

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

INTRODUCTION

A critical objective of the International Federation of Accountants (IFAC) is to encourage and support the delivery of high quality audits. The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of 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. Its ultimate goal is to increase public confidence in financial reporting.

Questions have been raised regarding the applicability and relevance of the international auditing standards to the audits of small- and medium-sized entities (SMEs).

This paper sets out IFAC's view that the IAASB's International Standards on Auditing (ISAs) are designed to be applicable to the audits of entities of all sizes. If auditors intend to issue an ISA audit report, they must comply with all the ISAs.

This paper also analyzes the core issues affecting SME audits and considers their public interest implications. It identifies IFAC and IAASB initiatives to address these core issues, including how IFAC and the IAASB take into account the needs and views of SMEs and small- and medium-sized audit practices (SMPs) so that ISAs can be used for the audits of the financial statements of entities of all sizes.

CORE ISSUES FOR SMES

The core issues affecting the applicability of ISAs to SME audits are:

- *Selected use of auditing standards* – With respect to financial reporting, it has been suggested that the public interest may be better served if separate reporting standards (differential reporting) are developed for SMEs. The International Accounting Standards Board (IASB) released an exposure draft of a proposed International Financial Reporting Standard for Small and Medium-sized Entities in 2007 (now renamed as IFRS for Private Entities) and is planning to publish the standard in the first quarter of 2009.

In light of the IASB's initiative, the concept of a similar model for auditing standards has been raised. It has been

suggested that, in relation to the audits of SMEs, it might be possible to follow only selected auditing standards and issue an audit report based on these selected standards.

- *Cost effectiveness* – SMPs, which frequently serve as auditors of SMEs, have expressed concern that conducting an audit in accordance with ISAs is becoming more expensive, especially in light of added requirements and changes resulting from the IAASB's Clarity project, in which all standards are being redrafted to enhance their clarity and understandability.¹
- *Relevancy* – SME perspectives need to be considered in the development of ISAs and other IAASB pronouncements so that SMEs are not subject to excessive compliance requirements and costs.
- *Exempting entities from compulsory audits* – Where there are audit regulations, there has been pressure to exempt some smaller entities from having an audit.

PUBLIC INTEREST IMPLICATIONS

In considering how to address the issues mentioned above, the following two matters need to be considered.

The public has expectations about what an audit means; issuing an audit report based on a modified or a different set of auditing standards will confuse the marketplace and may result in a loss of credibility in auditors, in the audit process, and in financial reporting. This is because the same level of assurance could not reliably be achieved from a subset of auditing standards or a different set of auditing standards and, thus, the term "audit" would not be associated with a single level of assurance.

The implication of exempting, by legislation or regulation, more SMEs from having their financial statements audited by an independent auditor needs to be carefully considered. This has been proposed or implemented in a number of jurisdictions as a means of reducing the regulatory burden on SMEs. This

¹ Key elements of the IAASB's clarity drafting conventions include: establishing an objective for the auditor with respect to the subject matter of each standard; clearly distinguishing requirements from guidance on their application; avoiding ambiguity through eliminating the present tense to describe actions by the auditor and using more imperative language where a requirement was intended; and other structural and drafting improvements to enhance the overall readability and understandability of the standards.



may not always be in the best interests of the SME, or the public, and the benefits and costs of changing the requirement for an audit need to be carefully evaluated. While the audit imposes compliance costs, there are public interest reasons for requiring an audit where the legal form of the SME (limited liability companies, for example) exposes third parties to risk if they do not have reliable financial information as a basis for dealing with the SME. This is a matter to be determined by the individual jurisdiction, taking account of market participants' evaluation of the benefits and costs of the audit requirement in that jurisdiction, in comparison with alternative assurance services provided by professional accountants.

THE REASONS FOR A SINGLE SET OF AUDITING STANDARDS

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 are free from material misstatements, regardless of the size or type of the entity that has been audited. IFAC considers that high quality auditing standards should be, and in fact are, capable of being applied to the audits of the financial statements of entities of all sizes. Therefore, the word "audit" should not be associated with any other level of assurance as this is likely to confuse users of financial statements.

Auditing standards require the auditor to obtain reasonable assurance that financial statements are free from material misstatement. This consistent level of assurance associated with the word "audit" is important. It serves the public interest by allowing users of financial statements to have a common understanding about the reliability of financial statements. If the word "audit" were to encompass different levels of assurance, this would either add costs to users, as they would need to spend time and money to understand the differences in the assurance being given and then assess the impact on the reliability of the financial statements, or add risk, if they chose to make decisions without understanding the level of assurance associated with the "audit."

To conduct an audit and obtain reasonable assurance, auditors need to evaluate the information provided by management in the financial statements. Auditing standards define the responsibilities of auditors in carrying out this task. They do this by setting out requirements, including in some cases specific procedures, which the auditor must follow in conducting an audit and forming an opinion. They also provide guidance for the application of the requirements in practice. They do not 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. Auditing standards focus on the

principles to be followed, the objectives to be achieved and the essential considerations for the auditor in planning, conducting, documenting, and reporting on the audit.

In addition, ISAs allow for the fact that, occasionally, a requirement within the standards may not be relevant to a particular audit, in which case that requirement is not applicable. In some exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement and is then required to conduct alternative procedures in order to achieve the aim of that requirement. By applying the standards rigorously, using professional judgment, the auditor can thereby adopt the most effective approach for a particular audit of an entity regardless of size.

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

IFAC, therefore, strongly supports the approach taken by the IAASB to develop a single set of standards that can be applied to all audits.

