

IFAC'S SUPPORT FOR A SINGLE SET OF AUDITING STANDARDS: AUDITS OF SMALL- AND MEDIUM-SIZED ENTITIES

It is in the public interest that users of audited financial statements have confidence that audits of entities, whether small or large, simple or complex, have been performed to the same high standards. The International Auditing and Assurance Standards Board (IAASB)'s International Standards on Auditing (ISAs) are designed for audits of entities of all sizes, and their design enables them to be applied in a manner proportionate to the size and complexity of an entity.

Introduction

A critical objective of the International Federation of Accountants (IFAC) is to encourage and support the delivery of high-quality audits. The IAASB, an independent standard-setting board supported by IFAC, establishes international standards on auditing, review, other assurance, quality control, and related services, and works to improve the quality of practice by professional accountants throughout the world. These standards are established in the public interest. The IAASB's ultimate goal is to increase public confidence in financial reporting.

An objective of financial reporting is to provide users with relevant and reliable information for decision making. The credibility of this information is generally seen as being enhanced when it has been subjected to an audit.

This paper discusses the public interest considerations relevant to the application of ISAs for audits of small- and medium-sized entities (SMEs). It highlights how IFAC and the IAASB take into account the needs and views of SMEs and small- and medium-sized accountancy practices (SMPs), as well as describing initiatives undertaken so that ISAs can be used cost-effectively for the financial statement audits of entities of all sizes. Implications for IFAC members and associates are also discussed.

Public Interest Considerations

IFAC identifies two key public interest considerations regarding the applicability and relevance of the ISAs to the audits of SMEs. The first consideration is the importance of having an audit of financial statements associated with one consistent level of assurance, regardless of the size of the entity being audited or the size of the firm performing the audit. The second consideration is the assurance needs, on a benefits and costs basis, of SMEs; and whether an audit, an assurance service other than an audit, or no assurance is required.

An Audit: One Consistent Level of Assurance

The public has expectations about what an audit means, and will assume that an audit has been conducted on the same basis to arrive at the same opinion. Issuing an audit report based on a set of auditing standards that are different from ISAs, or where the ISAs have been modified, will confuse the marketplace and may result in a loss of credibility in auditors, the audit process, and financial reporting. This is because the same level of assurance could not necessarily be reliably achieved from a subset of ISAs (i.e., the ISAs must be taken together as a suite of standards) or a set of auditing standards different from the ISAs and, thus, the term "audit" would not be associated with one single level of

assurance. Therefore, IFAC strongly supports the IAASB's mission to develop and maintain a single set of auditing standards that can be applied to all audits.

Users of Financial Statements

It is IFAC's view that the word "audit" should convey a message to users of financial statements that the auditor has obtained reasonable assurance that the financial statements, as a whole, are free from material misstatements, regardless of the size, complexity, or type of the entity that has been audited.

One consistent level of assurance associated with the word "audit" is important, as it serves the public interest by allowing users of financial statements to have a common understanding about their reliability. It assists in minimizing the differences in understanding between different groups of what constitutes an audit, and the objective of undertaking an audit. The absence of one consistent level of assurance associated with the word "audit" would: add costs to users, as they would need to devote resources to understanding the differences in the assurance being given and then assess the impact on the reliability of the financial statements; and/or add risk, if users chose to make decisions without understanding the level of assurance associated with the "audit."

While the audit approach itself may differ, the auditing standards on which it is based (i.e., the ISAs) and the level of assurance the auditor is required to obtain should not. It is in this sense that "an audit is an audit."

Therefore, the word "audit" should not be associated with any other level of assurance as this is likely to confuse users of financial statements.

Auditors' Approach to an Audit

When conducting audits using ISAs, all auditors are required to meet stringent quality control and ethical requirements, regardless of the size and complexity of the entity being audited.

ISAs define the responsibilities of auditors in obtaining reasonable assurance that a set of financial statements is fairly presented and free from material misstatement. In conducting an audit, auditors evaluate the information provided, and assertions made, by management and/or those charged with governance in their financial statements. ISAs set out the auditor's objectives and specify requirements designed to help achieve those objectives in conducting an audit and forming an opinion. They also provide guidance to assist in the consistent application of the requirements in practice. They do not ordinarily specify or limit the procedures that an auditor must perform to arrive at a level of assurance sufficient to enable the auditor to express an audit opinion.

