

By Alex Vuchnich, CPA, CFE

The new risk assessment standards are requiring firms to adjust their audit approach to a risk-based methodology. This can be a daunting challenge for firms who have become accustomed to traditional substantive audit approaches for their small business clients. Developing a basis for making your risk assessment becomes paramount to performing a high quality risk-based financial statement audit. The risk assessment standards require that auditors perform risk assessment procedures during planning such as, preliminary analytical review and obtaining an understanding of the entity, including internal controls. Computer Assisted Audit Techniques and Tools (CAATTs) can play a role in enhancing the effectiveness and efficiency of performing risk assessment procedures. The key to effectively and efficiently leveraging software applications in assessing risk is to use the software to improve the quality of the audit evidence used as the basis of the auditor's judgments about the financial statement risk assertions.

Traditional CAATTs have largely been in the realm of data extraction software that allows the auditor to efficiently manage large sets of data and effectively stratify that data for testing. These CAATTs are primarily used in performing substantive tests, tests of details and for responding to specific risks. However, business analytics software can now play a significant role in the audit engagement when used to assist the auditor in performing the preliminary analytical review in the risk assessment process. Comprehensive analytics can provide one of the best sources of audit evidence to support the auditor's risk assessment. The result of the risk assessment process will drive the overall audit approach; consequently, effective risk assessment procedures are the foundation for performing a high quality financial statement audit. Effective analytics help identify audit areas that may present higher risk for certain audit assertions.

Comprehensive analytics typically include developing expectations from multiple sources to help identify unusual or unexpected relationships. These expectations may include period-on-period variance analysis, regression analysis, ratio analysis, industry comparisons, budget-to-actual and other predictive tests. A good CAAT should make it easy for the auditor to develop these expectations by automating the calculations and comparisons so that the auditor can focus on evaluating the relationships. These analytics are used for identifying both inherent and control risks in the engagement. For example, if actual sales are significantly greater than the calculated trend and gross margin percentage exceeds the typical industry range then the auditor would likely identify these as flags for an inherent revenue recognition risk, such as a bill and hold scheme and as a risk of ineffective internal controls over cutoff procedures.

Business analytic software is initially used to develop the auditor's expectations. This process is greatly enhanced by CAATTs because they remove much of the subjectivity and bias that can be introduced in performing financial analysis. These tools can also take the complexity out of the statistical calculations used in performing trend analysis. The auditor can save time on the engagement by using software to automate the calculation of historical trends using statistical methods such as regression analysis. Historical trend analysis provides an objective baseline for identifying financial statement line items which warrant further investigation. Trend analysis can then be supplemented with comparisons to industry data to further support the preliminary analytical review. Finally, budget expectations or other calculated predictive tests such as interest expense from an amortization schedule can be factored in and compared to the trend analysis and industry data. All of these analytics can be brought together in

one worksheet providing the auditor with a comprehensive analysis resulting in a higher level of confidence when relying on preliminary analytical review to support their risk assessment.

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Fig. 1 – An example of a comprehensive preliminary analytical review using CAATTs

CAATTs that perform Business analytics can also go beyond the numbers, assisting the auditor in obtaining a deeper understanding of the client and its environment. For financial statement analysis to be effective the auditor needs to be able to interpret multiple financial statement relationships simultaneously. This can be challenging and time consuming and in many cases results in a financial analysis that only consists of prior year and current year comparisons. Business analytics software aids the auditor by providing multivariate financial analysis that can help the auditor identify relationships between changes in financial ratios and multiple line items in the financial statements. This can assist the auditor in seeing how changes in liquidity, profitability, sales growth or debt levels impact other aspects of the financial statements. Once armed with this knowledge the auditor will be able to better identify associated risks. This can also enhance the management inquiries performed in the financial statement audit. A multivariate analysis generated by such CAATTs can pinpoint areas that the auditor needs to further inquire of management in order to gain an understanding of the underlying transactions that resulted in the variance or relationship noted. This ensures that the auditors are not only asking the required questions but also asking the rights questions. Based on the analysis the auditor can also better gauge management's responses and possibly corroborate those responses.

There is a sentiment that the new risk-based approach will result in significant increases in time budgets on audit engagements due to the increased emphasis on internal controls and the associated testing of those controls. For that reason it is important that firms identify areas where they can leverage CAATTs to enhance the efficiency and effectiveness of the financial statement audit. Effectiveness can come from more comprehensive analytics and multivariate financial analysis, while efficiency is gained by automating the calculations and comparisons that go into financial statement analysis. When CAATTs are used properly time budgets can be maintained and the new risk assessment standards suddenly don't seem so daunting.

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