

IAASB CAG PAPER

IAASB CAG Agenda (September 2006)

Agenda Item I.5

SME / SMP / DN Audit Considerations—IDW

Feedback on SME/SMP issues for discussion at the CAG in September 2006

Prepared by IDW Institut der Wirtschaftsprüfer in Deutschland eV

Documentation of (ISA) audits of SMEs

We agree that documentation relating to an audit of an SME performed by a SMP will necessarily differ considerably from that relating to an audit of, for example, a large public interest entity performed by a large firm. However, in our opinion, this differentiation primarily results from two factors. Firstly, an SME is likely to be less complex or sophisticated, and, by definition, will be far smaller than a large public interest entity; therefore there will automatically be fewer facets to such entities requiring audit documentation. Secondly, the organisational structure of a SMP will be less complex than that of, for instance, a big-4 firm. This in turn will impact the firm's review procedures such that the documentation thereof will similarly be less complex. We do not believe that auditing standards should differentiate the scope or the degree of detail when establishing minimum standards for audit documentation. There does however seem to be an urgent need for interpretative guidance of ISA requirements to allay the fears recently expressed by some practitioners. We understand that the IFAC SMP Committee is confident that both the IAASB's ongoing clarity project and the IFAC SMP Committee's initiative in respect of an ISA Guide will go a long way to solving perceived problems. We would not support differentiation of the scope of documentation requirements, based on the size of an entity or of a firm.

General rather than specific nature of the concerns raised

The general nature of the discussions relating to the perceived overly burdensome documentation requirements within the ISAs for auditors auditing SMEs may, unless backed up by specific examples to support the position taken, not reflect well on the SME/SMP representatives, in the light of the current political climate.

We believe that if there is a technically sound case to be made it must be possible for those calling for a reduction in documentation requirements to provide specific examples of such requirements. To date the discussion has been of a general rather than a specific nature. We are aware that some believe that documentation of internal control in the detail required pursuant to ISA 315 may provide one such example, however we do not agree. In our view, every entity has some form of internal control along the lines of those foreseen in the most recent clarity draft of ISA 315. We accept that SMEs are not likely to have as sophisticated control systems as those encountered in larger entities, nevertheless they have to have these minimum controls or the auditor would not be able to perform an audit. Unless the SME/SMP representatives can list specific documentation requirements of individual IAASB pronouncements and provide a reasoned argument as to why each of them should not apply in the audit of an SME, the contention that ISA documentation requirements are overly onerous does not appear, to us, to be technically well founded.

"An audit is an audit" - ISA as a quality trademark

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We are concerned that certain views expressed by individual SME/SMP representatives may be detrimental to the “an audit is an audit” stance adopted by the auditing profession in general.

There have been insistent calls from some quarters for reduced involvement of the profession in the development of auditing standards. If the quality of audits were to be impaired as a result of pressure from within the profession this would serve to strengthen their case. Criticism along the lines that certain of the documentation requirements should be either reduced or made non-applicable in SME audits do not appear to be founded on any basis other than cost and the resultant impact on demand for audits of SMEs. We appreciate that in many jurisdictions SME audits, and in particular those of micro entities, are predominantly carried out on a voluntary basis. The fact remains, however that when an *audit* is requested, the parties interested in the results of the audit (i.e., banks/creditors who insisted an audit be performed in the first place) expect uniform audit quality with the same level of assurance, and the auditor, irrespective of the size of the entity being audited is liable for his or her work (when not otherwise agreed, auditor liability may even be greater for voluntary audits e. g., Germany where the statutory limitation of auditor liability may not apply for some voluntary audits). When the level of assurance obtained in an audit is not required, an alternative engagement (review, compilation or agreed upon procedures) may be more appropriate.

Protection for the auditor

In our view, documentation is a key issue for SME audits, since without appropriate documentation of audit planning (including risk assessment, encompassing knowledge of internal control, and its impact on the audit), audit work performed, the findings thereof and the conclusions drawn supporting the audit opinion, an auditor will be unable to substantiate subsequent claims that the audit was carried out in compliance with the ISAs (i.e., it is important for the self protection of the SME auditor). SME auditors may need recourse to audit documentation for a number of reasons, including quality control inspections (see below), legal proceedings initiated against the auditor and for future reference purposes.

