

## IAASB CAG PAPER

IAASB CAG Agenda (September 2006)

Agenda Item I.7

SME / SMP / DN Audit Considerations—European Federation of Accountants and Auditors for SMEs



*European Federation of Accountants and Auditors for SMEs*

Mrs. Alta Prinsloo  
Technical Manager of IFAC  
545 Fifth Avenue, 14th Floor  
New York  
NY 10 017 - USA

Mr. David Damant  
Chairman of IAASB CAG  
12 Agar Street, Apt 2  
London WC2N 4HN  
UK

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### **Subject: AUDITING SMEs, DOCUMENTATION, CONTINUING EDUCATION AND TRAINING**

#### **GENERAL VIEW**

After discussions during the IAASB CAG meetings and in other several public meetings on audit it seems quite clear that SME audits raise concerns of different kinds. These concerns are directly related to the way in which ISAs are being clarified and redrafted.

At this stage of the process the profession is requested to comment on one of the topics that raise questions: documentation.

The following comments do not limit the discussion on documentation as a specific matter because documentation is the part of the auditing process representing how the auditor is carrying out the job of applying objectives and requirements.

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For documentation we normally intend the working papers produced during the audit by the auditor in order to justify the work done and how (audit evidence) “reasonable assurance” has been reached at the end of the audit process.

More complex audits are expected to produce more documentation. If auditing an SME is supposed to be less complex because of the lower complexity of its financial statements, the documentation should be less and less documentation should also mean fewer costs and workload. This should facilitate auditing the SMEs and generally enhance the quality of the financial statements.

After the presentation of the IAASB ED containing changes in the Preface and proposing the first redrafted and clarified ISAs (ISA 240, 300, 315, 330) it seems that there are (more) concerns on the equivalence SME audits = simpler audits = less documentation.

These concerns would not be justified if the comments proposed in the “Wong report” specifically addressing the audits of SMEs and proposing simplifications to reduce burden and costs were borne in mind.

### **AUDITING AN SME IN THE CLARITY PROJECT PERSPECTIVE**

So a question could be: what happened to the starting considerations on SMEs audit during the redrafting and clarifying process?

As everybody agrees on the famous concept that “an audit is an audit”, the IAASB received substantial assurance that the Clarity Project would in any case lead to a better result. It must be said that the comments received by the IAASB on the ED were almost favourable.

It is clear that eliminating doubts in the application of the standards and in the wording (because also of the specific characteristic of English) has been perceived as a good achievement. However, a number of comments from a wide range of users argued against the increase of requirements (shalls). Therefore it

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seems that we now have clearer but heavier standards. And there should not be doubt that more requirements means more documentation. Of course, this is particularly important in the SMEs audit perspective.

EFAA believes that the specific considerations on SMEs audit contained in the application material are useful but do not fully answer the SMEs audit needs. The application material, in fact, is just guidance to help the auditor fulfil the requirements stated in each ISA and therefore does not solve problems related to the relevance of the (increased) requirements.

During the discussions in the CAG the regulators stressed several times that they were expecting the IAASB to allow rare cases of departure; and Mr. Kellas once stated that the IAASB will supervise the possible excess in considering cases of non relevance of the requirements.

So the question, basically, is: how much professional judgement is the auditor allowed to use with the new ISAs in comparison, for instance, with what was allowed before? This is another important comment in the SMEs audit perspective.

Similar discussions also took place at the European level. During the meetings of the EGAOB ISA Subgroup (the CAG established by the EC in order to assist the process of endorsement of the ISAs accordingly to the new 8<sup>o</sup> Directive) the regulators stressed very often that the auditors should reach all the objectives following all the requirements with rare cases of departure. In this perspective, a discussion on the “inherent limitations” of an audit also started and is still ongoing.

