A MODEL FOR EXPANDING THE ATTEST FUNCTION

Beyond the financial statements—progress with protection for all.

by Martin C. Stilwell and Robert K. Elliott

Accountants are being asked more and more frequently to attest to the reliability of a widening variety of assertions. Recent examples include attesting to the accuracy of schedules of retailing space in a shopping center, union election results, statistical survey results, market feasibility data and data underlying insurance claims.

While the demand for attest services burgeons, however, accountants are sometimes hesitant to expand the scope of their services because, in many of these new areas, there is little or no authoritative guidance.

In 1968 the American Institute of CPAs adopted a set of objectives, published in *Achieving the Profession's Objectives.* One objective endorses efforts to encourage and accommodate future expansion of the attest function: "To identify those areas in society where the need for the CPA's attest function exists and to assist [the Institute's] members in equipping themselves to perform the attest function wherever a useful social purpose would be served." This objective is now part of the AICPA's bylaws and has been integrated into the charge of the auditing standards board (ASB).

As part of its response to this charge, the ASB, in conjunction with the accounting and review services committee (ARSC), in February 1985 issued an exposure draft of a proposed statement, *Attestation Standards.* (The comment deadline is June 14, 1985.) The proposed standards are designed to ensure that the expansion of the attest function will be orderly and professional; it is also intended that the document will obviate the need to define procedures for every conceivable subject at various levels of assurance.

A generalized risk model of the type described in Statement on Auditing Standards no. 47, *Audit Risk and Materiality in Conducting an Audit,* is the linchpin of the proposed standards. This article discusses how the risk model provides a conceptual basis for the proposed standards (we think of them as "generally accepted attestation standards"), one that will permit an orderly growth of the attest function while protecting the profession and the users of assertions.

The SAS No. 47 Risk Model

SAS no. 47 (paragraph 2) defines *audit risk* as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." The statement requires the auditor (attester) to limit audit risk to a level that is, in the attester's professional judgment, appropriately low for issuing an opinion on the financial statements. Because the evidence the auditor gathers generally relates to account balances and classes of transactions, the SAS also describes audit risk as it applies to these items. The description treats audit risk at the account-balance or class-of-transactions level as a combination of inherent, control and detection risks.

The definitions of the three risk elements (paragraph 20) are intended to be mutually exclusive and collectively exhaustive:

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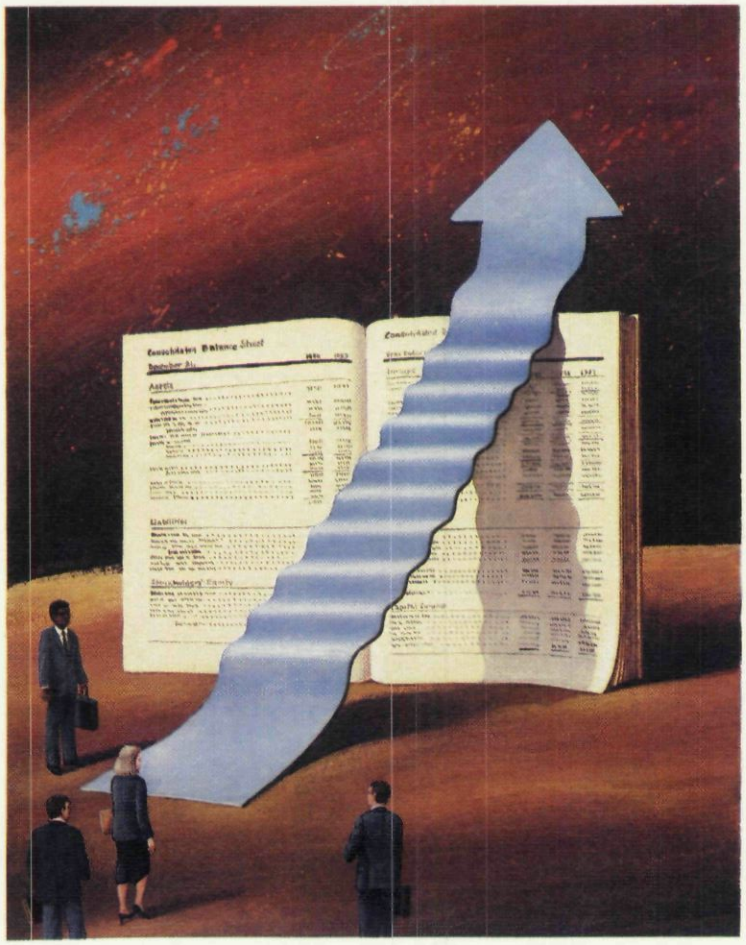
☐ Inherent risk is the risk, assuming no related internal accounting controls, that an account balance or a class of transactions contains error that could be material when aggregated with error in other balances or classes.

