



**THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS**  
IN ENGLAND AND WALES

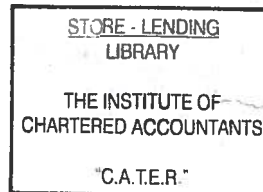
29 October 2008

Our ref: ICAEW Rep 124/08

Your ref:

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Dear Mr Thompson

**GUIDE TO USING INTERNATIONAL STANDARDS ON AUDITING IN THE AUDITS OF  
SMALL- AND MEDIUM-SIZED ENTITIES**

Further to the letter dated 4 August from the Institute of Chartered Accountants in England and Wales (the Institute), setting out high level comments on the December 2007 *Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities*, I write with detailed comments and recommendations for the next, 'clarity' version of the Guide.

These comments have been prepared by the IFAC SMP audit working party on behalf of the Institute. I hope that you will find them useful, but please contact Mary-Louise Wedderburn, Secretary to the working party, if you would like to discuss any of the points in more detail.

Yours sincerely

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**ICAEW Representation**

**ICAEW REP 124/08**

**GUIDE TO USING INTERNATIONAL STANDARDS ON AUDITING IN THE  
AUDITS OF SMALL- AND MEDIUM-SIZED ENTITIES**

**Detailed comments submitted in October 2008 by The Institute of Chartered Accountants in England and Wales on the IFAC Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities.**

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Institute high level comments dated 4 August 2008

## WHO WE ARE

1. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
2. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

## INTRODUCTION

3. The Institute submitted interim comments on the *Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities* published in December 2007 (the Guide) in a letter dated 4 August. The letter, which is appended to this submission, dealt with the general approach and structure of the Guide and stated that we proposed to review the Guide in depth with a view to providing more detailed comments and recommendations for the updated guidance that is now being prepared by the IFAC Small and Medium Practices Committee. The following paragraphs set out those comments and recommendations.
4. We would say at the outset that we are entirely aware that there is much good and useful material in the Guide. Almost all individuals who have read the Guide have found items that are of particular interest and many have reconsidered some aspects of their audit work in the light of material in the Guide. Similarly, many trainers have appreciated those sections of the Guide that are particularly useful in illuminating a specific aspect of auditing, and have gone on to adapt them for use in the training they provide. Our comments should not be taken to imply that we undervalue the effort and expertise that has gone into the production of the Guide, merely that we have very significant concerns about the nature of the package that has resulted.
5. We support IFAC's view, set out in its statement of 1 October 2008, that International Standards on Auditing (ISAs) are designed to be applicable to audits of financial statements of entities of all sizes. We agree that the consistent use of the ISAs is essential to meeting the public interest expectations of an audit. If auditors intend to issue an ISA audit report, they must comply with the ISAs. The way in which requirements of standards are met will differ between sizes of entity, although we would also note that the same diversity of detail will affect different types of entity. But the need to meet those requirements must be absolute.
6. We consider that the Guide evinces a lack of focus. Many of the specific problems that we have identified stem from this basic problem. The Guide attempts to provide an overview of the approach that underpins ISAs, to deal with the requirements of each standard, to deal with the generality of audit work whilst also covering areas that have changed, and to be useful to experienced practitioners whilst meeting the needs of persons new to auditing. Unfortunately we consider that in trying to meet so many needs, it has failed to meet any of them adequately.

7. We do not specifically comment on whether there might be value in the production of separate ISA guidance aimed directly at the needs of different potential user groups, other than experienced auditors acting in respect of SMEs. We consider such an issue outside of the scope of comments on this Guide. However, a point for consideration by the working party is whether two guides might be published, rather than trying to produce in one document guidance that will be useful in all jurisdictions and economies. It may be better to publish two guides, one along the lines of the current Guide, for new economies where there is not a large body of existing professional guidance and experience, and the other much shorter, comprising material such as the 'consider points' and examples that will help auditors to scale and adapt the requirements of ISAs to the circumstances of individual clients. This short guide would be based on the key stages of the audit, rather than follow an ISA by ISA approach.
8. We would note that all of our recommendations are geared towards providing assistance in the production of a revised Guide which covers the clarity ISAs.

