

**September 11, 2014**

**Small and Medium Practices (SMP) Committee Response to the International Auditing and Assurance Standards Board (IAASB) Exposure Draft *Proposed Changes to the International Standards on Auditing (ISAs): Addressing Disclosures in the Audit of Financial Statements***

**Introduction**

The SMP Committee is pleased to respond to the IAASB (the Board) on this Exposure Draft (ED).

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small-and medium-sized entities (SMEs). The constituents of the SMP Committee are small and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

**General Comments**

We have been broadly supportive of the objectives behind the project on Auditing Disclosures and the direction taken by the Board to try and achieve a change in auditor behavior. The proposed changes to the ISAs should enhance the focus of the auditor on disclosures. We agree with the approach to make changes to the relevant ISAs, rather than developing a new separate ISA and welcome the Board's emphasis on the provision of additional application material rather than adding more requirements.

While we believe that the issue of disclosures is typically not significant for the majority of SMEs, we are somewhat concerned that the proposals to revise such a large number of ISAs may place a disproportionate administrative burden on many SMPs. We fear that this burden may outweigh the modest benefits in terms of improved audit quality for the majority of their audit clients. As the Board progresses this project we trust it will carefully consider the cost/benefit analysis of the proposals and whether further evidence of the impact is required.

**SME Environment**

We recognize the concerns which have been raised by some stakeholders in regards to the volume of note disclosures and the risk that useful or relevant information may be obscured. In our opinion, the issue is primarily one for listed and other public interest entities with lengthy and complex disclosures. Worldwide it is estimated that 95% of enterprises are SMEs.<sup>1</sup> The disclosure requirements in the financial reporting frameworks for many SME audits are not as complex and the auditing of their disclosures typically straightforward. In addition, giving appropriate attention to disclosures early in the audit process is unlikely to significantly impact many SME audits, as the time to complete these audits is often fairly short.

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<sup>1</sup> Edinburgh Group, *Growing the Global Economy through SMEs*



In the SME environment there can be instances where the client's staff resource limitations prevent the auditor from receiving all information on disclosures in a timely manner. The SMP may also assist in preparing the financial statements, in particular the relevant disclosures, and as a result these are often made at the end of the audit and hence can be difficult to audit earlier. Nevertheless, we recognize the importance of the auditor being proactive and addressing this issue as early as practicable during the audit.

It is well recognized that SMPs do not have access to the same level of in-house technical resources available at larger firms and so face disproportionate challenges in efficiently and cost effectively implementing international standards. Indeed, keeping up with new regulations and standards continues to be one of the biggest challenges facing SMPs.<sup>2</sup>

We acknowledge that many of the proposed changes are to the ISAs application material, but practitioners will nevertheless have to both familiarize themselves with all the changes, and consider whether their audit methodology and, where applicable, software and training material needs revision. Even when no change is needed, this preparatory work consumes a firm's resources and where the practitioner determines that changes are needed, even more resources would be required.

### **Collaboration and Cooperation**

We agree that many of the issues cannot be solved by the IAASB alone and commend the Board on its active liaison and out-reach with the main stakeholder groups. The close liaison with the International Accounting Standards Board (IASB) and other national standard setters who are reviewing their approaches to disclosures in their standards is especially important. This collaboration is essential in securing global consistency and in helping ensure that disclosures are relevant and financial statements readily understood by the non-expert reader.

In this respect, the Board's continued dialogue with the IASB on its Disclosures Initiative is critical. Whilst we recognize that there remains uncertainty around the timing and outcome of this work we note that, for example, the IASB intends to discuss research on how materiality for disclosures is perceived and applied at its September 2014 meeting. Given the necessity of close alignment of these projects, we are concerned that further revisions to the ISAs could be proposed by the Board (as noted in footnote 16) in the near future. We believe that the IAASB should give further consideration to how the outcomes of both projects could be more closely aligned. This is important to avoid any further disruption to SMPs when implementing new standards and is essential to achieving more appropriate and useful guidance for preparers, in particular in regard to materiality.

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<sup>2</sup> See <https://www.ifac.org/publications-resources/ifac-smp-quick-poll-2013-year-end-round>



## Implementation and Effective date

We support the Board's proposal to align the effective dates for the disclosures proposals with the changes to Auditor Reporting and revision of ISA 720.<sup>3</sup> This should help reduce the costs and facilitate effective adoption and implementation by SMPs. In our view, the minimum effective date for the standards should be 12 months after issuance of the final standards. As earlier application will be permitted, and since the combined number of changes will be significant, we would encourage the Board not to make this period shorter purely to align the effective dates for the Auditor Reporting and ISA 720 projects.

We have outlined below our detailed comments in response to the questions raised in the ED.

### Specific Comments

1. **Whether, in your view, the proposed changes to the ISAs are appropriate and sufficient for purposes of enhancing the focus of the auditor on disclosures and, thereby, will further support the proper application of current requirements in the ISAs?**

Yes, we agree, subject to our comments below.

The proposed changes to the ISAs should enhance the focus of the auditor on disclosures. However, despite these changes, it may not be possible to resolve all issues concerning the auditor's work on disclosures. For example, if financial reporting standards remain insufficiently clear on the way materiality is intended to impact disclosures and the sources of information for certain disclosures, auditing standards cannot offer a satisfactory resolution. Similarly, factors such as tight deadlines or clients' staff resource limitations, which, in practice, may preclude the auditor from receiving all information on disclosures in a timely manner, cannot be overcome by changing audit standards alone.