Burdens and costs for SMEs as a consequence of a “bureaucratic” application of the new ISAs are likely to increase. This creates a problem in terms of efficiency of the markets and of balanced competition between the different parts of the auditing profession (the big auditing firms vs. other auditors)

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EFAA does not think that the “solution” to this problem in Europe (which is EFAA’s field of action) can be what was “proposed” by the Commission in its comments to the IAASB ED answering the specific question on SMEs audits. In fact the EC simply stated that (because of the thresholds established in the Directives) most companies in Europe are supposed to be exempted from compulsory auditing by the individual national legislations. This seems to be a political statement and EFAA thinks that it leaves the problem unsolved. Firstly because in many European countries the exemption thresholds are not applied or are lower, secondly because there is the risk to leave non audited the majority of the enterprises in Europe. This, to some extent, appears to contradict the whole process.

### ***THE THINK SMALL FIRST APPROACH***

It has been proposed that an alternative approach in redrafting the ISAs could have been the “think small first” approach. The aim of this idea is to set a way in which the standards are developed with a “bottom up” approach. But this idea did not completely develop because audit has a “large company” historical background, and because, probably, it seems to be in contrast with the basic statement “an audit is an audit”. Nevertheless, it should be clear that “an audit is an audit” does not mean that every audit is performed in the same way, but that every audit should lead to the same level of assurance.

However, the two concepts of “an audit is an audit” and “think small first” are not incompatible. The way you carry out the audit should be a wise and balanced mixture of objectives, requirements and professional judgement, backed up with the proper documentation.

It appears at this stage of the discussion that once you have accepted the kind of objectives proposed (each one with its own requirements), documentation is no longer a matter of discussion; rather it’s the result of a process that seems to leave less space for professional judgement. And once it is noted that the special considerations for SMEs, contained in the application material section,

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are more or less obvious, this is accepted as the consequence of the fact that the IAASB considers the way an audit is carried out equivalent, should the company be large or small.

It has been commented by many people that auditing should not be reduced to a simple process of ticking and filling in the blanks; photocopying papers and just “producing volume” in order to let the auditor better defend himself/herself in front of the court or of the regulators. However, regulators still think that the auditor “must” achieve all the objectives applying all the requirements, with rare cases of departure and very few cases of non relevance. How can this expectation be feasible for the audit of a smaller company?

### ***EFAA POINT OF VIEW***

EFAA’s first comments on the clarity project were issued at the IAASB CAG meeting of June 2005 in Washington. They stated the importance of the bottom up approach as originally described by our Secretary General Mr. Peter Poulsen. They were also in line with the comments proposed by the IFAC SMP Permanent Task Force in the same occasion. In particular, the SMPTF noted that “an audit is an audit but we interpret this to mean that the objectives and principles are the same for across all audits. The audit approach and methodology should differ according to the size of the entity being audited”. Another important comment from the SMPTF in the same paper was that “The standards in ISA are not, however, direct audit quality standards but rather standards of audit procedures. Being indirect quality standards ISAs concentrate on standardizing the audit process in order to influence its outcome. *To a large extent the audit procedures prescribed in the standards are designed for large entity audits*”. Moreover and in the same paper “ the audit issue is about meeting the needs in an SME audit to allow the exercise of professional judgement in forming the opinion not requiring extensive and

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*redundant (or just marginally useful) audit procedures and documentation where alternative measures are more practical and cost effective". The SMP Task Force proposed also "flexibility to be built into the standards so as to allow for auditor judgement in determining appropriate procedures in the circumstances. For this reason we suggest that the Clarity Project should aim to substantially reduce procedural requirements while including additional explanatory guidance separate from these requirements".*

EFAA still fully agrees with the above comments which have direct impact on documentation. EFAA considers that the IAASB can improve its action in the proposed direction in particular by reducing (in the first redrafted ISAs and as a future approach for the all the other ISAs) the procedural requirements and improving the additional guidance. This process is very important not only in the documentation perspective but also in setting standards that are easier to read and to apply and in which there is no confusion between pure requirements and additional explanatory requirements. This will reduce, also, the basic conflicts between the auditing profession and the regulators and will lead to judge the quality rather than the quantity.