## **GENERAL POINTS AND RECOMMENDATIONS**

9. As well as recommendations concerning specific aspects of the Guide, we also have some general recommendations.
10. In the very first section of the Guide (Page 5) it is stated that "It is assumed that practitioners already have a knowledge of the 2007 edition of IFAC's Handbook of International Auditing, Assurance, and Ethics Pronouncements." Despite this statement, we remain unconvinced that the assumption has in fact been followed through in the production of the Guide, since in many cases it contains an extensive discussion of the requirements of particular standards, without concentrating on the ways in which the standards can be applied in the context of an SME audit.
11. The terminology used in the Guide, and explicitly dealt with in the section from page 9 onwards, also makes it clear that the Guide has not been developed with a typical SME in mind, even supposing that there were such an entity – see our paragraphs 18 to 23 below. "Those Charged with Governance" have been distinguished from management, when one of the major issues facing the SME auditor is often the absence of such a level as distinct from the management of the entity.
12. Against the background of the clarity project we would note that extreme care will need to be taken in drafting the revised version of the Guide to avoid using terms with specific meanings or implications. Terms such as "should," "would," and "will" in relation to actions to be taken by the auditor should not be used in the Guide unless they are quoting or reporting a requirement in the clarified ISAs.



13. It is also essential that the revised Guide avoids prescription (over and above the items prescribed by standards) and specific detail: it should instead explain the principles so that auditors can use their professional training and judgment to apply the ISAs and other pronouncements in issue to the circumstances of each audit. Experienced practitioners need more emphasis to be placed on those areas which are new in the ISAs and where auditors of smaller entities are likely to experience implementation difficulties. As noted above, we are entirely supportive of the idea of providing specific examples of how the requirements of standards could be met. Indeed, this is likely to be one of the main benefits of any Guide of this nature. However, it must be made clear where an example is simply that; one way in which a requirement could be met in a specific set of circumstances. The revised Guide must not, implicitly as well as explicitly, place any additional requirements on auditors or imply that the only way to meet a requirement is to follow a specific procedure where that procedure is not mandated by the relevant standard.
14. Where procedures are described, care needs to be taken to ensure that such procedures are potentially scalable, and could be applied to different sizes and types of entity, even whilst acknowledging that auditors of, for example, differently sized entities might adopt other procedures which would equally be entirely acceptable. The reason for this is that many auditors will deal with both SMEs and non-SMEs. It would not be beneficial to embed in the revised Guide any approach which could not also be applied to other entities. However, whilst we consider that the approach must be scalable, we do not consider that this should be dealt with explicitly in the Guide. To do so would, in our view, reinforce the lack of SME focus of the Guide that is our greatest criticism of the current version.
15. The Guide needs to integrate the procedures required under individual ISAs so that they flow naturally through the audit process. Findings from procedures need to be linked to their implications for amounts and disclosures appearing in financial statements or the audit opinion. For example, there needs to be better follow-through from assessment of internal control, through design of substantive procedures, to the assessment of evidence obtained to support the audit opinion.
16. We recommend that the Guide include consideration of efficiency, through discussion of the cost/benefit balance of tests of control versus substantive tests. The risk model developed should enable the auditor to focus effort on what is going to achieve the audit objective for the best use of resources.
17. We also recommend that the Guide include a section on audit completion and file closure. As well as going concern – where there are often particular issues relating to the vulnerability and informal systems of smaller entities - there are overarching issues of quality control that need to be considered.

#### **DEFINITION OF 'SMES'**

18. We consider that some of the problems with the current guide, in addition to its lack of focus, derive directly from the absence of a clear definition of the nature of the entity towards which the Guide is directed. As we have indicated above, we consider that the Guide should be directed towards entities which have internal controls which are relatively few and informal. The current Guide appears to assume a level of controls which is considerably in excess of that likely to be found, or indeed to be appropriate, within a smaller entity. This then means that the audit methodology embedded in the Guide places far too great an emphasis on the controls within accounting systems. What would be more useful would be guidance on the extent of understanding and documentation of simple control systems, and the auditor's reaction to such systems.

19. In order to ensure that the Guide can be sufficiently focussed there needs to be at least a working definition of 'SMEs' which is used for the purposes of the Guide. We are aware of IFAC SMP working group reservations about a precise definition of SMPs, and similar considerations could apply to defining SMEs, but we believe that reference to a set of qualitative characteristics would enable the Guide to focus on audit considerations that are particular to such entities. Qualitative characteristics suggested by APB in PN26 are:
- Concentration of ownership/control in the hands of a few, or one, individual;
  - Operations uncomplicated with few sources of income and activities;
  - Business processes and accounting systems are simple; and
  - Internal controls are relatively few and may be informal
20. We would reject any criteria which were solely or largely quantitative, since if the revised Guide is to have value it must focus on a particular type of entity which is subject to audit, and not on entities which happen to fall within arbitrary size limits.
21. If it is too difficult to devise a precise definition of an SME, then we would suggest that another term be used, again in order to limit the scope of the Guide. The key feature of entities that we consider should be the subject matter of the guidance is that they are not complex. We therefore suggest the term 'Non Complex Entity', or NCE, and we illustrate this point by using the term for the remainder of this submission, except where we are quoting an existing reference or publication.
22. We would note that there is precedent for this in that the IASB has amended the title of its IFRS for SMEs so that it now refers to private entities. (For the avoidance of doubt we are not suggesting that the same term or definition be used for the purposes of the Guide, simply that an alternative description may be more appropriate.)
23. The Guide could also scope out entities that are definitely not NCEs. Listed companies are certainly not NCEs, but other types/structures/sizes might also be ruled out of a working definition. One suggestion is to exclude entities that have public accountability or which, such as charities, hold assets in a fiduciary capacity or are involved in the collection of donations or subscriptions.

