

Policy Statement

Standing for trust and integrity

April 2009

Auditing and Assurance

International Standards on Auditing (ISAs)

It is anticipated that the European Commission will in the near future adopt the auditing standards as issued by the International Auditing and Assurance Standards Board (IAASB).

This Policy Statement is designed to explain the background to the development of IAASB International Standards on Auditing (ISAs), explain the IAASB due process for the drafting and completion of ISAs, comment on the IAASB's recently completed Clarity Project, look at the requirements of the European Statutory Audit Directive, consider the practical issues relating to the use of ISAs, particularly in relation to Small- and Medium-sized Entities (SMEs), and reflect the views of the International Federation of Accountants (IFAC), IAASB and FEE on the implementation of ISAs.

About FEE

FEE represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent, and sustainable European economy.

Development of the IAASB and the use of ISAs

In March 1978, the IAASB¹, an independent standard-setting board under the auspices of IFAC, was established. The IAASB's mission is to enhance the quality and uniformity of practice throughout the world and to strengthen public confidence in the global auditing and assurance profession.

In 1991, it was decided to recodify its guidelines as standards which became the ISAs. In order to assist with the implementation and use of the ISAs it was also agreed to adopt a "black letter" type format whenever the basic and essential procedures appeared throughout the ISAs; an approach similar to the International Accounting Standards Board (IASB) in its setting of international financial reporting standards (IFRSs).

An IFAC Member Body Compliance Program survey identified in 2007 more than 100 countries that have adopted IAASB standards or use them as a basis for national standards.

The IAASB Due Process

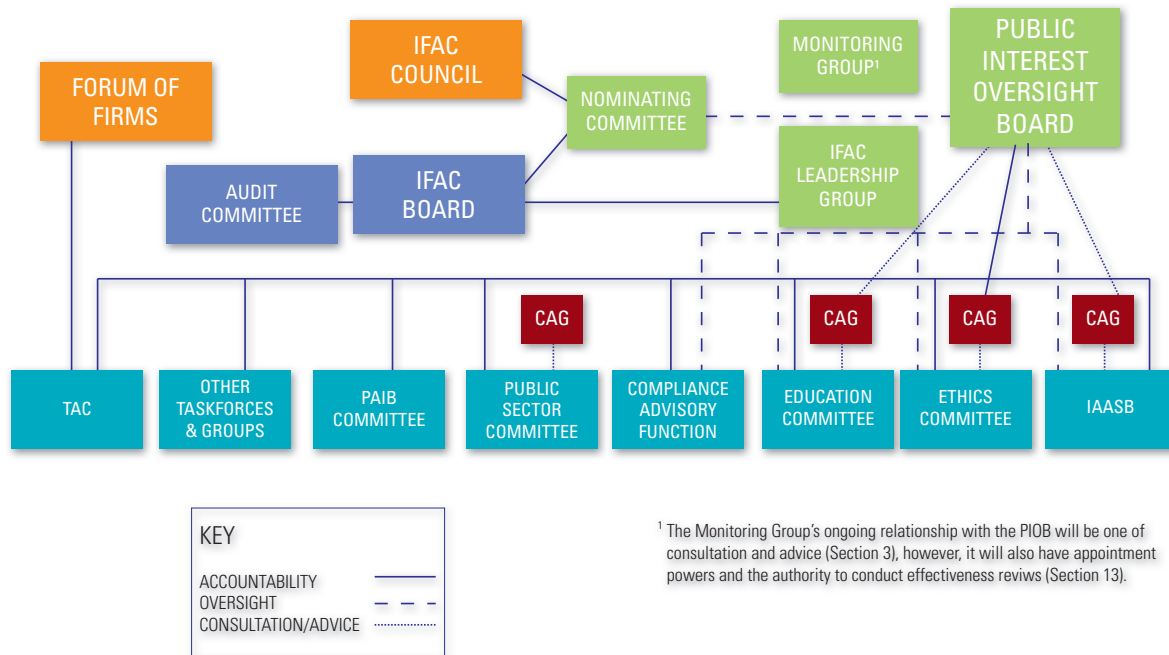
Gradually, the due process followed by the IAASB became more rigorous as it was recognized that it is critical to ensure that the views of those affected by its standards and guidance (i.e. stakeholders in general) are thoroughly considered. This due process covers:

- The development or revision of every standard;
- Research and consultation by an IAASB task force;
- Debate in IAASB meetings which are open to the public;
- Exposure of draft standards for public comment;
- Consideration of comments received on exposure; and
- Approval of each ISA by the affirmative vote of at least two-thirds of the IAASB members.

