

Briefing Paper

Standing for trust and integrity

September 2011



Auditing and Assurance

Proportionality and International Standards on Auditing (ISAs)

One of the key audit debates in recent years has been whether one size of auditing standards fits all – in other words, do the clarified ISAs issued by the International Auditing and Assurance Standards Board (IAASB) work equally well for listed companies as for small and medium-sized entities (SMEs)?

In the FEE response to the *EC Green Paper on Audit Policy: Lessons from the Crisis*, we said: “FEE fully supports the adoption of ISAs for all statutory audits in the EU without further delay”. We are, however, aware of concerns about this approach in the responses received to the Green Paper. In their *Summary of Responses*, the European Commission noted that professional bodies, larger firms, public authorities and academics were generally in favour of adoption. However, the paper also outlined concerns from:

- Small and medium-sized practices (SMPs) requesting sensitivity to the additional administrative burden; and
- Preparers, businesses and organisations of companies indicated a “willingness to further explore this area” but expressed some concerns that “ISAs should be further developed to be better suited for SMPs and SMEs”.

This briefing paper seeks to answer some common questions about the suitability of ISAs for SME audits and for use by SMPs and demonstrates that clarified ISAs can be used to audit very small entities in a proportionate way. It is especially aimed at FEE Member Bodies and their many practitioners in an increasing number of European countries who are or will soon implement the ISAs for use in their audits. In this respect, we note the support of the European Parliament for ISAs and hope that the European Commission in its legislative proposals will respond by putting their adoption forward.

Questions & Answers

Question 1

Are ISAs not developed by the IAASB for use primarily in auditing large public interest entities?

No. ISAs are designed by the IAASB to be usable for entities of all sizes, of all types, in all jurisdictions. Their application to audits of SMEs is clearly demonstrated in the *IAASB Staff Questions & Answers on Applying ISAs Proportionally with the Size and Complexity of an Entity* of August 2009. The IAASB consulted publicly on

FEE and ISAs

FEE’s response to the Green Paper “FEE fully supports the adoption of ISAs for all statutory audits in the EU without further delay” summarised our more detailed response to the Commission’s 2009 consultation on the adoption of ISAs. We explained our reasons for adopting ISAs for all statutory audits of all companies, including small companies for which an audit is required. The rationale for this response, as repeated in the FEE Briefing Paper on European Passport for Auditors and Audit Firms of June 2011, included:

- Consistent audit quality throughout the EU, enhancing reliability, comparability and credibility of financial reporting. Adopting different standards for audits of SMEs would risk confusion and misunderstanding as to the nature and level of assurance;
- Damage to European harmonisation. If European Union Member States were allowed to apply different standards, then the degree of assurance given by audits of SMEs might differ from country to country;
- Damage to the profession. This might result in the emergence of a two-tier auditing profession, resulting in less rather than more choice of audit firms for a company seeking an auditor, and making it harder for partners and staff to move between firms;
- Increased cost to business and the profession from having two sets of training, methodologies, tools, software, exams, etc.;
- Difficulties in conducting transnational audits if different standards are applied to different subsidiaries; and
- Increased costs in maintaining two sets of oversight and regulation for audit firms.

FEE also believes that the ISAs do provide a proportionate response to the needs of SMEs and SMPs. Set out below are some answers to common challenges raised.

their standards and includes in each standard a specific section “Considerations specific to smaller entities.” This forms part of the application guidance and sets out specific ways in which the relevant standard might be applied to an SME. This can be both indicating a simpler approach or a particular challenge. For example, ISA 315 on risk assessment points out both that in a smaller entity the active involvement of an owner-manager may mitigate certain risks, for instance risks arising from a lack of segregation of duties in a small entity, but equally that it may increase other risks, for instance, the risk of override of controls.

Question 2

Are there any SMPs/SMEs involved in the development of the standards?

Yes. The IAASB includes individuals from smaller firms that are not members of global networks. In addition, the board has sought input from the IFAC SMP committee which represents the interests of SMPs. In addition, these standards were exposed for public comment during their development and commentators were asked for their views on the audits of smaller entities. For example, SMPs contributed to developing FEE's draft comment letters which also benefitted from input by the FEE SME/SMP Working Party before they were submitted.