#### **RESTRICTING GUIDE TO NCE-SPECIFIC CONSIDERATIONS**

24. If the Guide were restricted to issues that require particular considerations in relation to NCEs, much of the material in the current version could be omitted. A number of ISAs contain general requirements and guidance that apply equally to every audit. Where this is the case, it may be better for the Guide to contain nothing more than a reference to the ISA, indicating that there are no NCE specific matters that require consideration in the Guide. We recommend that text on the following ISAs could be dropped, apart from noting in the revised Guide that they apply on every audit, irrespective of the complexity of the entity:
- ISA 210: Terms of Audit Engagements
  - ISA 300: Planning an audit of financial statements
  - ISA 580: Management Representations
  - ISA 700: The Auditor's Report on Financial Statements
  - ISA 701: Modifications to the Auditor's Report

## **CASE STUDY**

25. The case study examples need not only to illustrate the procedure described in the preceding text, but also to follow through to the resulting audit actions/judgment. For example, the case study on materiality at the end of chapter 2.5 shows how materiality is calculated, but not how it is used in the audit.
26. We recommend that a more realistic example of a NCE be used for a case study to illustrate different stages of the audit process to show how the procedures flow through the assignment. The case study must demonstrably be based on the same characteristics that have been used in defining an NCE for the purposes of the Guide. As noted previously, we do not consider that the current case study meets this criterion. While the numbers may be small the case study appears to be a large and complex entity in miniature.
27. In addition there should be unconnected, short illustrative examples within the Guide. Whilst the use of a single case study is better suited to demonstrating the interaction between elements of the audit, the use of multiple small case studies is better suited to showing how an ISA compliant audit can be undertaken in varied circumstances. We would again note Practice Note 26 issued by the APB which provides more than one example of documentation for situations, in order to avoid the problem of implying that one method is most appropriate.
28. The case study and examples should concentrate on particular aspects of the audit that may be problematic under ISAs and where issues may arise which are specific to an NCE audit. For example, they could demonstrate the risk assessment procedures, and the impact that those procedures will have for the audit, for an entity where:
- the control environment amounts to the attitude of the owners of the business, who are also involved in day to day management;
  - control activities are limited, and may not be susceptible to testing of operational effectiveness; and
  - monitoring of controls is limited.
29. The current case study is based on the assumption that testing of the operating effectiveness of controls is both possible, and the most efficient method of undertaking the audit. With many NCEs, one or both of these assumptions will be invalid. The Guide then provides extensive documentation concerning the control activities in place. We do not consider that this is likely in practice; a better focus would be achieved by concentrating on the extent of understanding and documentation required where testing of controls is unlikely to be a major element of the audit. This is an area which gives rise to significant problems in practice.

## **BASIC CONCEPTS**

### **What is a Risk Based Audit?**

30. While this section of the Guide provides a reasonable brief summary of the approach underpinning ISAs (albeit with no particular reference or relevance to NCEs) we would query the need for such a section at all. It is insufficient for the uninformed and superfluous for the informed (who are assumed to "have a knowledge" of ISAs, according to the statement on page 5).



31. What would be valuable would be a brief introduction to some of the specific issues that arise in the application of the ISA approach to NCEs. These would then form the content for the remainder of the Guide.

### **Nature of Internal Control**

32. Again, this section provides a reasonable high level overview of internal control, but lacks any focus on the smaller entity with limited formal control systems. For example, on page 49 it is stated that entity wide controls are sometimes referred to as "head-office controls". We do not consider that this is appropriate terminology for the types of entity towards which this Guide should be directed, since we do not consider such entities will have a "head office" and the use of such terms indicates it is other, larger, entities which are actually being considered.
33. Similar to our recommendations in the previous section, what would be useful would be guidance that identifies the likely control characteristics of an NCE, and then shows how the approach towards such control characteristics can be dealt with and documented under ISAs. This would include the auditor's reaction to the likely absence of controls that might be encountered routinely in the audits of larger and more complex entities.
34. The documentation requirements implied within this section also do not, in our opinion, reflect the requirements of ISA 315 for the auditor to document "Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 20, including each of the internal control components.." but go far beyond the key elements, assuming that the elements will form the basis for extensive testing of the operating effectiveness of control activities.

