

# IAASB CAG PAPER

IAASB CAG Agenda (September 2006)

Agenda Item I.1

SME / SMP / DN Audit Considerations—ECSAFA



## THE EASTERN, CENTRAL AND SOUTHERN AFRICAN FEDERATION OF ACCOUNTANTS

TO : David Damant, Chairman IAASB CAG

COPY : Ndung'u Gathing, ECSAFA CEO

DATE : 4 August 2006

FROM : Linda de Beer

SUBJECT : **AUDIT DIFFICULTIES FACED BY SMEs AND SMPs**

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### OBJECTIVE OF THIS PAPER

As mentioned at the previous meeting of the CAG in Paris, there seems to be some level of uncertainty regarding the exact audit difficulties that developing nations are facing - which of those issues relate to small and medium enterprises (SMEs) and which to small and medium practitioners (SMPs) and also what IFAC structures would be the best place to address such issues. This paper is intended to give my perspective on those issues, but has not had the benefit of an ECSAFA-wide exposure and discussion. This will be done at our ECSAFA standard-setters meeting in Malawi in mid-September.

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#### **THE DIFFERENCE BETWEEN SME AND SMP NEEDS**

In our view, SMEs and SMPs face different issues, which should be considered and addressed in different ways. However, there might be an overlap of issues.

#### **SMPs**

The point of the complexity and understandability of IAASB standards has been made outside the SME/SMP debate. To the extent therefore, that the ongoing clarity project simplifies the standards for all, the whole profession will be better off. But until this is completed, SMPs will continue to suffer more than their larger counterparts who have other ways of getting the clarification they may need.

In our view, the SMP issue is often a capacity issue. If an SMP is performing the audit of a listed company or other public interest entity, it should meet the same standards (auditing and otherwise) as any other auditor. If these SMPs are experiencing difficulties in understanding/implementing/complying with accounting or auditing standards, they should put processes in place to address this issue. The focus, from the IAASB's perspective, should not be on making it easier for SMPs, but on the public need for a quality audit. However, the current perceived "big firm" approach to the setting of standards will continue to cause problems, unless addressed.

Therefore, in our view, the IAASB's focus should be on the audit of SMEs (whether it is performed by an SMP or a larger firm) and not SMPs. There is one exception to this and this is the impact on ISQC 1.

#### **ISQC 1**

As ISQC 1 is not an auditing standard per se, but an overall quality control standard over the audit process as a whole, it is the one exception where the IAASB might need to consider further assistance/relief for SMPs.

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There are requirements in ISQC1 in so far as external reviews are concerned, that puts SMPs in a disadvantaged position as far as competition is concerned as such practitioners are forced to get other practitioners, external to its business in to ensure compliance with the standard. This is a matter that needs to be further explored and there might be a need to do some field-testing and research to ascertain the impact of this on SMPs.

#### **SMEs**

##### **Definition of an SME**

The debate around SME needs from a reporting and auditing perspective often get stuck on the definition of an SME. What is classified as an SME varies significantly from one country to the next and the classification, in our view, should be left to each jurisdiction. Some guidance has been given in the IASB's SME reporting project, which is useful. However, jurisdictions might decide to make the distinction on a quantitative basis (turnover, asset value, number of employees) as apposed to a principle/user basis, as suggested by the IASB. For this reason, in our view, we believe that the IAASB should not be focusing too much on the definition, when trying to address the issue.

##### **The issue relating to SMEs**

Small enterprises face difficulties in trying to comply with financial reporting standards that are intended for public interest entities. This is often a jurisdictional issue, as legislation does not always allow for differential reporting. However, it is also in certain instances a standard-setters issue, where legislation allows for differential reporting, but the IASB has not yet developed such standards. This is outside the scope of the IAASB.

With regard to the audit – ECSAFA agrees with the concept that “an audit is an audit”, as long as it is not used to ignore relevant issues such as complexity and understanding. We value the importance of an audit, particularly in economies where the credibility of the markets and financial reporting standards are important in attracting investors.

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The view is often put forward that, if an audit is too expensive or too much of a burden for an SME, these entities should be relieved from the audit requirements. This view is well noted and many countries have already addressed this matter in legislation and we are aware of more countries that are considering changes to legislation to allow this. There are however two matters for consideration that follows from this:

1. Firstly, some countries opt not to provide for an audit threshold, which would exempt certain companies from the need to be audited. This is often done to ensure credibility, root out corruption or for other reasons, which is the prerogative of the legislature. However, in our view, the IAASB still has a role to consider the requirements of these countries and the need to provide some relief in instances where such SMEs have to be audited. This relief should be given without diluting the quality of the audit.

There might be scope to simplify audit requirements, in particular documentation requirements, and still perform a proper audit. This is further explored later in this paper.

2. The legislatures in some countries do not want to move away completely from some level of assurance, often because of reasons mentioned before, such as credibility of reporting, anti-corruption, etc. However, they would possibly be comfortable with a lower/limited level of assurance, which could be obtained from a review. Again, we believe that the IAASB has an important role to play in this regard, as further explored later in this paper.

#### **Reasonable assurance with assistance/relief for SMEs**

As mentioned under item 1 above, there might be scope to simplify auditing requirements without diluting the quality of the audit and moving away from a reasonable assurance framework. The IAASB has already gone a long way to address this issue by giving it specific focus in the clarity project.

Further work could be done with regard to documentation requirements, as proposed by the UK standard-setter at the IAASB's National Standard-setters meeting earlier this year in Brussels. In

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our own experience the current documentation requirements are very burdensome for the auditors of SMEs (whether they are SMPs or not) and the time spend to ensure compliance with the documentation requirements pushes up audit hours and hence audit fees. We support the UK in recommending that this option be explored by the IAASB as this might be done without moving away from the concept that “an audit is and audit”.

#### **Limited assurance – the role of the IAASB**

Where a country opts to allow SMEs not to be audited, but still require a review, the IAASB can provide an important service to its member bodies, regulators and investors. The reason, in our experience, why some countries are not considering limited assurance for SMEs is because they do not have adequate standards to which such reviews should be performed. In the ECSAFA region, there is often no audit standard-setter as these countries have all adopted ISA. Therefore, if (a) comprehensive review standard(s) existed, that were developed specifically with this objective in mind, this would be extremely useful in these countries.

#### **Compilation reports**

Compilation reports are an option that can be explored in instances where the legislature decides to completely remove the audit requirement for SMEs. However, the concern is that these reports are often misconstrued, even by very sophisticated users, such as banks, as giving some level of assurance.

#### **IN CONCLUSION**

The following are the areas where the IAASB should be playing a role:

1. Documentation and, if possible, other relief in instances where SMEs are audited, without moving away from reasonable assurance.
2. Enhanced standard(s) on reviews/limited assurance assignments.

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3. Considering the impact of ISQC 1 on SMPs with a focus on providing alternative requirements where an auditor cannot comply with the external review requirements.