Discussion of views previously presented

To illustrate some inconsistencies in the argumentation put forward so far, we have noted both our own views on the purposes of documentation discussed in ISA 230, and those of others, which we are aware have been previously expressed:

1. *Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.*

Some have pointed out that smaller audits are likely to be undertaken by fewer staff and informal reviews of working papers are likely to be effective. We agree, and further believe that an initial of the reviewer on the face of the audit working paper

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would normally suffice, where applicable, accompanied by any notes or requests for further work or explanation the reviewer deems necessary. Where there is no reviewer (sole practitioner) documentation assumes even more importance. Furthermore, fewer “layers” of review will automatically lead to less documentation. The closer the degree of review the less structured the documentation needs to be. As nothing in the ISAs suggests otherwise, we believe this is an issue that will be resolved by the proposed ISA guide currently being developed under the direction of the IFAC SMP Committee.

2. Assisting the audit team to plan and perform the audit.

There have been questions raised as to the value of prior year papers. We agree that they are likely to be relevant to audits of all sizes, however, there needs to be evidence that the auditor has updated his understanding gained in the prior year as required by ISA 315. This could mean minimal “extra” documentation, e.g., a note referring to a meeting with the client to confirm that there have either been no significant changes which would impact the audit approach, or detailing significant changes thus identified and the initial impact on the current audit. This would not normally be overly onerous, unless there have been such changes. Documentation of these changes will be essential.

3. Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220 (Revised).

We agree that smaller audits are likely to be undertaken by fewer staff and informal reviews are likely to be effective. Nevertheless, the review responsibilities identified in ISA 220.25 still apply. Even effective informal reviews need to be documented to some degree. Our above comments as to review “layers” apply equally here.

4. Enabling the audit team to be accountable for its work.

Some have suggested that accountability may be more of an issue within the context of a large audit team. We do not accept this, as we believe accountability is firstly in the mind of the individual performing the audit work. This may be particularly important when an SMP does not have access to experienced staff. In addition, the auditor is accountable to external parties (e.g., courts, external quality assurance or professional oversight authorities) in certain circumstances.

5. Retaining a record of matters of continuing significance to future audits.

We agree that this is relevant to audits of all sizes.

6. Enabling an experienced auditor to conduct quality control reviews and inspections in accordance with ISQC 1.

Some have expressed the view that ISQC 1 reviews are probably less important to smaller firms. We believe this is a quality issue too. Smaller firms are also subject to ISQC 1 and ultimately the courts in their respective jurisdictions. Therefore we do not

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agree that ISQC 1 reviews are probably less important. It would be unwise for SME auditors to argue that there is no need to document as comprehensively as other auditors, merely on the basis of “we aren’t subject to quality control”. External inspection programs vary between jurisdictions, however ISQC 1 reviews are always then a minimum (see below). Furthermore, we need to bear in mind that audit documentation is not solely for external purposes.

7. Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.

Some have taken the view that while all firms are subject to some degree of external inspection, this is increasingly focused on the audits of listed companies. We believe this is a dangerous line of argumentation. Firstly, it contradicts the “an audit is an audit” principle. Secondly, it calls the integrity of the profession into question by suggesting the degree of external supervision should dictate documentation requirements.

We would also like to discuss certain possible option [reproduced below in bold lettering] put forward in a number of discussions on this topic. We do not consider any of these suggestions to be totally acceptable, as all are contrary to the “an audit is an audit” position. We discuss each in turn as follows:

1. To limit the requirement in ISA 230 to document those exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances to the audit of listed companies.

Such circumstances are likely to occur rarely in any audit. It is unlikely that they will occur often in SME audits, thus the practical degree of “relief” is likely to be minimal. For the above-mentioned reasons we do not believe that auditors of SMEs would benefit from this form of relief. It is especially important for departures to be sound and so arguments such as documentation of work help the individual to focus would be most appropriate here.

2. To limit all the documentation requirements in individual ISAs to the audit of listed companies.

This is unworkable, for all the reasons we have discussed above.

3. To limit some of the documentation requirements in individual ISAs to the audit of listed companies.

If specific requirements can be identified and technically sound arguments put forward this suggested approach would be the most acceptable. However, our review of the ISAs does not suggest that many, if any, such documentation requirements would “qualify”.

