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Proportionality and the Australian and New Zealand Auditing Standards¹

This Bulletin/Explanatory Guide ²[*delete whichever term does not apply*] is issued jointly by the Australian Auditing and Assurance Standards Board (AUASB) and the New Zealand Auditing and Assurance Standards Board (NZAuASB).³

The AUASB and the NZAuASB have issued auditing standards that conform with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). In Australia, these standards are referred to as Australian Auditing Standards (ASAs)⁴ and in New Zealand they are referred to as ISAs (NZ).⁵ For the purposes of this Bulletin/Explanatory Guide [*delete whichever term does not apply*], references to the auditing standards issued by the AUASB and the NZAuASB will be referred to as the Auditing Standards.

The Issue

One of the key audit debates in recent years has been whether one size of auditing standards fits all – in other words, do the clarified Auditing Standards work equally well for entities defined as listed companies in Australia, and entities defined as issuers in New Zealand, as for small and medium-sized entities (SMEs).

The AUASB and the NZAuASB support the adoption of Auditing Standards for all statutory audits in Australia and New Zealand and note that this view is supported generally by the professional accounting bodies, larger firms, the public sector and academics. At the same time, the AUASB and the NZAuASB note that concerns have come from:

- Small and medium practices (SMPs) requesting sensitivity to the additional administrative burden; and
- Preparers, businesses and organisations of companies indicating that Auditing Standards should be further developed to be better suited for SMPs and SMEs.

This Bulletin/Explanatory Guide [*delete whichever term does not apply*] seeks to answer some common questions about the suitability of Auditing Standards for SME audits and for

¹ Acknowledgement

The information in this Bulletin/Explanatory Guide [*delete whichever term does not apply*] is adapted from the Federation of European Accountants (FEE) Briefing Paper No. 7 *Proportionality and ISAs* which is available on the FEE website at: www.fee.be/publications.

² In Australia this document is being issued as a Bulletin. In New Zealand it is being issued as an Explanatory Guide. The content is the same in each document.

³ The NZAuASB is a sub-Board of the External Reporting Board (XRB), New Zealand established under schedule 5 of the Crown Entities Act. Refer to www.xrb.govt.nz.

⁴ The Australian Auditing Standards (ASAs) were approved and issued in October 2009 and became operative for financial reporting periods commencing on or after 1 January 2011. Refer to www.auasb.gov.au.

⁵ The New Zealand Auditing Standards (ISAs (NZ)) were approved for issue by the XRB Board on 1 July 2011. These standards were previously issued by the New Zealand Institute of Chartered Accountants (NZICA) and are now maintained by the NZAuASB on behalf of the XRB.

use by SMPs and demonstrates that clarified Auditing Standards can be used to audit very small entities in a proportionate way.

Questions & Answers

Question 1

Are Auditing Standards not developed for use primarily in auditing large public interest entities?

No. Auditing Standards are designed to be usable for entities of all sizes and of all types. Their application to audits of SMEs is clearly demonstrated in the *IAASB Staff Questions & Answers on Applying ISAs Proportionally with the Size and Complexity of an Entity* of August 2009. The IAASB consulted publicly on their standards and includes in each standard a specific section “Considerations specific to smaller entities”. Similarly, the AUASB and the New Zealand Institute of Chartered Accountants (NZICA) consulted publicly on the equivalent Australian and New Zealand standards and include in their standards specific sections on “Considerations specific to smaller entities”. This forms part of the application guidance and sets out specific ways in which the relevant standard might be applied to an SME. This can be both indicating a simpler approach or a particular challenge. For example, ASA 315 and ISA (NZ) 315 on risk assessment point out that in a smaller entity the active involvement of an owner-manager may mitigate certain risks, for instance risks arising from a lack of segregation of duties in a small entity, but equally that it may increase other risks, for instance, the risk of override of controls.

Question 2

Are there any SMPs/SMEs involved in the development of the standards?