### **Financial Statement Assertions**

35. This section should be much shorter. The assertions are covered in ISA 500 and do not vary according to the size or nature of the entity subject to audit. What is needed is guidance on the nature of the work undertaken to obtain sufficient appropriate audit evidence in respect of each of the assertions in the context of a NCE. Whilst we consider that this section does not need to be long, we do consider that its importance must be stressed. The use of assertions lies at the heart of all audits, including those of NCEs. However, we would prefer that other sections, where dealing with the audit tests that are being planned, should reinforce the importance of assertions, rather than there being a simple statement in just one section.
36. At a more detailed level we would note that:
- a) the listing of assertions from ISA 500 is incomplete, in that it does not deal with assertions relevant to account balances;
  - b) we are concerned that the section starts with generic assertions, and then attempts to fit these into the framework of ISA 500. In a Guide to ISAs we would have expected the assertions of ISA 500 to form the starting point; and
  - c) we are unconvinced by the use of combined assertions. Whilst we acknowledge that this approach is entirely consistent with, and allowed for in, ISA 500 we consider it would be preferable to base the use of assertions in an ISA Guide on those that are actually referred to in the ISAs.

## **RISK ASSESSMENT**

### **Understanding the Entity**

37. We consider this section to be excessive, and insufficiently geared to the needs of an NCE. For example, when dealing with the nature of the entity it is noted that "Complex structures may give rise to risks of material misstatement..." This is clearly true, but we would consider that this Guide should not be directed towards the types of entity where such issues arise. Similarly, when dealing with measurement and review of financial performance reference is made to divisional and departmental reporting. The type of entity towards which we consider this Guide should be addressed will not have such a structure.
38. More generally, this section summarises the requirements of ISA 315 insofar as they apply to all entities; requirements that the user is assumed to know.
39. The diagrams provided are not always helpful and in some cases are misleading. In particular 2.1.7 appears to imply that all inherent risks are high, and that it is then the environmental factors that reduce risks to moderate and then control activities that reduce the risk to low. This may apply in some cases, but is presented as though it is generic. We can see no value whatsoever in 2.1.8, which appears to add nothing, other than the facile statement that fraud is intentional.

### **What Are Risk Assessment Procedures?**

40. This is another perfectly reasonable summary of the relevant requirements of ISA 315, with insufficient focus on any particular issues that might arise in the context of an NCE audit.

### **Client Acceptance and Continuance**

41. The guidance provided is generally unobjectionable, other than that it assumes the only method of recording the terms of an engagement is through an engagement letter, and should acknowledge that this is not the only method acceptable under ISA 210. However, this section continues to exhibit a lack of focus. For example, references to firms having policies on risk for "publicly traded entities" (page 89) or the challenges created by "a high level of public scrutiny and media interest" (page 90) are hardly germane to an NCE audit.

### **Overall Audit Strategy**

42. There are useful elements within this section, and in particular some of the points to consider are helpful, and relevant to the audit of an NCE. However, in some cases these feel to have been bolted on to a structure which is not itself related to an NCE. For example, on page 99 there is the inherently unobjectionable comment that the nature and extent of planning activities will vary with the size and complexity of the entity; unobjectionable but of little relevance in a Guide that is purportedly not directed towards audit of entities of varying sizes and complexities but to a particular size and type of entity.

43. We are somewhat concerned at the point to consider on page 103, which calls into question the ability to undertake an audit of an owner managed business. We entirely agree that there are particular problems associated with owner managed businesses, and that there are cases where an auditor should decline to act. However, we would consider the function of this Guide to be to assist the auditor in being able to undertake the audit of precisely such an entity. The Guide notes that one question to be addressed is "Is it possible to develop further audit procedures that would respond appropriately to the assessed risk factors?" Rather than leaving this as virtually rhetorical, it would be more appropriate for this Guide to show ways in which this question can be answered in the affirmative, albeit with an acknowledgement that there may be particular cases where this is not possible.
44. We do not consider the reference to a "temporary" materiality level on page 108 clear. We assume that this is intended to refer to the materiality level determined at an early stage of the audit, which may be subject to change in the light of further information. We are not convinced that temporary conveys the right tone, and suggest that "initial" may be a better description.