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Application of ISQC 1 (Quality Control) for SMPs (including sole practitioners)

In our view, ISQC 1 is an important IAASB pronouncement. In order for an auditor to claim ISA compliance the practice to which the auditor belongs has to comply with ISQC 1. We believe it is highly desirable, for the reputation of the auditing profession, that minimum levels of quality be attained at practice level covering audit engagements. In Germany, the equivalent standard (VO 1/2006) is not restricted to audit/assurance engagement activity, but applies to all areas of the practice encompassing the requirements of both ISQC 1 and ISA 220, with a few isolated exceptions resulting from the German legal environment.

As ISQC 1 is directed at firms there has been some confusion as to how the requirements apply to sole practitioners. For example, should a sole practitioner have to set up (and document) a formal staff appraisal system even when he or she currently employs no professional staff, but could theoretically do so in the future? ISQC 1 also does not only apply to audits of financial statements, but other assurance engagements (sustainability reports internal control etc) and so also applies to firms not carrying out (only) statutory audits.

In contrast ISA 220 (Revised) requires the engagement partner responsible for the individual audit to apply the measures determined at firm level in the performance of the individual audit and to ensure that members of the engagement team comply therewith.

Following extensive discussion within the profession in Germany the VO 1/2006 includes guidance and interpretations not found in the international standards. These aim to provide a better understanding of the individual requirements of ISQC 1/ISA 220 as they are to be applied in smaller firms. Our practitioner representatives deemed this necessary because the requirements of ISQC 1/ISA 220 were developed on the basis of an organisational structure more common in larger firms.

Examples:

1. ISQC 1.8: *The quality control policies and procedures should be documented and communicated to the firm's personnel. Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. [...]*

In developing the VO 1/2006 (Paragraph 21 et seq.) we became aware of the need to clarify that in smaller practices with relatively simple organisational structures and limited scope for delegation, the requirement to document the system of quality control can equally be satisfied by evidencing compliance with professional standards and ethical requirements in practice organisation and performance of engagements e.g., by filing employee assessments, planning related to training and CPD courses, the independence declarations obtained from employees and the initialling of papers reviewed by the engagement partner etc. A separate comprehensive procedures manual may not be appropriate in every case.

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Sole practitioners, in particular, commented that it would be counterproductive to require them to formally document the procedures to which they adhere during an audit in a separate quality control handbook, when these are readily discernable from their working papers. They contend that it should be sufficient that the fact that such procedures exist and have been adhered to can be satisfactorily evidenced in an external review.

Similar clarification for SMPs would be useful in ISQC 1.

2. Performance of Inspections in SMPs

ISQC 1.79: The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

We recognise that the requirements of ISQC 1.79 would be impossible for a sole practitioner to comply with. Accordingly, the German VO 1/2006 permits a practice to deviate from the requirement “those inspecting the engagements are not involved in performing the engagement or the engagement quality control review“, when the practice does not have available such appropriately qualified personnel. Sole practitioners may perform the inspection themselves as a form of making sure themselves/satisfying themselves as to adherence with their own procedures.

This deviation was deliberately adopted in Germany, so as not to disadvantage sole practitioners.

3. Human Resources (ISQC 1. 36 et seq.)

The requirements of ISQC 1 pertaining to development of personnel can only be applied to a limited degree in the smaller firms, which have no or only a few experienced professional staff, and of course for sole practitioners (e.g. recruitment, performance evaluation, promotion, compensation policy etc.). There is a need to clarify that, in this context, sole practitioners do not need to set up formal policies. It is sufficient for the sole practitioner to evidence his or her compliance with CPD requirements.

4. Engagement Quality Control Review (ISQC 1.60 et seq.)

The performance of engagement quality control reviews entails a significant expense for SMPs and sole practitioners, as they usually have to have recourse to external persons, with the necessary knowledge and experience, to perform such reviews. This is justifiable for audits of financial statements of public interest entities or engagements involving specific risks. However, the criteria listed as guidance in paragraph 62 of ISQC 1 are very broad:

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- *The nature of the engagement, including the extent to which it involves a matter of public interest.*
- *The identification of unusual circumstances or risks in an engagement or class of engagements.*
- *Whether laws or regulations require an engagement quality control review.*

In particular, the first point may lead to a wide range of engagements being subject to external quality control review by SMPs or sole practitioners. For example, one might question whether the audit of a government owned business enterprise is not always of public interest. Similarly it is not clear how widely the term „unusual circumstances“ should be interpreted. ISQC 1 should give more precise guidance on such matters. For example, banks and insurance companies that are not listed entities could be exemplary in the first point. The second point might refer to a case where the going concern principle is threatened.