☐ Control risk is the risk, given that an account balance or a class of transactions contains error that could be material when aggregated with error in other balances or classes, that the control system wouldn't prevent or detect such error.

☐ Detection risk is the risk that the audit procedures will lead the attester to conclude that error in an account balance or a class of transactions that could be material, when aggregated with error in other balances or classes, doesn't exist when in fact it does.



It can be seen from these definitions that the risk model is an organizing concept for the auditor's efforts to plan and execute effective, efficient audits. The attester is given an audit objective and a method to relate planned audit procedures and resulting evidence to the objective. The model is a useful conceptual tool for evaluating the sufficiency of evidence related to a financial statement assertion.

Given the auditor's assessments of inherent and control risks, there can be an evaluation of the sufficiency of the specific procedures to restrict detection risk for the assertion. In the course of this evaluation, the auditor can select the combination of procedures believed to be most efficient in the circumstances. This approach is feasible because the model doesn't restrict the procedures that the auditor can select.

Broadening to Other Assertions

Although the SAS risk model ostensibly applies only to audits of historical financial statements, it can easily be made applicable to attest engagements involving other types of assertions. (See the sidebar on page 68.) This expansion can be accomplished by deleting the explicit and implicit references to audits of historical financial statements contained in the model's definitions of the risk components.

In this way inherent risk becomes the risk that an assertion, assuming no control procedures to prevent or detect error in the assertion, contains material error. Control risk becomes the risk that the procedures the asserter established to prevent or detect material error in the assertion wouldn't detect or correct material error. And detection risk becomes the risk that the auditor's procedures would lead the attester to conclude that material error in an assertion doesn't exist when in fact it does.

Thus, the risk model becomes an organizing concept for the attester's efforts to plan effective, efficient attest engagements in general. The model permits the attester to use any effective combination of procedures to attain the engagement objective, thereby preserving the advantage of allowing the attester to select the most efficient combination of procedures to meet the standard.

Broadening to a Moderate Level of Assurance

As we've noted, the SAS requires the auditor to restrict audit risk to a low level that is appropriate for issuing an opinion on the finan-

cial statements. Clearly there is a need to develop standards for future attest engagements providing the equivalent of an audit opinion with respect to other types of assertions (reports that provide a high level of assurance).

It is likely that standards will also be necessary for attest engagements that provide only a moderate level of assurance. In fact, such engagements already exist—for example, interim financial statement review, which doesn't result in an auditor's report that expresses assurance equivalent to an unqualified opinion. It would be easy to apply the broadened risk model to engagements to attain a moderate level of assurance. The attester would be required to restrict attestation risk to a moderate level appropriate for issuing a report imparting moderate assurance. No other changes would be necessary.

The proposed standards provide assistance to attesters in making the risk model operational for attest engagements designed to limit risk to a moderate level. The proposed standards say that generally it is possible to perform only inquiry and analytical procedures to restrict risk to this level. This is desirable because such procedures usually are the least expensive.

The inquiries and analytical procedures could be directed toward inherent and control risks as well as detection risk. For example, procedures directed toward inherent risk might cover the stated qualifications of the asserter in the subject of the assertions, the extent to which a particular assertion is affected by the asserter's judgment, and the past history of error in the assertion. For control risk the attester might ask questions about the asserter's procedures for identifying, recording, classifying and summarizing the items constituting the assertions and the extent to which these procedures are subject to controls. As for detection risk, the attester might perform analytical procedures to identify unusual individual items and relationships.

The proposed standards presume that, if, as a result of performing such procedures or others that are more cost-effective in the circumstances, nothing comes to light that causes the attester to believe that the assertions are incomplete or inaccurate, the auditor would be justified in issuing a standard moderate (negative) assurance report. On the other hand, if, as a result of performing the procedures, the attester believes that the assertions may be incomplete or inaccurate, the auditor should (1) perform those additional procedures deemed necessary to restrict attestation risk to a moderate level or (2) withdraw from the engagement.

The additional procedures might consist of more detailed analytical or any other type of attest procedures (confirmation, for example) if they were judged more efficient or if they were considered necessary in the circumstances. Although, as we've indicated, frequently it would be appropriate for an attester to apply only inquiry and analytical types of procedures in a moderate-assurance engagement, at no point in the engagement would the proposed standards (or the risk model) preclude the auditor from applying the procedures judged to be appropriate.