Yes. The IAASB, the AUASB and the NZAuASB include individuals from smaller firms that are not members of global networks. In addition, the IAASB, AUASB and the NZICA have sought input from parties representing the interests of SMPs. The ISAs, and the Auditing Standards, were also exposed for public comment during their development and commentators were asked for their views on the audits of smaller entities.

Question 3

I have heard that the new clarified Auditing Standards are more onerous. Will this not drive yet more SMEs away from having an audit?

No. Whilst it is true that the new clarified Auditing Standards do include some additional requirements, it is unfair to assume that this will make all audits more time consuming and expensive to perform:

- Firstly, the majority of “new” requirements resulting from the clarity project are in more complicated areas such as fair values, accounting estimates, the use of experts and audits of group financial statements. In many cases, these will simply not be relevant to SMEs. Where they are relevant, the additional complexity is normally driven by more complex accounting (for example, SMEs that choose to move to IFRS may have to fair value more things, which in turn will mean that auditors have to audit those fair values); and
- Secondly, the “new” clarified standards make it clearer what is required and what is application guidance. In some cases, this will make it clearer that something does not need to be done in a particular circumstance, for instance in the considerations specific to smaller entities; and

- Thirdly, in a small number of areas, additional work may be needed even on smaller audits. This should, however, help the auditor deliver increased value and insights about the audited entity to management and directors. For example, considering the appropriateness of the internal controls on the collection of debt gives those running a company an insight into the longer term sustainability of their business.

Question 4

Australian Auditing Standard ASQC 1 / Professional and Ethical Standard PES 3 Quality Control (New Zealand) seem to have generated a lot of debate. Is this standard not designed more for large audit firms? Will it cost me a lot to implement in my SMP?

No. There are a lot of misconceptions around the degree of complexity required for an ASQC 1 / PES 3 compliant quality control system. For example:

- Some people believe ASQC 1 / PES 3 mandates an engagement quality control review of every audit before the opinion is signed. This is only the case for listed company audits in Australia, and issuer audits in New Zealand. For other entities, the audit firm simply needs policies and procedures to decide which entities do need an engagement quality control review. This may be limited to only more complicated or riskier engagements.
- Others are concerned that the requirements of ASQC 1 / PES 3 can force SMPs to purchase expensive audit manuals, training and documentation from third party suppliers. The requirements of ASQC 1 / PES 3 are drafted such that it is possible to scale the requirements depending on the complexity of the audit firm and its client base – a simpler firm with simpler clients will need less complicated policies and procedures.

Question 5

Many auditors have questioned whether the Auditing Standards have resulted in a “box-ticking” approach to audit which leaves no room for professional judgement and which requires extensive documentation not only of why the auditor has done certain things but also of why he has not. Is this true?

No. The majority of documentation requirements are set out in ASA 230 / ISA (NZ) 230 with some additional requirements for specific areas set out in the relevant specific standard. It is possible to take a proportionate approach to documentation of an audit and, in particular:

- The standard set by ASA 230 / ISA (NZ) 230 is that documentation should enable an experienced auditor, having no previous connection with the audit, to understand what has been done, the results of the work performed and the evidence obtained, the significant matters arising during the audit, the conclusions reached thereon, and the significant professional judgements made in reaching those conclusions. This is good advice for all professional work as it is sensible risk management if an audit firm is challenged as to how it reached the opinion it gave. But it does not require documentation of every matter considered or professional judgement made or every last thought by the auditor. The test is whether an experienced auditor can understand what has been done, not whether someone with no knowledge of auditing can. This should also be sufficient for internal and external quality assurance reviews, inspections or other supervisory purposes.
- ASA 200 / ISA (NZ) 200 on the objectives of an audit and auditor make clear that there is no requirement to apply an Auditing Standard or those individual requirements of an Auditing Standard which are not relevant to the audit. So, if the auditor does not use the work of an expert or if there is no internal audit function (two areas less likely to be relevant to an SME audit), then the auditor does not need to justify why he/she

has not applied ASA 610 / ISA (NZ) 610 on using the work of internal auditors and ASA 620 / ISA (NZ) 620 on using the work of an expert.

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