### Materiality for non-quantitative disclosures

The issue of materiality for non-quantitative disclosures is an important area for preparers and auditors in practice, and for which SMPs in particular would welcome further clarification. However, we support the IAASB's decision not to change ISA 320<sup>4</sup> in isolation as explained in the Explanatory Memorandum, since it cannot be fully addressed by the IAASB alone.

SMPs deal with a variety of different financial reporting frameworks worldwide, as many of their SME clients apply local GAAP. Indeed, recognizing that there is no common definition of materiality in financial reporting frameworks throughout the world, the IAASB chose not to define materiality within its suite of standards during the revisions made in the Clarity Project. Not only do some frameworks fail to contain an explicit definition of materiality, there are likely also differences between those that do. For this reason we suggest the phrase "could be material" should replace the phrases "*could be reasonably expected to influence the economic decisions of the users of the financial statements as a whole*" in ISA 315.A128b<sup>5</sup>

<sup>3</sup> ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

<sup>4</sup> ISA 320, *Materiality in Planning and Performing an Audit*

<sup>5</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*



and “...may be relevant to the economic decisions of the users of the financial statements, such as evolving financial reporting requirements or the changing economic environment” in ISA 700.4b<sup>6</sup>, since the proposed wording may not be in line with all applicable financial reporting frameworks auditors may encounter.

In paragraph ISA 320.6, we note that it may be impossible for the auditor to consider all potential misstatements, especially as some may result from omissions, which by definition would not necessarily be visible to the auditor at the planning stage. We suggest the wording be revised to read: “It is not practicable for the auditor to design audit procedures to detect all misstatements in relation to risks of material misstatement of which the auditor is not aware where such misstatements ~~that~~ are material solely because of their nature. However, consideration of the nature of potential misstatements in non-quantitative disclosures is relevant to the design of audit procedures to address risks of material misstatement when the auditor is aware of these risks.”

### **Audit Evidence**

We also note that the IAASB has deferred further consideration of the issue of sources of information for disclosures and sufficient appropriate audit evidence, pending its deliberations on its strategy and work program. Whilst the majority of SMPs audit financial statements of SMEs that likely do not have many, if any, disclosures based on information derived outside the accounting systems, these are important issues. We will continue to monitor the developments in this area, but accept the IAASB’s reasons for not proposing amendments to ISA 500<sup>7</sup> within this project. In practice it may not be easy to obtain sufficient reliable audit evidence for certain disclosures, especially in respect of those not derived from the accounting system – or more time may be needed than at first anticipated. We therefore suggest adding “or difficulty in obtaining evidence” to the last sentence of ISA 315.A19.

2. **Are there any specific areas where, in your view, additional enhancement to either the requirements or guidance of the ISAs would be necessary for purposes of effective auditing of disclosures as part of a financial statement audit?**

Yes. We have identified the areas below where we believe further clarity or an amendment to the proposed changes is required.

### **Drafting Conventions**

Some of the proposed changes to the application material in the standards appear to have departed from drafting conventions established in the IAASB Clarity Convention project in that they are phrased in the present tense and as such read as requirements. We recommend that the Board clarify whether its intention is for auditors to be required to perform the specific procedure or whether the guidance is intended to merely to suggest that they may decide to do so. For example: ISA 315.A21a and A30; ISA 450.A2a, and A13a<sup>8</sup>; and ISA700 A3b, A4, A4a, A4b, and A4c.

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<sup>6</sup> ISA 700, *Forming an Opinion and Reporting on Financial Statements*

<sup>7</sup> ISA 500, *Audit Evidence*

<sup>8</sup> ISA 450, *Evaluation of Misstatements Identified during the Audit*



We note that certain text in the application material uses “could” (e.g. ISA 450.A13a and A17a) when the term “may” was used in drafting similar text throughout the clarity project and suggest that similar terms be used unless a different meaning is intended. This is particularly an issue for translators where clarity is needed.

### **ISA 700**

We believe that an amendment is required to the end of the first bullet point in ISA 700.A4c, which refers to information being misleading. The issue of whether financial statements are misleading is relevant to compliance only frameworks, whereas for fair presentation frameworks, fair presentation is the issue in question. Paragraph 19 in ISA 700 already deals with the former. We suggest the phrase “*..or results in misleading information*” be amended to read “*..or results in information that is not fairly presented*”.

### **ISA 450**

We welcome the additional examples in the second bullet point in ISA 450.A3 and suggest “erroneous recognition and presentation decisions” be added, since these also lead to judgmental misstatements.

- 3. Whether, in your view, the proposed changes to the assertions will help appropriately integrate the work on disclosures with the audit work on the underlying amounts, thereby promoting an earlier and more effective audit of disclosures?**

The proposed changes to assertions may focus the auditor’s attention earlier on the audit of disclosures. As already highlighted, however, we are concerned about the potential cost of changing the assertions for practitioners, who may need to update their audit methodologies as well as prepare training material for staff. These costs are likely to be disproportionately higher for SMPs compared to large firms and may yield limited benefits for SMEs and their stakeholders in terms of enhanced audit quality.

### **Concluding Comments**

We hope the IAASB finds this letter helpful in further developing proposals to enhance the audit of disclosures. In turn, we are committed to helping the Board in whatever way we can to build upon the results of this exposure draft. Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

A handwritten signature in black ink, appearing to read "Giancarlo Attolini", with a horizontal line above it.

Giancarlo Attolini  
Chair, SMP Committee