

New Audit Standards

The massive investor losses in 2001 to 2002 in companies like Enron, WorldCom and others created the Sarbanes-Oxley Act of 2002 (SOX). Among other things, this legislation created much tougher auditing standards for public companies, and shifted the responsibility for setting auditing standards for public companies from the American Institute of CPAs (AICPA) to the newly created Public Company Accountability Oversight Board (PCAOB). This left the Auditing Standards Board (ASB) of the AICPA with the responsibility for auditing standards for all entities other than public companies, mainly private companies, non-profit, organizations and governmental entities.

The ASB has just released eight new auditing standards referred to as the "Risk Assessment" Standards. Although the origin of the development of these standards began before the SOX legislation, the ASB took the SOX standards into account in the final drafts of these standards.

The main objective of the new standards is to enhance the application of the audit risk model by requiring:

- A more in-depth understanding of the entity being audited and its environment and internal controls, to identify the risks of material misstatement in the financial statements, and what the audited entity is doing to mitigate those risks.
- A more robust and detailed assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage of the assessed risks, and the nature, timing, and extent of the audit procedures used in each audit in response to the risks identified.

Specifically, audits must now include the following:

1. A "top down" approach to audit risk assessment. What this means is that each significant balance sheet and income statement caption appearing on the financial statements will be risk assessed individually, and audit procedures designed accordingly. No longer will auditors be able to use a "cookbook" approach using canned audit programs.
2. Each significant financial statement item will also be analyzed as to the controls surrounding it. If the audit risk assessed for a particular item assumes controls are in place, the auditor must document the controls and test them.
3. A complete understanding of the company's controls, including entity controls, accounting controls, and IT controls will be analyzed and understood. To gain an understanding the auditor will conduct a "walkthrough" of each significant process.
4. Analytical procedures applied to account balances and processes will no longer be the only tests applied to profit and loss accounts. Detailed transaction testing will be applied to all significant revenue and expense process.