Each audit is different and in conducting the audit the auditor must use professional judgment. ISAs focus on the objectives to be achieved and the essential considerations for the auditor in planning, conducting, documenting, and reporting on the audit.

ISAs acknowledge that some requirements may not be relevant in the circumstances of a particular audit (e.g., an audit of an SME), in which case that requirement is not applicable. In exceptional cases—where a specific procedure would be ineffective in achieving the aim of a requirement—the auditor may judge it necessary to depart from a relevant requirement; the auditor is then required to conduct alternative procedures in order to achieve the aim of that requirement. Also, there will be situations where an entire standard will not be relevant (e.g., ISA 600, *Special Considerations—Audits of Group Financial Statements (including the work of Component Auditors)*) may not be relevant for an audit of an SME). The facts and circumstances surrounding the audit dictate whether particular ISAs, or

requirements within ISAs, are relevant to the audit. In applying ISAs, the auditor exercises professional judgment to determine the most effective approach for an audit of a particular entity.

Determining the Need for an Audit, Assurance Other than an Audit, or No Assurance

In determining the appropriate assurance service, on a benefits and costs basis, for SMEs, several factors should be considered. First, while the audit imposes compliance costs, there are public interest reasons for mandating an audit where the legal form of the SME (limited liability companies, for example) exposes third parties, such as investors, banks, or suppliers, to risk if they do not have reliable financial information as a basis for dealing with the SME. Furthermore, while some people consider that the cost of conducting an audit using ISAs may be higher than the cost of using a different set of auditing standards, or a set of “modified” ISAs, there are potentially significant benefits accruing to the SME where an auditor uses internationally accepted high-quality ISAs. Potential benefits, including the enhanced credibility of financial reporting, greater chances of access to finance, and improved risk management, control systems and governance, should not be discounted. SMEs that engage in cross-border transactions, or that have plans to grow and potentially become publicly listed, can also benefit from the discipline of having audits undertaken by an auditor using ISAs.

Second, if an audit is not required for SMEs, careful consideration must be given to decisions pertaining to assurance services other than an audit, or requiring no assurance at all, in relation to the financial reporting of SMEs. This is a matter to be determined by each individual jurisdiction, taking account of market participants’ evaluation of the benefits and costs of an audit requirement in that jurisdiction, as compared with assurance services other than audit provided by professional accountants, or no assurance at all. The IAASB recognizes two levels of assurance. They are a reasonable level of assurance, provided by audit engagements, and a limited level of assurance, provided by review engagements. While generally provided at a lower cost, review engagements typically offer a lower level of assurance.

It is recognized that even in situations when assurance is not mandated, SMEs may voluntarily choose to have an audit or seek some other form of assurance.

Exemptions, by way of legislation or regulation, from audit, or indeed any form of assurance, have been proposed or implemented in a number of jurisdictions as a means of reducing the perceived regulatory burden on SMEs. Many of these exemptions have been directed toward small-sized entities, rather than medium-sized entities. However, this may not always be in the best interests of the entity or the public. In many countries small entities represent a considerable proportion—in some major economies over 90 percent—of the total enterprises operating within a country, and hence a loss of credibility in the financial reporting of these entities may have a significant impact on the economy of those countries. Careful evaluation needs to be made of the benefits and costs of changing the requirement for an audit, in particular when exempting SMEs from any form of assurance.

Addressing the Needs of SMPs and SMEs

IFAC and the IAASB are committed to addressing the needs of SMEs and SMPs (many of which perform audits of SMEs) by enhancing their capacity to provide high-quality services. These two organizations have undertaken numerous initiatives to address issues pertaining to SME audits, with a focus on serving the public interest and with attention given to the practical needs of SMEs.