Question 3

I have heard that the new 'clarified' ISAs which apply from December 2010 are more onerous. Will this not drive yet more SMEs away from having an audit?

No. Whilst it is true that the new 'clarified' ISAs do include some additional requirements, it is unfair to assume that this will make all audits more time consuming and expensive to perform:

- Firstly, the majority of "new" requirements resulting from the clarity project are in more complicated areas such as fair values, accounting estimates, the use of experts and audits of group financial statements. In many cases, these will simply not be relevant to SMEs. Where they are relevant, the additional complexity is normally driven by more complex accounting (for example, SMEs that choose to move to IFRS may have to fair value more things, which in turn will mean that auditors have to audit those fair values); and
- Secondly, the new "clarified" standards make it clearer what is required and what is application guidance. In some cases, this will make it clearer that something does not need to be done in a particular circumstance, for instance in the considerations specific to smaller entities; and
- Thirdly, in a small number of areas, additional work may be needed even on smaller audits. This should, however, help the auditor deliver increased value and insights about the audited entity to management and directors. For example, considering the appropriateness of the internal controls on the collection of debt gives those running a company an insight into the longer term sustainability of their business.

FEE considered all of these issues when responding to individual draft ISAs and to the EC consultation on adoption of ISAs.

Question 4

A lot of the debate in Europe seems to be around International Standard on Quality Control 1 (ISQC 1). Is this standard not designed more for large audit firms? Will it not cost me a lot to implement in my SMP?

No. There are a lot of misconceptions around the degree of complexity required for an ISQC 1 compliant quality control system. For example:

- Some people believe ISQC 1 mandates an engagement quality control review or hot file review of every audit before the opinion is signed. This is only the case for listed company audits. For unlisted entities, the audit firm simply needs

policies and procedures to decide which entities do need a hot file review. This may be limited to only more complicated or riskier engagements;

- Others are concerned that the requirements of ISQC 1 can force SMPs to purchase expensive audit manuals, training and documentation from third party suppliers. The requirements of ISQC 1 are drafted such that it is possible to scale the requirements depending on the complexity of the audit firm and its client base – a simpler firm with simpler clients will need less complicated policies and procedures.

FEE's comment letters to the IAASB on the exposure draft of ISQC 1 and to the EC on the application of ISAs stated our belief that it was possible to apply ISQC 1 as drafted in a proportionate manner for SME audits and by SMPs. We are, however, aware of concerns from some SMPs that local regulators have not taken a proportionate approach and are expecting a degree of complexity disproportionate to the size and nature of their audit firm and their client base. In our comment letter on the IAASB's strategy for 2012-2014, we have called on the IAASB to work on a project to demonstrate how a proportionate approach can be taken to establishing and documenting an appropriate quality control system, which local regulators could use.

Question 5

Many auditors have questioned whether ISAs have resulted in a 'box-ticking' approach to audit which leaves no room for professional judgment and which requires extensive documentation not only of why the auditor has done certain things but also of why he has not. Is this true?

No. The majority of documentation requirements for ISA audits are set out in ISA 230 with some additional requirements for specific areas set out in the relevant specific standard. It is possible to take a proportionate approach to documentation of an audit and, in particular:

- The standard set by ISA 230 is that documentation should enable an experienced auditor, having no previous connection with the audit, to understand what has been done, the results of the work performed and the evidence obtained, the significant matters arising during the audit, the conclusions reached thereon, and the significant professional judgments made in reaching those conclusions. This is good advice for all professional work as it is sensible risk management if an audit firm is ever challenged as to how it gave the opinion it gave. But it does not require documentation of every matter considered or professional judgment made or every last thought by the auditor. The test is whether an experienced auditor can understand what has been done, not whether someone with no knowledge of auditing can. This should also be sufficient for internal and external quality assurance reviews, inspections or other supervisory purposes;
- ISA 200 on the objectives of an audit and auditor makes clear that there is no requirement to apply an ISA or those individual requirements of an ISA which are not relevant to the audit. So, if the auditor does not use the work of an expert or if there is no internal audit function (two areas less likely to be relevant to an SME audit), then he does not need to justify why he has not applied ISA 610 on using the work of internal auditors and 620 on using the work of an expert.

About FEE

FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States. In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. Based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in this public policy debate.