### **Materiality**

45. Again this section suffers from being generic, and paying insufficient attention to how materiality may be assessed differently within an NCE. For example, a common issue in an owner managed business is that remuneration is highly variable and effectively replaces equity returns that might be paid out in another type of business. While this is mentioned, a discussion of the impact this has specifically on assessments of materiality would be useful.
46. We are seriously concerned about the benchmarks included within the Guide. No explanation of these is provided, nor comments on their interaction. The case study example is a simple scenario, which deals with none of the practical problems that arise in practice. We do not necessarily reject the use of benchmarks. However, if they are to be provided we consider the Guide must:
- a) explain both that, and why, there are no such benchmarks in the standards;
  - b) deal comprehensively with the limitations of any standard benchmarks; and
  - c) show how assessments might be made taking into account a variety of factors, covering situations where a simplistic approach will lead to inappropriate results (such as break even situations, significant fluctuations in annual profits, asset based businesses with profits low relative to asset base, and service entities with high profitability and minimal net assets.)

### **Audit Team Discussions**

47. We recommend that guidance be given on the procedures and documentation where the audit team is just one person.

### **Business Risks**

48. We consider that this section provides a reasonable summary of the principles but are struggling with the implications for audit methodology that are intended to be inherent in the examples provided. The examples of documentation are inadequately explained, and it is unclear precisely how the auditor would use the tools shown.

49. If an example approach is to be given (with appropriate comment to the effect that it will illustrate only one of the many methods possible) this must go into sufficient detail to demonstrate to an auditor how this could be adopted, adapted and applied. The case study example has effectively no explanation whatsoever.

### **Fraud Risks**

50. Our comments on this section are basically the same as for business risk; a reasonable overall discussion with little demonstration of how a methodology could be applied.

### **Significant Risks**

51. This is a reasonable summary of the requirements, which would benefit significantly from being more closely focussed on the non complex entity.

### **Internal Control**

52. This section is useful, in that it addresses issues directly related to smaller entities.
53. However, even here there is some confusion, Page 165, under "Consider Point" stresses the existence of controls in the smallest of entities, albeit that they may lack formality. Under "Auditability", on the same page, and having started by referring to informality a question mark seems to be put over whether an entity with undocumented controls is capable of being audited.

### **Assessing Internal Control Design and Implementation**

54. This is potentially one of the most useful and relevant sections of the Guide, since it is a key area that proves problematic for auditors of NCEs.
55. However, the approach adopted appears too complex and insufficiently responsive to the nature of the controls that are likely to be in place for smaller entities. The matrices, for example, are very helpful when dealing with entities of a certain size and complexity but if we go back to the owner managed business with informal controls it is unlikely to be an efficient method of recording how controls operate. The section deals with other possibilities, but is posited on an approach that is unlikely to be used effectively.

### **Assessing the Risks of Material Misstatement**

56. Section 2.12.2 on the documentation of assessed risks uses the four 'combined' assertions defined in Chapter 1.3. We have the same objection to the use of assertions that do not derive from ISA 500 that we have explained in our paragraph 36 above.
57. In other respects, this is a reasonable summary of the ISA requirements.

## **RISK RESPONSE**

### **Detailed Audit Plan**

58. We are unconvinced by the description of the audit toolbox. In particular
- a) the reference to procedures that would always be performed. Some procedures are common, and may be performed on nearly all audits, but ISAs provide little support for tests that are performed universally without reference to risk;



- b) the distinction between substantive procedures, substantive sampling and extended substantive procedures introduces distinctions not acknowledged in standards, terminology not in general use, and a distinction between procedures and extended procedures that seems based on an assumption that only extended procedures are based on risk. We are unclear what "extended procedures" have been extended from.

### **Tests of Controls**

- 59. This is a reasonable generic section.
- 60. There appears to be an error in the penultimate paragraph of page 216 where unreliable controls are defined as those for which there is no likelihood of exceptions being found. It might be better to say that it is not worth testing controls on which we would not choose to place reliance.

### **Substantive Procedures**

- 61. The section on design of substantive procedures is not helpful. As a general matter it states that certain substantive procedures are required, when the first items are not particular procedures at all. More worryingly, where examples are given these are not entirely accurate:
  - a) observation of an inventory count is not required if inventory is not material;
  - b) there is no unconditional requirement to confirm some receivable balances
- 62. Some of the commentary on procedures is again insufficiently informed by the need to address NCEs. For example, analytical procedures for NCEs are affected by the nature of the entity, so the payroll expense example provided is almost certain to be inappropriate (due to the likelihood of a small number of employees.) Yet a proof in total of payroll costs may often be feasible and efficient. For a larger entity this would often be reversed, yet it is this example that is given in the Guide.

### **Summary of ISAs not Addressed Elsewhere**

- 63. We have already noted that, with some exceptions, we consider this section superfluous. The standards addressed generally have no different impact on NCE audits than any other.
- 64. It might be worth including specific comments on:
  - a) ISA 402 – but only in relation to the potential outsourcing of functions such as payroll; and
  - b) ISA 550 – given that formal processes are unlikely in an NCE.

