

Comparing AS5 to Audit Standards For EuroSox[®].



Source: GRC Handbook by Dr. Anthony Tarantino &
EuroSox Institute Whitepaper on this subject

US Audit Standard Number Five

- AS5 replaced the much criticized AS2 that US companies followed under Sarbanes-Oxley's Section 404.
- **The reforms in AS5 are:**
 - Focus the internal control audit on the most important matters
 - Risk Based & More Top Down
 - Eliminate procedures that are unnecessary to achieve intended benefits
 - Make the audit clearly scalable to fit any company's size and complexity
 - No longer One Size Fits All
 - Reward The Automation of Controls
 - Much Reduced Internal & External Audit Fees
 - Rely on the Work of Others
 - Reduce Internal Audit Fees

Changes from AS2 to AS5:

Using the Work of Others in AS5

- 13. The auditor should evaluate the extent to which he or she will use the work of others, including management's internal control evaluation. Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*, establishes direction for obtaining an understanding of the nature, timing, and extent of the work performed by others, and determining its effect on the audit. That standard states that to use the work of others to reduce the nature, timing, and extent of the work the auditor would have otherwise performed, the auditor should evaluate the nature of the subject matter tested by others, evaluate the competence and objectivity of the individuals who perform the work, and test some of the work performed by others to evaluate the quality and effectiveness of their work.

What it Means:

Even under the AS2, auditors were compelled to rely on the work of their clients as long it was conducted by competent and non biased resources. AS5 removes some the verbiage that auditors hid behind to limit the use of their clients work.

Changes from AS2 to AS5:

New Audit Standard for Using the Work of Others

- **4. *The Board is proposing a new auditing standard, Considering and Using the Work of Others in an Audit.*** This standard would provide direction to the auditor for using the work of others in both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, it would supersede the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replace the direction on using the work of others in an audit of internal control that is currently included in AS No. 2. This change would, therefore, affect both integrated audits of internal control and the financial statements and audits of only the financial statements.

What it Means

The PCAOB acknowledges the need for a separate audit standard to cover the work by company employees including internal auditors, IT, and business owners as well as third party experts.

Changes from AS2 to AS5:

Material Weakness Definition

- A8. A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.
- Note: There is a reasonable possibility of an event, as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5").

What it Means

AS2 used the term "remote possibility" which auditors took to mean virtually any possibility. AS5 terminology is more sensible and reduces the hypersensitivity of the earlier audits.

Changes from AS2 to AS5:

Definitions of Control Types

- A9. Controls over financial reporting may be preventive controls or detective controls. Effective internal control over financial reporting often includes a combination of preventive and detective controls.
- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.
- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

What it Means

Preventative controls are far superior to detective controls. Detective controls require after-the-fact evaluation of reports and challenged by a very high number of false positives that make diligence difficult. The analogy of car alarms is a case in point. No one looks when a car alarm goes off because they are virtually always a false positive.

Preventative controls with dashboard alerts and analytics are the highest form of automated controls and the best means to lower risks and compliance costs.

Changes from AS2 to AS5:

Benchmarking Automated Controls

- B30. **Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.**
- B31. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), **the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control.** The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the **strength of the company's program change controls.**
- B34. Benchmarking automated application controls can be especially effective for companies using purchased software from IBM when the possibility of program changes is remote—e.g., when the vendor does not allow access or modification to the source code.

What it Means

Benchmarked automated controls with the proper change controls in place over the software can cut audit costs in half.

Changes from AS2 to AS5:

Use Prior Audit Results

•2. Permitting Consideration of Knowledge Obtained During Previous Audits

•Many commentators have suggested that, after the first-year's audit of internal control, the auditor should be allowed to reduce the nature, timing, and extent of testing based on his or her cumulative knowledge related to individual controls. The degree to which commentators believed that testing should be decreased has varied, with some suggesting that certain lower risk controls be tested less in subsequent years and others suggesting that the auditor should be allowed to rotate his or her tests of controls.

What it Means

Fully automated controls will be candidates for benchmarking and only tested every other year. Manual controls will continue to be extensively tested every quarter both internally and externally. The testing of automated controls is easy and painless while the testing of manual controls is labor intensive.

Changes from AS2 to AS5:

Risk Based vs. Location Based Testing

- 3. Refocusing Multi-location Testing Requirements on Risk Rather than Coverage
- Based on its monitoring over the past two years, the Board agrees that the approach described in AS No. 2 may not allow the flexibility necessary to efficiently address the specific risks of a particular company. In the proposed standard on auditing internal control, therefore, the Board has omitted the provision requiring testing of Companies with multiple controls over a large portion of the company and, instead, directs the auditor to use a risk based approach to determining the proper strategy for auditing multiple locations. The flexibility provided by this approach should allow auditors to exercise the necessary judgment in the particular circumstances and result in more efficient multi-location audits.

What it Means

Standardizing controls on an enterprise-wide basis and then fully automating them will substantially reduce audit costs and risks while improving efficiencies

International Standards of Auditing (ISA)

- The International Auditing and Standards Board (**IAASB**) created a series of audit standards that are being widely accepted and adopted throughout the world.

The IAASB's Strategy and Objectives are as follows:

“The objective of the IAASB is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.”