Some recent attestation engagements

- ☐ Financial forecasts, projections and feasibility studies.
- ☐ EDP software and hardware performance.
- ☐ Internal controls at service and fiduciary organizations.
- ☐ Utility-rate applications.
- ☐ Reorganization and bankruptcy plans.
- ☐ Antitrust case data.
- ☐ Contract costs (especially for cost-plus-fixed-fee contracts).
- ☐ Compliance with contract terms (for example, loan covenants).
- ☐ Regulatory filings.
- ☐ Compliance with government regulations.
- ☐ Lease payment contingencies.
- ☐ Management audits.
- ☐ Royalties (for example, coal, oil and motion pictures).
- ☐ Ad valorem and realty tax bases.
- ☐ Occupancy, attendance and enrollment statistics (for example, apartment buildings and educational institutions).
- ☐ Political contributions and expenditures.
- ☐ Labor negotiations data.
- ☐ Budget compliance.
- ☐ Cost reimbursement (for example, Medicare).
- ☐ Productivity indicators.

Benefits of Applying the Model

Although the risk model can serve as an organizing concept for the auditor's efforts to plan effective, efficient, high- and moderate-assur-

ance attest engagements, its claim to inclusion in the proposed standards rests on more than that. The model helps meet one of the key objectives of a set of generally accepted attestation standards: to provide a framework within which the attest function can expand in an orderly, professional manner.

For the protection of the public and of the profession's reputation, it is desirable that such standards apply to all appropriate attest engagements that are accepted in response to market demand. The proposed standards would set limits for which of these market-

The risk model helps meet a key objective of a set of attestation standards: to provide a framework for orderly expansion of the attest function.

demanded engagements would be done—as the introduction to the exposure draft states and the argument below on boundaries underscores.

The risk model helps meet this objective because it contributes a universally applicable set of planning and evidence-gathering concepts. It can be applied at any risk level to any set of attestable assertions, by either the individual attester or the proper AICPA group, such as the ASB or the ARSC, developing guidance for a nascent attest area.

It is true that substantial judgment will be required to apply the risk model in situations in which, for example, the auditor wants to achieve a high or moderate level of assurance that nonfinancial assertions aren't materially misstated. But the requirement for judgment won't be unique to these situations. A significant amount of judgment is necessary to apply the risk model in an audit of historical cost financial statements, just as the same level of judgment is necessary to apply all the other elements of GAAS.

Even an auditor who believes in using quantitative methods whenever possible in an engagement can't accurately measure the effectiveness of an inquiry procedure in detecting material error or the effectiveness of a system of internal accounting controls in preventing or detecting such error—significant judgment is always required. And even if auditors could accurately measure audit risk at the account-balance or class-of-transactions level, they would be faced with the fact that no rigorous methods exist to combine the risk at the financial statement level—again, substantial judgment is always necessary. There is also no consensus—among users or attesters—on the amount material to the financial statements or, for that matter, on the appropriately low level of risk for issuing an opinion on them.

Despite these limitations, the risk model does provide a useful conceptual basis for analyzing the procedures necessary for an effective audit engagement. We believe that it can also be extended to provide a conceptual basis for analyzing the procedures necessary for an effective attest engagement on other assertions. It would be inconsistent to maintain that professionals capable of designing a set of procedures to achieve a high level of assurance on one set of assertions (historical financial statements) aren't capable of designing procedures to achieve a high or moderate level of assurance on other sets of assertions.

The risk model would permit the attest function to expand in response to the demands of the marketplace. But it would help set boundaries around that expansion because the model requires the attester to restrict attestation risk to a level appropriate for the assurance imparted by the report.

Thus, it would help limit the growth of the attest function to those assertions for which the attester can gather evidence for restricting risk. Such a limitation should help assuage potential concerns of the public and regulators about the expansion of the attest function, and it would protect the interests of those sectors of the public that rely on attest reports.

In addition to the sufficiency of attest evidence, effective attest engagements depend on the effectiveness of reports in communicating to users. The risk model also contributes to achieving this objective.

The current limited-assurance services and reports encompassed by the Institute's statements on auditing standards have developed case by case in response to the new attest services. As a result, the extent of attester effort and the amount of evidence necessary to issue a limited-assurance report vary widely. In addition, the expressions of assurance include explicit and implicit assurance and are expressed in several forms—for example, positive assurance, disclaimers of opinions, statements of findings accompanied by a dis-

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claimer, negative assurance and (in SAS no. 27, *Supplementary Information Required by the Financial Accounting Standards Board*) no explicit report at all.