### **Extent of Testing**

- 65. We are particularly concerned that this section provides a very specific approach without adequate explanation or justification.
- 66. However, we would prefer that an approach be retained, as this is potentially useful to the practitioner, but that a full explanation be provided of the rationale behind it. We are concerned that if an auditor were to adopt the approach, and later be subject to challenge, the Guide as currently written would not provide adequate support. In addition to a clearer explanation of the rationale in the body of the text, the Guide could include an explanation of sampling in an appendix.



## **Documenting Work Performed**

67. The Guide, at every stage, emphasises the need for documentation. We of course agree that audit procedures need to be properly documented, but the level proposed in the Guide is likely to be excessive in the majority of cases, which will make the work unnecessarily time-consuming and therefore unduly expensive. We recommend that the Guide have regard to Practice Note 26, which gives guidance on smaller entity audit documentation. In this regard, we would note that we consider that the Guide goes beyond the requirements of ISA 230, and the documentation requirements in other standards; expecting a level of detail that is not justified by reference to those standards. In particular, page 38 of the Guide contains the statement that:

"The ISAs place a lot of emphasis on the need to carefully document each step of the audit process. Although this may add some additional cost at first, careful documentation will ensure that an audit file can stand by itself without the need for any oral explanations of what was done, why it was done, or how the audit conclusions were reached.

This appears to go beyond the statements in paragraphs. 11 and 12 of ISA 230 that:

"It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation"

68. We are also not convinced by the need for a separate section on documentation, unless the working group were to develop a 'short' guide as suggested in our paragraph 7 above. We consider the Guide should be focussed on those standards and aspects of standards that are of particular relevance, or cause particular problems, in the audit of NCEs. For NCE audits it is not documentation per se that presents a particular problem, but the documentation of specific matters, such as risk assessment procedures and the response to assessed risks, it would be better to deal with documentation requirements solely when dealing with these areas. This would also avoid the duplication in the current material.

## **Management Representations**

69. We have already noted (paragraph 24 above) that we do not consider this section to be necessary.

## **REPORTING**

### **Evaluating Audit Evidence**

70. This section contains little if anything specific to NCE audits. We question its value.

### **Communicating with Those Charged with Governance**

71. We consider this an important area, but one that should be dealt with on the basis that there will be no distinction between those charged with governance and management. While this is referred to, it is not assumed in the current Guide,

### **The Auditor's Report and Modifications to the Auditor's Report**

72. As noted in our paragraph 24 above, we do not consider these sections necessary as there are no factors relevant to NCEs, other than minor matters that can be better dealt with elsewhere.



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS

IN ENGLAND AND WALES

4 August 2008

Our ref: ICAEW Rep XX/08

Your ref:

Paul Thompson  
Senior Technical Manager  
Small and Medium Practices Committee  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017  
USA

By email: paulthompson@ifac.org

Dear Mr Thompson

**GUIDE TO USING INTERNATIONAL STANDARDS ON AUDITING IN THE AUDITS OF  
SMALL- AND MEDIUM-SIZED ENTITIES**

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the *Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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**THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS**  
IN ENGLAND AND WALES

## **ICAEW Representation**

**ICAEW REP XX/08**

### **GUIDE TO USING INTERNATIONAL STANDARDS ON AUDITING IN THE AUDITS OF SMALL- AND MEDIUM-SIZED ENTITIES**

**Memorandum of comment submitted in XXX 2008 by The Institute  
of Chartered Accountants in England and Wales, in response to  
the Implementation Guide published by IFAC: Guide to Using  
International Standards on Auditing in the Audits of Small- and  
Medium-sized Entities**

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## INTRODUCTION

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the *Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities* published by IFAC in December 2007.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

## GENERAL COMMENTS

### Preparing for the Clarity edition of the Guide

4. The Institute is concerned that there are significant problems with the Guide that undermine its utility for practitioners. There needs to be a thorough technical review as well as improvements to the structure of the document and more appropriate case study material. We propose to review the Guide in depth over the next two or three months with a view to providing comprehensive and detailed recommendations for changes. We consider that improvements must be made if the next edition, based on the new Clarity ISAs, is really to help practitioners conduct high quality, cost-effective audits of small and medium-sized entities.