- **To achieve its objective, the IAASB is focusing on three major initiatives:**
 - **Development of Standards** – establishing high quality auditing, review, other assurance, quality control and related services standards.
 - **Global Acceptance, Convergence and Partnership** – promoting the adoption and acceptance of IAASB pronouncements throughout the world, and supporting a strong and cohesive international auditing profession by coordinating with regional organizations, member bodies and national standard setters.
 - **Communications** – improving the quality and uniformity of auditing practices and related services throughout the world by encouraging debate and presenting papers on a variety of audit and assurance issues; and increasing the public image and awareness of the IAASB's activities and outputs.

ISA 300, 315, 330 - Introduction

- One of IAASB's most significant projects is to improve the clarity of its Standards.
- This is a project that the European Commission (EC) has deemed essential to its proposed consideration of the adoption of ISAs for statutory audit in Europe.
- In September 2006, the IAASB approved amendments to the *Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (Preface) that establish the conventions to be used by the IAASB in drafting future International Standards on Auditing (ISAs), and the authority and obligation attaching to those conventions.
- It also approved at this meeting the application of those conventions to the following three, ISAs:
 - ISA 300, *Planning an Audit of Financial Statements*;
 - ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*
 - ISA 330, *The Auditor's Responses to Assessed Risks*.
 - In addition, a fourth redrafted ISA (ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) is near final approval

ISA 300 - The Audit Process (1/2)

- Objective is to plan the audit so that it will be performed in an effective manner. Requirements include:
- The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members.
- The auditor shall perform the following activities at the beginning of the current audit engagement:
 - Quality Control for Audits of Historical Financial Information,” regarding the continuance of the client relationship and the specific audit engagement.
 - Evaluating compliance with ethical requirements, including independence
- Establishing an understanding of the terms of the engagement
- Performing these activities at the beginning of the audit assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor’s ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level.

ISA 300 - The Audit Process (2/2)

- The auditor shall establish the overall audit strategy for the audit that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. In establishing the overall audit strategy, the auditor shall:
 - Determine the characteristics of the engagement that define its scope.
 - Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.
 - Consider the important factors that will determine the focus of the engagement team's efforts.
 - Consider the results of preliminary engagement activities, experience gained on other engagements performed for the entity, where practicable, and other matters relevant to planning the engagement.
- Ascertain the resources necessary to perform the engagement. (Ref: Appendix, Para. A6)
- The auditor shall develop an audit plan for the audit that includes:
 - A description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under ISA PSA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements."
 - A description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance, and disclosure, as determined under ISA PSA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks."

ISA 315 - The Entity, Risks & Internal Controls

- The Objective:
 - **The goal is to establish mandatory requirements and to provide explanatory guidance on obtaining an understanding of the entity and its environment, including its internal control, and on assessing the risks of material misstatement in a financial report audit.:**
- Requirements:
 - **Create risk assessment procedures and sources of information about the entity and its environment, including its internal control.**
 - **Explain the audit procedures that the auditor needs to perform to obtain an understanding of the entity and its environment, including its internal control (risk assessment procedures).**
 - **Discuss the susceptibility of the entity's financial report to material misstatement.**
 - **Understand the entity and its environment, including its internal control.**
 - **Understand specified aspects of the entity and its environment, and components of its internal control, in order to identify and assess the risks of material misstatement.**
 - **Assess the risks of material misstatement.**
 - **Consider the classes of transactions, account balances, and disclosures in the financial report;**
 - **Determine whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.**
 - **Evaluate the design of the entity's controls, including relevant control activities, over such risks and determine whether they have been implemented.**
 - **Communicate with those charged with governance and management in matters relating to internal control that the auditor communicates with those charged with governance and management.**
 - **Establish related documentation requirements.**

ISA 315 - The Entity, Risks & Internal Controls (2/2)

- Obtain an understanding of the entity and its environment as an essential aspect of performing an audit in accordance with Auditing Standards.
- Establish a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial report and responding to those risks throughout the audit, for example when:
 - Establishing materiality and evaluating whether the judgment about materiality remains appropriate as the audit progresses.
 - Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial report disclosures.
 - Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions.
- Develop expectations for use when performing analytical procedures.
- Design and perform further audit procedures to reduce audit risk to an acceptably low level.
- Evaluate the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- The auditor uses their professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control.
- Determine if the understanding that has been obtained is sufficient to assess the risks of material misstatement and to design and perform further audit procedures.

ISA 330 - Auditors Response to Risks

- Objective:
- **Establish mandatory requirements and to provide explanatory guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial report and assertion levels in a financial report audit.**
- Requirements:
 - Determine overall responses to address risks of material misstatement at the financial report level.
 - Develop Audit procedures that are responsive to assessed risks of material misstatement at the assertion level.
 - Design and perform further audit procedures, including tests of the operating effectiveness of controls, when relevant or required, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level.
 - Evaluate the sufficiency and appropriateness of audit evidence obtained.
 - Evaluate whether the risk assessment remains appropriate and to conclude whether sufficient appropriate audit evidence has been obtained.
 - Establish related documentation requirements.
 - In order to reduce audit risk to an acceptably low level, determine overall responses to assessed risks at the financial report level, and design and perform further audit procedures to respond to assessed risks at the assertion level.

Governance Risk and Compliance Activities

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CONTACT INFORMATION

C(?!)NTROLLERS

www.eurosox.dk
Tel. +45 2121 0616
info@eurosox.dk

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