The proposed standards would provide consistency in the form in which assurance is expressed: they provide for two general-use reports, a high (positive) and a moderate (negative) assurance report, and a limited-use, agreed-upon-procedures or agreed-upon-presentation-criteria report. The standards would also offer more consistency in the amount of evidence needed to express a moderate level of assurance. This enhanced consistency should improve the effectiveness of attest reports in communicating with users.

Disadvantages of a Prescribed-Procedures Approach

It should be pointed out that consistent forms for expressing limited assurance could be obtained without using the SAS no. 47 risk model. The ASB could simply decide on the appropriate form or forms of assurance and modify all existing reports to conform to it or them. But this approach would still leave wide diversity in the amount of evidence underlying the limited-assurance reports.

It could be argued that there is an easy answer to this problem, too: the ASB could prescribe a set of procedures to be performed and have the requirements for all existing limited-assurance services conform to it. There are, however, several problems with a prescribed-procedures approach.

Prescribed procedures can never be calibrated to achieve uniform levels of attestation risk.

First, and most important, because inherent and control risk vary (sometimes greatly) among sets of assertions, a given set of prescribed procedures would result in a different achieved level of attestation risk for each of several different sets of assertions. And it is possible for a more intensive set of prescribed procedures to result in higher attestation risk than a less intensive set, provided the more intensive set is applied in a situation of high inherent and control risk and the less intensive set applied in a situation of low inherent and control risk.

Thus, prescribed procedures can never be calibrated to achieve uniform levels of attestation risk, and if the profession adopted such an approach for high- or moderate-assurance engagements while using a standard expression of high or moderate assurance, users would be unaware that they were reading reports conveying different levels of assurance.

Such a situation, obviously, is undesirable. Application of the SAS no. 47 risk model, we submit, would avoid this problem.

A second problem with a prescribed-procedures solution is that it is difficult to specify a list of procedures that would be applicable in the many circumstances that will arise as the attest function evolves. Thus, such an approach would hamstring the development of the attest function by making the ASB's and the ARSC's promulgation of a list of procedures a prerequisite for an attester's dealing with a new class of assertions.

Such a prerequisite would have hampered the development of the attest function in areas that are significant today—for example, reviews of forecasts—and would even have inhibited, if not prohibited, the development of audits of historical financial statements. The SAS no. 47 risk-model approach, on the other hand, can be applied in any fact situation by attesters using their professional judgment.

A third problem with a prescribed-procedures approach is that in practice many accountants subject to the prescription would nevertheless widely vary the extent of procedures they perform to support their reports. They would do so because they recognize that inherent and control risks vary among representations.

We believe that most accountants vary their procedures as a matter of course in review engagements conducted under Statement on Standards for Accounting and Review Services (SSARS) no. 1, *Compilation and Review of Financial Statements*. However, because some accountants believe a prescribed-procedures approach dominates in SSARS no. 1, these professionals think that, by going beyond the specified procedures, they are placing themselves in an untenable position.

In a situation of high inherent and control risk, performing additional procedures makes it appear that the attester is assuming additional responsibilities; but, in the same situation, refusal to extend procedures would result in

work the quality of which would make the accountant uncomfortable.

The SAS no. 47 risk model offers comfort by providing a logical explanation for the variance of review (and other moderate-assurance attest engagements) procedures in different situations, and it would provide attesters with a tool for considering when and which variances are appropriate.

A final problem with a prescribed-procedures approach is that specified procedures are, in an important sense, incompatible with *standards* for expansion of the attest function. Standards, including interpretive statements, are intended to be objectives, not a list of procedures that must be performed. The risk model doesn't present this problem.

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Using the risk model as an element of the proposed standards, while avoiding all these problems, would help bring order to current attest engagements providing various levels of assurance and, as noted, would also provide a conceptual basis for a rational evolution of the attest function.

The Model and Existing Attest Engagements

Some accountants may be concerned that applying the SAS no. 47 risk model would require significant changes to the standards for certain existing attest engagements (for example, a review of historical or prospective financial statements). Some professionals may believe that the standards for a review of historical financial statements are dominated by a prescribed-procedures approach. But this concern isn't warranted. Almost any set of prescribed procedures—including those specified in SSARS no. 1—would address the components of the risk model.

The two approaches, then, are harmonious, although one prescribes what procedures should be performed and the other allows the attester to choose procedures that provide evidence for reducing attestation risk.

Further, we believe that the risk-model approach is consistent with a SSARS no. 1 review engagement. Thus, in appendix A of the SSARS we find that, "in determining his inquiries, an accountant may consider (a) the nature and materiality of the items, (b) the likelihood of misstatement . . . (d) the stated qualifications of the entity's accounting personnel, [and] (e) the extent to which a particular item is affected by management's judgment. . . ." These matters are all indicators of the level of inherent risk related to an assertion in the financial statements.