EFAA therefore suggests that the "shall" requirements are better redrafted and reduced to the amount relevant to the objective, while any other "procedure" should be moved to the application material section. This process should, also, help the European auditors in applying the ISAs in case the EC decides not to endorse the application material section as an integral part of the ISA (discussion is still ongoing). If the finally approved objective and requirement sections will consist of limited easy and clear statements, each auditor will apply them in the Nation using his/her professional judgement and the provided guidance as a toolkit.

The above proposed process of "limiting" the requirements to the pure and relevant ones is also very helpful if an auditor faces a case of departure or non relevance of requirements as illustrated in ISA 230 (revised). With specific and pure requirements it will appear very clear that departure happens in rare

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circumstances. Moreover, it should be easy to check when the documentation requirements do not apply because of non relevance of basic principles and essential procedures. Both these cases often upset the regulators because they see departure and non relevance as a way for the auditors to skip their duties. We believe that the more the requirements are essential the clearer is when there is departure and non relevance, with an increase in the quality of the audit and of the controls on the audit.

Also the above mentioned concept of “flexibility”, as proposed by the SMP Task Force, takes advantages from a clear set of basic and pure requirements. Documentation, of course, is very much influenced by the whole process.

EFAA believes that there is need for more professional education and training on auditing in order to create the best convergence in the application of the ISAs. As a matter of fact there is no common auditing framework in Europe. In most countries local GAAS are a simpler copy of the (old) ISAs. In some countries the local GAAS are far from being similar to the ISAs. The new 8<sup>o</sup> Directive aims the application of a common auditing framework and ISAs are taken into consideration as a possible good set of standards for Europe. In both cases Europe needs to move in a common direction and this means that the auditing profession is asked to cooperate in order to let the auditors be able to converge properly in a new and common set of standards.

For this reason specific training and continuing education will be the most important tool to help the process of best practice on new standards. Best practice will be also achieved by applying a clear and efficient set of standards completed and followed up by appropriate guidance. In some European countries the profession has developed papers and books to help auditors in applying the standards. A similar process has recently been taken into consideration also by IFAC. EFAA is ready to cooperate on this topic.

### **CONCLUSIONS**



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EFAA is of the opinion that the Clarity Project leads auditing (both the process and the profession) in the right direction, provided that the efforts in simplification and clarification are not biased by the attempt to define and prescribe as requirements all the possible situations that the auditor can face while auditing (with obvious consequences on documentation).

EFAA believes that there could be the danger of deviating from the original aim of improving the quality of the audit (as a consequence of some international scandals) because of excess of bureaucracy within the redrafted ISAs themselves, which is exactly what the Wong report wanted to avoid for SMEs.

EFAA believes that there is the possibility to increase the quality of the ISAs by using clear and direct requirements limited to what is essential for the auditor in order to focus on the main issues of the audit and therefore using all his/her professional judgement to achieve the proposed objectives. Documentation will follow as a necessary consequence. ISA 230 (redrafted) contains proper description applicable also to SMEs audits.

EFAA believes that the whole process must be developed with high level guidance, continuing education and training. The written guidance can be a development of the Application Material Section of the ISAs and will be of great help if also specifically directed to SMEs audits. This will solve the problems arising from a European endorsement process that could not accept the Application Material as part of the European legislation and will help the common application of the standards by the profession. EFAA believes that it would be better to concentrate efforts on the best application of standards containing clear and direct requirements rather than discussing if, for instance, the existing requirements are all relevant to the circumstances or not. As it has been broadly recognised that the audit is a judgement, common efforts should be made to improve the quality of this judgement rather than standardising it. Once more documentation is a consequence of the best auditing practice.



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EFAA is going to set up a working group to explore the possibility to overview the continuing education and the professional training in Europe on SMEs audits and will be very much pleased to cooperate with all the other international organisations on the same topic.

Federico Diomeda  
EFAA President