

Statements on Auditing Standards Nos. 104-111

BOLD items denote additional auditor requirements; ***BOLD ITALICS*** denote management considerations.

SAS 104 through 111 bring sweeping changes and provide definitive guidance for the conduct of audits and for the Authority **must be implemented for the 9-30-08 audit year**.

Change in terminology: *significant deficiencies* replaces *reportable conditions* in the independent auditor's report on internal control.

SAS 104 and 105 amend SAS 1 and SAS 95, respectively, and are administrative in nature, addressing codification of auditing standards and generally accepted auditing standards.

SAS 106 replaces the former model of 5 management assertions with **13 management assertions** (see Exhibit 1) in three categories: assertions about classes of transactions and events for the period under audit, assertions about account balances at period end, and assertions about presentation and disclosure.

SAS 107

- introduces *risk of material misstatement* as an auditor's combined assessment of inherent risk and control risk;
- provides **additional requirements for evaluating audit findings**;
- expands guidance for communicating misstatements to management; and
- makes the consideration of audit risk and materiality for financial statement purposes **an unconditional requirement**, rather than merely presumptively mandatory. **An auditor must consider audit risk and materiality** for the purposes of:
 - Determining the nature and extent of risk assessment procedures;
 - Identifying and assessing the risks of material misstatement;
 - Determining the nature, timing, and extent of further audit procedures; and
 - Evaluating whether the financial statements are fairly presented.

SAS 108:

- expands previous guidance on audit planning; and
- **greatly expands matters to be considered** in establishing the overall audit strategy, as well as in establishing the audit plan.

NOTE: The intent is that the auditor obtain an in-depth understanding of the entity and its environment, including its internal controls, in order to assess the risk that the financial statements might be materially misstated. Exhibit 2 indicates that the **auditor must obtain an understanding of five aspects of the client's circumstances through the application of these risk assessment procedures: inquiries, analytical procedures, observation, and document inspection.**

The auditor must then:

- identify risks (and any related controls) ;
- determine what could go wrong at the relevant assertion level; and
- consider the potential magnitude and probability that the financial statements could be materially misstated;
- determine whether identified risks of material misstatement are related to specific relevant assertions (e.g., classes of transactions, account balances, and disclosures), or more pervasively to the financial statements as a whole

NOTE: Higher levels of financial statement risk often derive from a weak control environment. The resultant risk assessment may then establish a link to responsive audit procedures.

An effective control environment and the reliability of internally generated audit evidence may allow the auditor to perform some audit procedures at an interim date. An auditor cannot use inquiry alone to test the operating effectiveness of controls, and should combine inquiry with document inspection or reperformance to provide more assurance. NOTE: Thorough and accurate documentation by the auditee of internal controls is a critical component of determining the reliability of “internally generated audit evidence.”

Both SAS 109 and 110 **significantly expand auditors’ documentation requirements.**

SAS 109:

- Members of the audit team must hold brainstorming sessions to discuss the susceptibility of the financial statements to material misstatement and can be held concurrently with discussions concerning fraud risks, as required by SAS 99;
- significant risks, which will exist in most audits, are defined as those risks the auditor identifies in the risk assessment as requiring special audit consideration. **An auditor must consider the inherent risk, the magnitude of potential misstatement (including the possibility the risk might lead to multiple misstatements), and the likelihood of the risk occurring;**
- an auditor should evaluate the design of entity controls related to significant risks and determine whether those have been implemented;
- **management should be able to prove its awareness of all significant risks by addressing the areas in its documentation of control procedures - the auditor will be interested in how management responds and whether control activities have been implemented to address those risks.**

SAS 110 now requires an auditor to document the linkage between assessed risks and resultant audit procedures:

- Provides additional guidance as to the applicability of substantive analytical procedures in responding to assessed risks;
- **an auditor should consider the reasons for conclusions regarding the assessment of risk of material misstatement**

SAS 111 amends SAS 39 regarding audit sampling and requires expanded documentation by the auditor.

EXHIBIT 1
**Relevant Assertions Used
by the Auditor**

**Assertions About Classes of
Transactions and Events for the
Period Under Audit:**

- Occurrence
- Completeness
- Accuracy
- Cutoff
- Classification

**Assertions About Account Balances
at Period End:**

- Existence
- Rights and obligations
- Completeness
- Valuation and allocation

**Assertions About Presentation and
Disclosure:**

- Occurrence and rights and obligations
- Completeness
- Classification and understandability
- Accuracy and valuation

EXHIBIT 2
 Understanding the Entity and Its Environment, Including Its Internal Controls

Required Understanding of Five Aspects	Audit Risk Assessment Procedures Performed to Obtain an Understanding of the Entity and Its Internal Controls
<p><i>Industry, regulatory, and other external factors:</i></p> <ul style="list-style-type: none"> ■ Industry conditions—market and competition, supplier and customer conditions, and technology issues relating to entity products ■ Regulatory environment—legal, regulatory, political, environmental requirements, and accounting principles and industry practices ■ General economic conditions—business cycle conditions, monetary policy, and fiscal policy 	<p><i>Understanding of the five aspects is obtained through:</i></p> <ul style="list-style-type: none"> ■ Inquiries of management, those charged with governance, internal audit, other client personnel, and external counsel, as well as reviewing external reports ■ Analytical procedures, considered along with other information gathered in identifying risks of misstatement ■ Observation; document inspection; reading management, internal audit, and governance reports; tracing transactions through the system; visits to premises and plant facilities
<p><i>Nature of the entity:</i></p> <ul style="list-style-type: none"> ■ Operations, revenue sources, markets ■ Investments and ownership ■ Financing, debt, leasing, and related parties ■ Financial reporting considerations 	
<p><i>Objectives, strategies, and related business risks that may result in material misstatements at:</i></p> <ul style="list-style-type: none"> ■ Financial statement level, or ■ Individual assertion level 	
<p><i>Measurement and review of financial performance:</i></p> <ul style="list-style-type: none"> ■ Performance benchmarks that management and others consider important (e.g., key ratios and performance measures) ■ Performance measures that may create incentives for management to misstate the financial statements (e.g., bonuses, options) 	
<p><i>COSO internal control components:</i></p> <ul style="list-style-type: none"> ■ Control environment ■ Entity's risk assessment process ■ Information system, including business processes relevant to financial reporting and communication ■ Control activities ■ Monitoring of controls 	