### Practical use of the Guide

5. Although there is much useful material in the Guide, we consider that it is too detailed. We also consider that it fails to draw sufficient distinction between the requirements of International Standards on Auditing (ISAs) and the practices it is suggesting which might meet such requirements.
6. We do not believe that the Guide meets the stated objective of assisting practitioners on the audit of small- and medium-sized entities (SMEs). It does not work as a practical framework within which auditors can use professional judgment to choose and adapt procedures to the circumstances of each small and medium-sized client. What is needed is an authoritative guide to the principles embodied in the ISAs, which is scaleable so that the approach of partners and staff is consistent across all audits, whatever the size and activity of the audit client. At the same time, the Guide needs to recognise the particular issues that are most likely to affect the audit of a small or medium-sized entity.

7. One of the main reasons why the Guide is not as practically helpful as it could be is its size: a 50 page document (as opposed to 400 pages) would have a better chance of being read and used. The material should not try to cover every International Standard on Auditing. Comprehensiveness is not necessarily a virtue, if the price paid for that comprehensiveness is a lack of focus on the issues which are either most problematic for all auditors, including those dealing with smaller entities, or which are likely to arise specifically in the audit of a smaller entity. We consider the Guide would be improved if it were to deal with fewer matters, but in greater depth. So long as the Guide makes clear that it is not intended to be a comprehensive guide to all standards, we believe that such a change would increase the likelihood of the Guide being used by practitioners.
8. We would note that many standards are applicable identically to audits of entities of all sizes. Other than passing reference, we do not consider that there is any need for the Guide to deal with such standards. Instead, and as noted above, it should concentrate on those standards whose application is most likely to be affected by the size and nature of the entity being audited.

#### **Principles- or rules-based approach**

9. The Institute is concerned that the Guide gives the appearance of replacing principles with rules. There is a risk that the Guide might be used by regulators as a standard against which to measure the performance of practitioners and to criticise or penalise them if they did not follow the material to the letter. In particular we are concerned that, even where the Guide provides a perfectly reasonable audit approach and methodology, it does not explicitly recognise that this approach and methodology may not be the only one available. We believe that the Guide should make clear where it is providing just one method by which a standard might be applied, and acknowledge that other methods may be equally valid.
10. Linked to this concern is the view that, the Guide does not always explain the rationale behind the procedures that it sets out for applying ISAs. We consider that the Guide should explain the principles so that auditors can use their professional training and judgment to apply the ISAs and other pronouncements in issue to the circumstances of each audit. This process will not work if the Guide simply describes a set of procedures to be performed. There is also a risk that users will not develop the level of lateral thinking required for effective auditing.

#### **Audit approach generally**

11. We disagree with the Guide's criticism, in the last paragraph on page 64 and first long paragraph on page 65, of the pre ISA 'substantive' approach adopted by many auditors. We consider that small and medium-sized entities (SMEs) are different from large/listed entities. Their operations are generally far less complex, so obtaining an understanding of the business and planning strategy and procedures in response to assessed risk may take relatively less audit time. While we fully acknowledge the benefits of the risk-based focus of ISAs, we do not consider that this entails the rejection of approaches which, after due consideration of risk, involve primarily substantive procedures, since in the context of a small or medium-sized entity these often remain a quick and efficient way of obtaining the necessary audit evidence.



12. The Institute is also concerned that the Guide's criticism of auditors' focusing on the financial statements reflects a failure on the part of the Guide itself to link the findings from procedures to their implications for the figures in the accounts or the audit opinion. Our view is that the auditors do need to consider what the evidence they obtain from procedures tells them about the assertions in the financial statements.
13. As the previous UK Statements of Auditing Standards (SASs) were based on the pre- risk ISAs, the main shift in emphasis for auditors in the UK has come from the 'risk' ISAs. Our review of audit files following the formal adoption of ISAs reveals that smaller practitioners found it particularly difficult to understand and apply the risk ISAs, especially with respect to the approach to internal control and the level of documentation required. We recommend that the Guide focus on application of the risk ISAs. It could also emphasise the benefits brought by requiring auditors to consider risks and internal controls in every audit, which in turn enables the auditors to promote improvements in client systems.

#### **Governance and internal controls**

14. We do not consider that the Guide deals adequately with the control environment and how to use the auditor's experience and judgment in assessing the ethos of an entity to develop an efficient, effective audit approach. Within the smaller entity it is often this ethos which is of the greatest importance, since such entities may lack the detailed controls that would be more common within the larger entity.
15. Nor is there sufficient consideration of the question as to what 'those charged with governance' means in different sizes of entity. It would be helpful if the Guide contained a working definition of the term 'SME'. By this we mean a definition that is not based on formal or numeric criteria, but rather sets out qualitative characteristics, perhaps along the lines developed by the Auditing Practices Board (APB) in paragraph 3 of Practice Note 26 (PN26), *Guidance on smaller entity audit documentation*. This definition assumes owner management, or at most close control by a highly restricted group, and the Guide should deal only with issues that might arise in such a context.

