

Bulletin: Auditing Small and Medium Sized Entities (SMEs)

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Auditing Small and Medium Sized Entities

1. Objective

The purpose of this Bulletin is to inform stakeholders of:

- The AUASB's response to issues identified by constituents in the AUASB Discussion Paper on *Auditing Small and Medium Sized Entities* released for public comment in March 2007.
- Constituent comments received on the *statements of principle* and *specific questions* posed by the above.

2. AUASB Action on identified issues

The AUASB received nine responses to its discussion paper which were considered at its meeting on 14 May 2007 when it resolved to continue to:

- (i) Actively monitor developments proposed at the international level, in particular, by the International Auditing and Assurance Standards Board (IAASB) and the Small and Medium Practices (SMP) Committee of The International Federal of Accountants (IFAC) which are considering the introduction of global guidance on the audit of Small and Medium Sized Entities (SMEs).
- (ii) Promote awareness of assurance providers and other stakeholders of the two distinct levels of assurance provided by an audit and a review respectively.
- (iii) Liaise with the Professional Accounting Bodies and encourage training and self-help guides to be provided by these bodies.

Details of the responses received are noted under item three Constituent Comments, later in this Bulletin.

2.1 Developments impacting on SME Auditing

Harmonisation and convergence with international standards by accounting and auditing standard setters around the world has tended to create complex accounting and auditing standards. Many argue this complexity has created an "understanding gap" for SMPs and SMEs which generally operate outside the capital markets. Standard setters have refocussed their attention recently on

facilitating the implementation of these accounting and auditing standards by SMPs and SMEs. As detailed below, this is an area to which Australian regulators and accounting and auditing standard setters are continuing to devote substantial resources.

Regulatory reforms

As part of the overall government objective to reduce the regulatory burden in the corporate and financial services sectors, legislation, the *Corporations Legislation Amendment (Simpler Regulatory System) 2007*, came into effect in June 2007. This legislation revised the size tests for a proprietary company with regard to financial reporting and annual audit requirements. The thresholds were increased as follows:

- consolidated revenue increased from \$10 million to \$25 million per annum; and
- the value of consolidated gross assets increased from \$5 million to \$12.5 million.

The *employee* test threshold remained constant at 50 and the requirement for a proprietary company to meet two of the three size tests remains unchanged.

Accounting standard setters

In February 2007, the International Accounting Standards Board (IASB) published for public comment the Exposure Draft of its *International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs)*. In May 2007, the Australian Accounting Standards Board published the Exposure Draft on *Proposed Revised Differential Reporting Regime for Australia and IASB Exposure Draft of A Proposed IFRS for Small and Medium-Sized Entities*. These proposed standards are aimed at establishing differential financial reporting requirements for SMEs.

Auditing standard setters

The IFAC Small and Medium Practices (SMP) Committee has developed a *Draft ISA Guide Fact Sheet* that:

- Provides a rationale as to why such guidance needs to be developed centrally by IFAC's SMP Committee.

- Stresses the importance of bridging the gap between the increasingly complex auditing standards and the capacity of SMPs to implement them effectively and efficiently.
- Specifies the substance of the proposed ISA Guide with a launch scheduled in the latter half of 2007.
- Includes measures proposed by IFAC to ensure the quality of the ISA Guide.
- Explains the relevance of prospective other guides, such as a *Quality Control Guide* and a *Practice Management Guide*.

The Accounting Practices Board (APB) in the United Kingdom issued two consultation papers in January 2007 on *The Need for Guidance to Aid the Implementation of Auditing Standards on Smaller Entity Audits* and *Draft Guidance on Smaller Entity Audit Documentation*. It is our understanding that whilst the APB will have input into the IFAC SMP Committee's *ISA Guide*, it is likely that it will issue guidance separately in the UK.

In May 2007, the Canadian Institute of Chartered Accountants (CICA) completed its project on the audit of SMEs and provided tools (*Audit of a Small Entity*, the *Professional Engagement Manual* (PEM) and related materials) to assist practitioners to understand, comply with and apply ISAs in SME audits. This was publicised in CICA's May 2007 *Risk Alert*. It is understood that the *ISA Guide* will be a variant of CICA's PEM.

The AUASB plans to actively monitor developments on SME auditing by IFAC's SMP Committee and examine the Proposed *ISA Guide*. The AUASB will use the *ISA Guide*, together with guides issued by the APB and CICA, to formulate guidance on the application of Auditing Standards.

2.2 Guidance on levels of assurance

The AUASB has been proactive in providing guidance on the levels of assurance obtained from the conduct of audits (reasonable assurance) or reviews (limited assurance) of financial information. In April 2006, the AUASB released Auditing Standard ASRE 2410 *Review of an Interim Financial Report Performed by the Independent Auditor of the Entity* which includes specific mandatory requirements and explanatory guidance on the level of assurance provided by reviews as against that provided by an audit. ASRE

2410 Appendix 2 includes detailed illustrative review procedures that may be performed in an engagement to review an interim financial report. In July 2007, the AUASB issued the *Framework for Assurance Engagements* and *Standard on Assurance Engagements ASAE 3000 Assurance Engagements other than Audits or Reviews of Historical Financial Information* which provides further explanatory guidance on the levels of assurance.

The AUASB is currently in the process of developing another proposed standard on review engagements, *ASRE 2400 Review of Financial Reports and Other Historical Financial Information*, which will provide assurance practitioners with further specific mandatory requirements and explanatory guidance on review engagements.

2.3 Liaison with Professional Accounting Bodies

The AUASB intends to continue liaison with the Professional Accounting Bodies. Further, the AUASB intends to encourage training and self-help guides to be provided by the Professional Accounting Bodies to their constituents.