INITIATIVES OF IAASB AND IFAC TO ADDRESS THE NEEDS OF SMES

The IAASB and IFAC have made a commitment to continue to address the needs of SMEs. They have undertaken numerous initiatives to address issues pertaining to SME audits, with a focus on serving the public interest and with attention to the very practical needs of SMEs.

- 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 an SME perspective is given proper consideration.
- Recognizing that its auditing standards are applicable for entities of all sizes, the IAASB membership also includes individuals with an SMP background.
- In developing its international standards, the IAASB gives due consideration to issues specific to SME audits. In addition, the IAASB's new standards include a section entitled "Considerations Specific to Smaller Entities."
- IFAC's Small and Medium Practices (SMP) Committee provides input to the IAASB's standard-setting process to ensure that specific needs of SMEs and SMPs are addressed when appropriate. Members of the committee also serve on IAASB project task forces when there are issues that are particularly relevant to the SME or SMP community.

² Details about the IAASB's due process are available on its home page: <http://www.iaasb.org>.

- The IAASB has established a standard (International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Financial Statements*) relating to the situation where a practitioner conducts a review of financial statements. This standard requires a different level of work effort by the practitioner and results in a different (and lower) level of assurance, thus giving SMEs an alternative to obtaining an audit.
- The IAASB has considered input, as part of its strategy review consultations, about the concept of an alternative assurance service for SMEs, also based on appropriate IAASB standards and supported by a specific and appropriate work effort. This alternative form of assurance would serve the public interest more effectively than developing differential standards of audit, but it would still enable the expression of some level of assurance by an external independent accountant. The idea of an entirely new service was not supported; however, revisions to the standards on compilation and review engagements may assist professional accountants in this market.
- Based on comments received on the IAASB's proposed future strategy, the IAASB has on its agenda for 2009 a proposal to consider changes to its standard on review engagements (ISRE 2400) in light of the current needs of the marketplace.

Additionally, it should be recognized that, while in some jurisdictions the difference between audits and review engagements is well understood by practitioners and accepted by the business community, in others the review engagement is not well understood or the audit is still considered the only service offered by practitioners. It is, therefore, necessary to communicate the meaning of the level of assurance provided by a "review" or a similar service to regulators, legislators, investors, lenders, and others who rely on financial statements.

The decision on whether an audit or an alternative assurance service best meets the needs of each individual SME must be evaluated on an entity-by-entity basis, where there is no legislative or regulatory requirement. IFAC does not see it as being necessary that a service like a review engagement be the subject of regulation, but rather takes the view that it should achieve market acceptance based on the communication of its benefits to lenders, owners and other users.

- As part of the project to revise the standard on review engagements, the IAASB has commissioned the staff of three national auditing standard setters to develop a consultation paper to assist the IAASB in seeking input

on the elements that would provide a relevant and cost-effective assurance service that is an alternative to an audit for SMEs in particular. IFAC encourages the broader accountancy community to assist the work of the IAASB by responding to the consultation paper issued in September 2008. IFAC is committed to ensuring that any new assurance service reflects the best traditions of independent judgment, and maintains the reputation of the profession.³

- IFAC recognizes that there is a need to provide implementation assistance to increase the capacity of auditors, especially SMPs, to efficiently comply with international standards while maintaining their competitiveness. IFAC continues to encourage the development of such guidance by its SMP Committee, member bodies, standard setters, and others.

To support SMPs and others in applying ISAs to the audits of SMEs, IFAC released new implementation guidance entitled *Guide to Using ISAs in the Audit of Small- and Medium-sized Entities*. This guide, which is available free from our website, provides an analysis of all ISAs issued as of December 31, 2006 and their requirements in the context of an SME audit. IFAC is already planning an update to the guide once the IAASB's Clarity project has been completed to include the newly redrafted ISAs.

IMPLICATIONS FOR IFAC MEMBERS AND ASSOCIATES

As part of its Member Body Compliance Program, IFAC continues to rely on its members and associates to promote to their individual members the use of IFAC's international standards as well as those released by the IASB. This will contribute significantly to achieving convergence, a goal shared by IFAC, the IAASB, and regulators and standard setters around the world who see convergence as a means of improving the quality, consistency and reliability of financial information.

In addition, it is important for members and associates to help communicate that auditors in any country may not indicate 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 applica-

³ The Consultation Paper, *Matters to Consider in a Revision of International Standard on Review Engagements 2400, Engagements to Review Financial Statements*, can be accessed at <http://www.ifac.org/ED>.

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*

tion of ISAs and contribute to greater clarity in the understanding of an ISA audit report.

Another challenge for members and associates is 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 mandated nationally. Additionally, if two levels of assurance are provided, members and associates need to inform the general public about these two forms of assurance and their implications for the financial statements. Such communication is necessary to make investors, lenders and others aware of the specific level of assurance provided on an entity's financial statements and its implications.

CONCLUSION

IFAC believes that high quality auditing standards should be

capable of being applied to the 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 in the light of a common understanding about the reliability of the financial statements.

IFAC will continue 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. IFAC will continue to develop implementation guidance when necessary to assist auditors in complying with ISAs and will also continue working on the other initiatives described above.

COMMENTS

IFAC and the IAASB welcome comments on the views presented in this paper. Comments may be sent to smeaudit@ifac.org.

This Policy Position has been prepared by IFAC.

The approved text of this Policy Position is published in the English language.

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IFAC'S MISSION

To serve the public interest, the International Federation of Accountants (IFAC) will continue to strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.



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