Additionally, since its inception in 1994, the IAASB Consultative Advisory Group (CAG) delivers valuable public interest input to the IAASB. FEE is a member of the IAASB CAG. The CAG is comprised of representatives of regulators, business and international organisations, and users and preparers of financial statements. Furthermore, in 2005, the activities of the IAASB came under the oversight of the Public Interest Oversight Board (PIOB). This structure is reflected in the IFAC organisational diagram hereafter.

¹ Originally named the International Auditing Practices Committee (IAPC)

IFAC Organisational Diagram



¹ The Monitoring Group's ongoing relationship with the PIOB will be one of consultation and advice (Section 3), however, it will also have appointment powers and the authority to conduct effectiveness reviews (Section 13).

The Clarity Project

To encourage greater use of its standards and facilitate translation, in 2004 the IAASB launched a project designed to improve the clarity of its pronouncements by:

- Identifying the auditor's overall objectives when conducting an audit in accordance with ISAs;
- Setting an objective in each ISA and establishing the auditor's obligation in relation to that objective;
- Clarifying the obligations imposed on auditors by the requirements of the ISAs and the language used to communicate such requirements;
- Improving the overall readability and understandability of the ISAs through structural and drafting improvements. The ISAs have a new structure as follows:
 - **Introduction:** Introductory material may include information regarding the purpose, scope, and subject matter of the ISA, in addition to the responsibilities of the auditors and others in the context in which the ISA is set;
 - **Objective:** Each ISA now contains a clear statement of the objective of the auditor in the audit area addressed by that ISA;
 - **Definitions:** For greater understanding of the ISAs, applicable terms have been defined in each ISA;
 - **Requirements:** Each objective is supported by clearly stated requirements. Requirements are always expressed by the phrase "the auditor shall"; and

- **Application and Other Explanatory Material:** The application and other explanatory material explains more precisely what a requirement means or is intended to cover, or includes examples of procedures that may be appropriate under given circumstances;

- Including considerations specific to smaller entities and to smaller firms in the Application and Other Explanatory Material.

In March 2009, the IAASB completed its clarity project and as a result, auditors worldwide have now access to 36 newly updated and clarified ISAs and a clarified International Standard on Quality Control (ISQC). All clarified ISAs will be effective for audits of financial statements for periods beginning on or after 15 December 2009. This will in practice oftentimes mean for 2010 year-end audits to be performed early 2011. The IAASB is currently developing a series of ISA modules to assist in the implementation of clarified ISAs.

The Forum of Firms, an association of over 20 of the largest networks of accounting firms, encourages its member to implement the clarified ISAs on a timely basis and they will use clarified ISAs from the due date.

Currently, in over half of the EU member states, earlier versions of translated ISAs have been adopted as the national auditing standards with additional requirements for local (legal) circumstances. In the vast majority of the other EU member states, earlier versions of the ISAs were translated and transposed to form the basis for the preparation of national auditing standards with national additions and deletions.

Implementation of ISAs for all statutory audits in the European Union (EU)

Article 26 of the Statutory Audit Directive

Article 26 of the Statutory Audit Directive (2006/43/EC)² provides for **statutory audits to be carried out in accordance with international auditing standards following their adoption by the European Commission (EC)** because the Directive aims to ensure consistent high quality statutory audits in Europe.

The Directive does not stipulate which international auditing standards are to be used but it is anticipated that these will be ISAs as they are the only internationally accepted high quality auditing standards.

The EC adoption of the ISAs

At a FEE Conference on Audit Regulation in December 2008, European Commissioner Charlie McCreevy announced the EC is evaluating ISAs to make them mandatory for use in the EU. Therefore, the EC:

- Has commissioned two **studies** for early 2009: one is looking at the costs and benefits of introducing ISAs in Europe, and the other is aimed at identifying potential differences between ISAs and the auditing standards of the PCAOB, and their implications for those European companies which are US foreign registrants;
- Intends to organise a **public consultation** on this issue in the first half of 2009.

In a Resolution of 10 March 2009 (2008/2247/INI)³ of the **European Parliament** of March 2009 on the implementation of the Statutory Audit Directive, the EC was requested to avoid unnecessary delay in the adoption of ISAs and to launch a broad public consultation in their adoption as undue delay in the approval of ISAs could have an adverse effect on the regulatory environment, resulting in further fragmentation, which is contrary to the general objective of the Directive.