3. Constituent Comments

In relation to the AUASB's discussion paper on the issue of SME audits, the AUASB received responses to its *statements of principle* and *specific questions* from nine constituents (refer Appendix 1), which are included on its website, www.auasb.gov.au, and are summarised as follows:

Statements of Principle

All responding constituents agreed with the following five of the six *Statements of Principle* espoused by the AUASB in its discussion paper:

- 1) The auditing principles enunciated in Australian Auditing Standards (ASAs) should be complied with in the conduct of an audit irrespective of the:
 - nature, size and complexity of an entity or the sector to which it belongs; and
 - applicable financial reporting framework under which the financial report is prepared.

- 2) An interim review is based on the premise that an annual audit will be conducted.
- 3) A review of a financial report (which provides limited assurance) is not a substitute for an audit (which provides reasonable assurance).
- 4) Differential financial reporting for SMEs would result in somewhat less onerous audit procedures being required in the annual audit of their financial reports.
- 5) Perceived difficulties in the financial reporting framework are thought to contribute to onerous audit requirements for SMEs.

However, constituents were of the view that there was sufficient delineation of the financial reporting responsibilities of an entity from the independent audit requirements in the *Corporations Act 2001*.

Specific Questions

The *specific questions* and constituent comments received are summarised as follows:

Q1. Do you think the AUASB should develop guidance on documenting the audit of SMEs?

The majority of the respondents, including the Professional Accounting Bodies, were of the view that the AUASB should develop guidance on the application of the audit documentation requirements to SMEs.

Q2. Do you think that proposed legislative reforms based on an argument of “regulatory burden” and that they would increase the threshold of entities required to be audited, could create a governance gap for stakeholders in those entities that would no longer be required to be audited?

More than half the respondents were of the view that legislative reforms aimed at increasing the current threshold of entities required to be audited, would not create a governance gap. A few of the remaining respondents expressed the view that shareholders were responsible for managing the governance gap and

depending on choice or pressure from users, could opt to have an audit.

Q3. *Do you accept that an independent audit can benefit a SME as much as it benefits a large entity operating in the global capital market? Alternatively, do you think SMEs should be free to choose a lesser level of assurance lesser than an audit?*

The majority of the respondent, including the Professional Accounting Bodies, acknowledged that an independent audit can benefit a SME. However the types of benefits obtained by SMEs differed from those obtained by large entities operating in the global capital markets. Benefits noted by at least two respondents include:

- fraud/misappropriation deterrent;
- preparation of annual financial report in compliance with the applicable accounting framework;
- independent health check especially the consideration of going concern;
- enhancement of reporting skills of organisations;
- exposure to a range of independent experts on matters such as risk management, information systems, internal control and corporate governance; and
- enhancement of corporate governance where a management letter on control deficiencies was issued.

Q4. *Do you think there is a general understanding by stakeholders, involved in financial reporting and audit processes, of the two distinct levels of assurance provided by an audit and a review respectively?*

The Professional Accounting Bodies expressed the view that their members were aware of the two distinct levels of assurance provided by an audit and a review. However, the majority of the respondents expressed the view that most stakeholders involved in financial reporting and audit processes, were not aware of the two distinct levels of

assurance provided by an audit and a review. One respondent indicated that the recent issuance of ASRE 2410 was useful in clarifying the differences between the two levels of assurance.

Q5. Do you think that there is a need to separate in the legislation the financial reporting requirements from the audit requirements?

All respondents were of the view that the legislation on financial reporting requirements is separate already from the audit requirements.

Q6. Do you think that there is need for further guidance to demonstrate the application of auditing principles to entities of differing sizes and complexities?

The majority of the respondents, including the Professional Accounting Bodies, were of the view that there is a need for further guidance to demonstrate the application of auditing principles to entities of differing sizes and complexities.

Q7. Do you think that a review should replace an audit in a SME?

The Professional Accounting Bodies reiterated the views of participants at their recent Differential Auditing Forum in Melbourne that there was little appetite for substituting a review for an audit of SMEs. However, other respondents were split in their views. One of the respondents, who related the benefit of audits to SMEs at Question 3, expressed the view that an independent review could replace an independent audit and still result in the benefits mentioned at Question 3. All respondents maintained the view that an audit required by regulation could not be replaced by a review.

Q8. Do you think that for non-listed public companies, there is scope for the imposition of a threshold for audit similar to that imposed on proprietary companies?

More than half the respondents, including the Professional Accounting Bodies, agreed that for non-listed public companies, there is scope for the imposition of a threshold for audit similar to that imposed on proprietary companies.

Q9. What is the cost/benefit outcome of the lower cost of less assurance compared with reduced governance?

Respondents varied in their views with some indicating that governance benefits would not dramatically diminish if a lower level of assurance was provided to SMEs, while others indicated that the costs to the Australian community would far outweigh any short term savings and create confusion. There were two respondents who indicated that more research was required on the level of corporate governance in SMEs.

APPENDIX 1

CONSTITUENTS WHO COMMENTED

The AUASB received responses to the *specific questions* and comments on the *statements of principle* from the following nine constituents:

- (i) BDO Kendalls;
- (ii) Grant Thornton;
- (iii) Graeme Greene, CA;
- (iv) John Oxley, CPA, CA;
- (v) Professional Accounting Bodies – a combined response from CPA Australia, National Institute of Accountants and The Institute of Chartered Accountant in Australia;
- (vi) PricewaterhouseCoopers;
- (vii) RSM Bird Cameron;
- (viii) The Institute of Internal Auditors Australia; and
- (ix) William Buck.