- IFAC’s Small and Medium Practices (SMP) Committee provides input to the IAASB’s standard-setting process (www.ifac.org/about-ifac/small-and-medium-practices-committee/smp-activities-and-interest-areas). It submits comment letters at all key stages of the development process, from project proposal to draft exposure draft (ED) and, often, post-exposure. Through representation on the IAASB Consultative Advisory Group (CAG)¹ the Committee ensures that specific needs of SMEs and SMPs are addressed when appropriate. Members of the Committee may also serve on IAASB project task forces when there are issues that are particularly relevant to the SME or SMP community.
- The IAASB follows a rigorous due process that is overseen by the Public Interest Oversight Board.² Among other things, this ensures that input from the SME and SMP perspectives is given proper consideration.
- Recognizing that ISAs are applicable to entities of all sizes, the IAASB also includes individuals with familiarity or direct experience with SME audits.
- In developing its international standards, the IAASB gives due consideration to issues specific to SME audits. In addition, the ISAs include a section, where applicable, entitled “Considerations Specific to Smaller Entities.” Their design enables them to be applied in a manner proportionate with the size and complexity of an entity.
- The IAASB suite of standards includes standards (e.g., International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Financial Statements*) that cover assurance services other than an audit.
- IFAC provides implementation support to enhance audit quality and increase the capacity of auditors, especially SMPs, to efficiently comply with international standards while maintaining their competitiveness. To support SMPs and others in understanding and efficiently applying ISAs to the audits of SMEs, IFAC has issued implementation guidance titled *Guide to Using ISAs in the Audit of Small- and Medium-sized Entities*³.

Implications for IFAC Members and Associates

IFAC members and associates play an important role in promoting the adoption, implementation, and effective use of ISAs. They can promote these aims in a number of ways.

- As part of its Member Body Compliance Program, IFAC relies on its members and associates to promote to their individual members the use of international standards issued by independent standard-setting boards supported by IFAC, as well as those released by the International Accounting Standards Board (IASB). These efforts will contribute significantly to achieving global adoption of high-quality international standards, a goal shared by IFAC, the IAASB, and the IASB. These bodies all recognize that global adoption will improve the quality, consistency, and reliability of financial information.

¹ The CAG is a key element of the standard-setting arrangements. It enables the IAASB to receive technical advice, as well as advice regarding agendas, from interested external public sector and private sector institutions.

² Details about the IAASB’s due process are available on its home page: www.iaasb.org.

³ www.ifac.org/about-ifac/small-and-medium-practices-committee/smp-resources-and-tools and www.ifac.org/auditing-assurance/clarity-center

- Members and associates help communicate the message that auditors in their respective jurisdictions may not assert that they have conducted an audit in accordance with ISAs unless they have adhered to all ISAs as published and applicable at the relevant time, or as modified in the limited respects set out in the IAASB's policy statement on modification to its standards.⁴ This will foster increased consistency in the application of ISAs and contribute to greater understanding of an ISA audit report.
- Members and associates aim to communicate to regulators in their jurisdictions the two levels of assurance (audit and review) and to mutually agree whether and how they should be promulgated nationally. This involves having a clear understanding of the benefits and costs of an audit vis-à-vis assurance other than an audit or requiring no assurance.
- It is recognized that some users may not appreciate the difference between audits and review engagements. If two levels of assurance are typically provided within their jurisdiction, members and associates need to inform the general public, investors, lenders, and others of the differences between the levels of assurance being provided.
- Members and associates aim to identify the needs of their members with respect to the application and use of ISAs. They encourage the development of guidance and tools and support the training needs of their individual members, to permit the effective application of ISAs to audits of all financial statements, regardless of the size of the entity.

Conclusion

IFAC believes that high-quality auditing standards (i.e., ISAs) are capable of being applied to audits of the financial statements of entities of all sizes. This enables a consistent level of assurance to be associated with the word "audit" and allows users to make decisions based on a common understanding about the reliability of audited financial statements.

IFAC continues to support the work of the IAASB in achieving its objective of ensuring that ISAs are applicable to the audits of all entities, regardless of their size. It will continue to develop implementation guidance when necessary to assist auditors in complying with ISAs, as well as to work on the other initiatives described above.

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⁴ See the IAASB's July 2006 policy position, *Modifications to International Standards of the International Auditing and Assurance Standards Board (IAASB) - A Guide for National Standard Setters that Adopt the IAASB's International Standards but Find It Necessary to Make Limited Modifications*

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IFAC’s Mission

IFAC's mission is to serve the public interest by:

- Contributing to the development, adoption and implementation of high-quality international standards and guidance
- Contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants
- Promoting the value of professional accountants worldwide
- Speaking out on public interest issues where the accountancy profession's expertise is most relevant



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