authorization controls to restrict access to the IT application, physical security, and appropriate change management protocols for the IT application.

Assessing control risk

SAS 145 requires a separate assessment of inherent risk and control risk.

As previously discussed, SAS 145 requires a separate assessment of inherent risk and control risk. You may assess control risk at high even when controls appear to be designed and implemented appropriately. Why? Because you plan to use a fully substantive audit approach and not test controls for operating effectiveness. One common reason for using substantive procedures rather than testing operating effectiveness of controls is the perception that a fully substantive approach is more efficient and, as a result, more cost-effective.

If you elect not to test internal controls for operating effectiveness, SAS 145 requires control risk to be assessed at the maximum level, which is unchanged from extant guidance. However, as previously noted, SAS 145 now specifies that in such cases, the combined risk of material misstatement is assessed at the same level as the assessment of inherent risk.

Not all maximum control risk assessments, however, result in the same audit responses. When designing the audit response, you need to draw on the understanding you obtained of the entity’s system of internal control and the results of your evaluation of design and implementation of identified controls. Consider, for example, an entity with one accountant who signs checks, posts transactions, reconciles bank statements, and creates financial reports. In a second example, suppose the entity has well-designed controls implemented throughout the audit period with appropriate segregation of duties. If you, as the auditor, decide not to test controls for operating effectiveness, control risk is maximum in both scenarios; however, all other factors being equal, your planned substantive procedures for the first example would likely be more extensive than those for the second based on your understanding of the entity’s system of internal control and evaluation of design and implementation of the identified control, which in this case would be proper segregation of duties.

Now that we have addressed the changes that SAS 145 makes to your risk assessment process, let’s look at some other aspects of the new standard.

Increasing complexity of entities and audit tools

Businesses and auditors operate in an ever-changing world of evolving economic, technological, and regulatory change. SAS 145 provides application guidance to address such changes, including:

- Remote observations of inventory with video cameras or drones
- The use of data analytics software and visualization techniques
- Performing risk assessment on large volumes of data using automated tools and techniques

Scalability and complexity

SAS 145 removes the *Considerations Specific to Smaller Entities* sections in the previous risk assessment standard, but it includes scalability information elsewhere in the standard. Complexity, rather than the size of the entity, drives the scale of the audit. Scalability means an audit for a complex entity will look quite different than one for a non-complex entity. The higher the risk of material misstatement, regardless of the entity's size, the greater the response (the nature and extent of procedures and documentation).

Complex entities require more extensive risk assessment procedures.

The nature and circumstances of the entity affect the nature and extent of risk assessment procedures. Complex entities require more extensive risk assessment procedures. For example, more work needs to be performed to understand the system of internal control of entities with complicated accounting systems.

Practical consideration: For more information on scalability in SAS 145, see the March 2023 edition of *PPC's Accounting and Auditing Update*, available on Checkpoint®.

Professional skepticism

SAS 145 stresses the auditor's need to maintain professional skepticism in applying risk assessment procedures by:

- Emphasizing understanding the entity and its environment as a basis for exercising professional skepticism
- Clarifying that understanding the applicable financial reporting framework is foundational to professional skepticism
- Underscoring the benefits of maintaining professional skepticism in the engagement team discussion
- Noting the potential for contradictory evidence in risk assessment procedures

SAS 145 advises auditors to consider all audit evidence, including contradictory information. It's okay for risk assessment procedures to yield conflicting information. For example, the sales supervisor may say that sales declined substantially, but the CFO asserts that sales increased twenty percent. The standard suggests that such differences are a normal part of risk assessment. However, professional skepticism calls the auditor to explore conflicting information. In our example, the sales supervisor may be focusing on one segment of the business, while the CFO is considering the entity as a whole. **It is up to the auditor to dig deeper when presented with contradictory responses.**

Effective date

SAS 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. The 2023 editions of the PPC audit guides and practice aids incorporate SAS 145. To accommodate a more robust risk assessment, enhancements have also been made to PPC's SMART Practice Aids and Checkpoint Engage. While there will be enhancements in your risk assessment process, including the understanding of the entity, the entity's system of internal control, and identification of significant audit areas, the basic PPC methodology will not significantly change.

Related resources

For more resources on this topic, see our series of articles in the 2023 editions of the Audit and Accounting Update (PPC) newsletter available on Checkpoint, our [SAS 145 blog posts](#), and the [on-demand webcast](#) featuring folks from AuditWatch and Checkpoint Editorial.