#### **POINTS ON WHICH IFAC HAS ASKED FOR COMMENTS**

***How do you use the Guide? For example, do you use it as a basis for training and/or a practical reference guide, or in some other way?***

16. As we have stated in our paragraph 6 above, we do not consider that the Guide is helpful for practitioners in the audit of SMEs in its current form. We believe that the only use our members are likely to make of it is for reference (although the structure means that it may be difficult to find answers to specific questions), and to mine extracts, such as templates for individual procedures.
17. We consider that the Guide is more likely to be useful to accountancy students and universities, as a learning or teaching aid. We know that training organisations in the UK find the Guide useful.
18. However, there is so much detail that it is easy to lose sight of the essential principles that underlie the audit process: getting the detail right will not necessarily translate into a sound audit overall. We do not think, therefore, that our members working in public practice will use the Guide as a basis for

conducting an audit or give it to staff. Their approach will more likely be to appoint training organisations to interpret/implement ISAs in force.

***Is the cross-referencing to the ISAs sufficient for you to easily refer to the ISAs while reading the Guide?***

19. Yes. The diagrams on pages 13 and 14 are especially helpful.

***Do you believe that the Guide has appropriately integrated all of the relevant ISAs into the audit process?***

20. No. We consider that the guide provides useful material on specific points (for example, Appendix B on walk-through procedures), but it does not integrate the ISAs in such a way that they flow naturally through the audit process.

***Do you consider the guidance to be conducive to the performance of an efficient, effective and economic ISA-compliant audit of smaller entities?***

21. We do not consider that the Guide is suitable for the majority of smaller entities because of its length, lack of focus, and other shortcomings as summarised in our paragraphs 5 to 8 above. What a lot of practitioners are likely to want is guidance that they can apply to an audit with which they are familiar (for example, a family owned company) and be satisfied that the resulting audit will comply with ISAs.
22. Many smaller entities will operate with a system heavily reliant on a small number of individuals and subject to possible management over-ride. There may be little or no segregation of duties and few controls that are capable of testing. If the Guide is to be useful it must address this issue with a full discussion of ways of addressing it to reduce audit risk to an acceptable level. There needs to be better follow-through from assessment of internal control, through design of substantive procedures, to the consideration of evidence obtained to support the audit opinion.

***Do you find the illustrative case study helpful? In particular, do you consider the case study example documentation to be comprehensive and of practical assistance, particularly in connection with the audit of smaller owner-managed businesses?***

23. We have a number of reservations about the case study.
24. In the first place, we feel that the case study is not, in fact, a realistic example of a small company, but, rather, that the figures have been scaled down from those of a large entity. In particular, the staffing levels are totally inappropriate, which undermines the credibility of the examples and use of the case study as a whole.
25. The interweaving of the case study with the guidance on applying individual ISAs is likely to influence the way in which the Guide is used. Firms are more likely to use the Guide for reference on particular points, and may or may not find the case study illustrations useful. On the other hand, training organisations and educational establishments are likely to find case study examples a very helpful teaching aid.
26. Changes that we believe would make the case study work better for both practitioners and trainers are:
- to ensure that the case study examples do not just illustrate the procedure described in the preceding text, but also follow through to the resulting audit actions/judgment. For example, the case study at the end of chapter 3.2 shows the possible documentation for tests of controls: it would be more

useful if the results of the tests were included, so that the impact on subsequent audit procedures and judgments could be demonstrated. Another example is the case study on materiality at the end of chapter 2.5, which shows how materiality is calculated, but not how it is used in the audit;

- to explain more clearly why the audit procedures described are appropriate and useful in a given context;
- to show how the provision of other services (where permitted) might interact with audit work, taking account of both the ethical risks and the advantages in terms of efficiency and knowledge/understanding of the business;
- to include illustrations of audit techniques, such as directional testing; and
- to illustrate file review and completion.

***Do you find the Guide is easy to navigate? If not, can you suggest how navigation can be improved?***

27. Many of the diagrams, such as those on pages 13 and 14, are helpful in navigating the Guide.

***In what other ways do you think the Guide can be made more useful?***

28. The fact that planning is dealt with in a discrete section does not help users to put into practice the requirement to keep the plan under review throughout the audit. We recommend that the guidance include a cross reference or reminder to refer the outcomes of audit procedures back to the plan, to see whether there is any need for the plan to be updated.

***Are you aware of any derivative products – such as training materials, audit software, forms, checklists, and programs – that have been developed based on the Guide? If so, please provide details.***

29. We are not aware of any derivative products that have been developed based on the Guide.

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