Appendix A also contains an illustrative list of inquiries the accountant might make during the course of a review engagement. The list includes, for example, inquiries about "the procedures for recording, classifying, and summarizing transactions" that relate to each of the major financial statement captions listed in the appendix; inquiries about whether "general ledger control accounts agree with subsidiary records"; and inquiries about whether "bank balances [have] been reconciled with book balances." Although these inquiries don't amount to a study and an evaluation of internal accounting controls (paragraph 29 of the SSARS specifically states that a review doesn't contemplate such a study and an evaluation), the questions do provide evidence pertinent to assessing control risk.

Finally, paragraph 29 says that a review also doesn't contemplate "tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter" and thus doesn't "provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit."

Nevertheless, paragraph 29 then says, "However, if the accountant becomes aware that information coming to his attention is incorrect, incomplete, or otherwise unsatisfactory, *he should perform the additional procedures he deems necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with generally accepted accounting principles*" (emphasis added).

This statement is completely harmonious with the risk-model concept of limiting risk that the financial statements are materially misstated to a level appropriate considering the assurance imparted by the accountant's report. A SSARS no. 1 review engagement is, then, consistent with the risk model.

It can also be argued that the risk-model

approach is consistent with the guidelines in the AICPA's 1980 *Guide for a Review of a Financial Forecast* (second edition, 1982). The accountant's procedures in such an engagement are directed toward two major assertions: (1) that the financial forecast is presented (that is, it is displayed and contains disclosures about significant assumptions and accounting policies) in accordance with the rules set forth in AICPA Statement of Position no. 75-4, *Presentation and Disclosure of Financial Forecasts,* and (2) that the assumptions provide a reasonable basis for management's forecast.

The accountant's procedures and report aren't directed to the "numbers" in the financial forecast (that is, that any specific outcome is expected) because the control of the business during the prospective period will be in the hands of management—the attester can't substantiate management's intent or be responsible for its future actions—and because it is impossible to predict future events and circumstances.

The guide says that "factors affecting the scope of the accountant's review include knowledge of the [entity's] business, management's forecasting experience, [and] the forecast period. . . ." The accountant's knowledge of the entity's business includes factors such as the nature and condition of its markets and factors specific to the industry, including levels of competition and sensitivity to economic conditions. Many of these factors are indicators of inherent risk related to the reasonableness of the assumptions underlying the financial forecast and the presentation of the forecast.

The guide further says that the process by which the responsible party develops its financial forecast is a factor affecting the scope of the accountant's review. This includes the "process by which the factors are identified and assumptions are developed, reviewed, and approved. . . ." The publication also says that the "accountant should consider the forecasting process in relation to the guidance in Management Advisory Services Guideline [no.] 3," *Guidelines for Systems for the Preparation of Financial Forecasts*. These matters are indicators of control risk related to the reasonableness of assumptions underlying the financial forecast and the preparation of the forecast.

The guide directs the accountant to perform the "procedures he considers necessary in the circumstances to enable him to report on whether he believes the assumptions provide a reasonable basis for management's forecast," as well as procedures to provide reasonable assurance that the financial forecast is properly presented. Thus, a review of a financial forecast engagement is also consistent with the SAS no. 47 risk model.

We believe that a review of a financial forecast, as currently defined by the AICPA, is intended to limit attestation risk to an appropriately low level for the high level of assurance imparted by the accountant's review report. Considering the fact that the accountant is attesting to management's assertions that the assumptions provide a reasonable basis for the financial forecast and that the forecast is properly presented, this objective is achievable and appropriate. Thus, a review of a financial forecast is substantially consistent with the proposed attestation standards.

Orderly Expansion

Given the reasonable expectation that the attest function will continue to evolve in response to the demands of the marketplace, there is much to be gained if this expansion proceeds in an orderly fashion while protecting attesters and users of assertions.

In keeping with this goal, we have suggested that using the generalized SAS no. 47 risk model in the proposed standards would offer a number of benefits.

Specifically, incorporating the model would

1 Provide a conceptual tool to help attesters design and execute effective, efficient attest engagements at high and moderate levels of assurance.

2 Set standards for such engagements that properly consist of goals to be met rather than specific procedures to be performed.

3 Help set limits for expansion of the attest function by requiring the attester to limit risk to a level appropriate for the assurance imparted by the attest report.

4 Give the attester a valid reason for varying the nature, timing or extent of attest procedures in response to the varying levels of risks among assertions.

5 Result in conceptual consistency among audits of historical financial statements and high- and moderate-assurance attest engagements on financial and nonfinancial assertions. ■