The implementation of ISAs for Small- and Medium-sized Entities

Concerns related to the applicability and relevance of ISAs for SMEs

Some have raised questions regarding the applicability and relevance of the ISAs to the audits of SMEs as well as concerns on the cost effectiveness of ISA audits for SMEs:

- They are concerned whether there is a common understanding of all relevant parties that the clarified ISAs, despite their level of detail, leave sufficient scope to apply professional judgment to **determine the audit approach in line with the nature, size, risk and complexity of the audited entity**;
- They have also pointed out that **excessive documentation requirements should be avoided**, especially regarding expectations which public oversight bodies might have related to the level of documentation.

It is important to note that 'auditing' is part of an entire process of risk management to accept or continue an audit engagement, planning the audit work, performance of audit procedures based on auditing standards, documentation of procedures and key judgements as the basis for formulating the audit report and opinion, internal audit firm quality control, external quality assurance reviews or inspections and supervision by the public oversight body. In each of these steps, **significant matters and judgements are to be documented** to enable the auditor to demonstrate that a high quality audit in accordance with applicable laws, regulations and standards was performed. This does not mean, however, that the auditor has to record all thoughts, actions or procedures he undertakes during the audit.

An ISA audit for SMEs

It is important to note that IFAC and the IAASB have stated that, though the ISAs are designed for entities of all sizes, this does not mean that each ISA audit is performed in exactly the same way:

- **The audit approach may differ**, but the auditing standard on which it is based and the level of assurance the auditor is required to obtain, should not. Because of the principles-based structure of the ISAs, the **specific audit procedures** to be undertaken to achieve the objectives and to comply with the requirements **may vary considerably** in the audit of a small and simple entity compared to that of a large and complex one;
- The auditor has to **comply (only) with the ISAs, which are relevant to the audit**⁴. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist. For instance, ISA 600, Special Considerations – Audits of Group Financial Statements (including the work of Component Auditors) will often not be relevant in an SME environment and its numerous requirements will not need to be complied with nor documented. **As an example, in a simple SME audit, up to one third of the 36 ISAs may not be relevant**;
- The auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:
 - The entire ISA is not relevant; or
 - The requirement is not relevant because it is conditional and the condition does not exist⁵;
- In exceptional circumstances, the auditor may **depart** from a relevant requirement in an ISA by **performing and documenting alternative audit procedures**.

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>

³ <http://www.europarl.europa.eu/oeil/resume.jsp?id=5682982&eventId=1070509&backToCaller=NO&language=en>

⁴ ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, paragraph 18.

⁵ ISA 200, paragraph 22

Based on these features of the ISAs, it is believed that the audit approach can be tailored to respond to the auditing needs in an SME environment. However, IFAC recognizes that there is a need to provide implementation assistance to increase the capacity of auditors to efficiently comply with ISAs while maintaining their competitiveness. One of the IFAC achievements in this regard is its December 2007 Guide to Using ISAs in the Audit of SMEs⁶ and its March 2009 Quality Control Implementation Guide for Small and Medium-Sized Practitioners (SMPs)⁷ whereby the former is being updated following completion of the IAASB clarity project.

As stated above, documentation is a major concern and, therefore, an initiative worth considering in respect of the documentation requirements for an SME audit is the United Kingdom Auditing Practices Board (UK APB) Practice Note 26 of September 2007 on Guidance on Smaller Entity Audit Documentation⁸.

FEE would very much welcome similar international guidance on audit documentation for smaller entity audits.

FEE position on ISAs

FEE started leading the debate on ISAs in Europe more than ten years ago. In 2001, FEE published a Discussion Paper entitled "Proposal on International Standards on Auditing in the EU" in which FEE proposed that by 2005 national auditing standards in the European Union should require auditors of financial statements to:

- Perform audit procedures that comply with International Standards on Auditing (ISAs);
- Report on financial statements in accordance with ISAs; and
- Perform additional audit procedures and report on additional matters in response to specific legal, regulatory or other needs established at a national level.

Therefore, in April 2006, FEE particularly welcomed the proposals in the Statutory Audit Directive requiring "statutory auditors and audit firms to carry out statutory audits in accordance with international auditing standards" to ensure consistent high quality statutory audits in Europe. This requirement supports the long standing belief that there is only one benchmark audit, whereby the level of assurance obtainable from an audit exceeds the level obtainable from other types of assurance engagements. If an auditor intends to issue a report under International Standards on Auditing, then compliance with all ISAs is necessary. This concept is generally referred to as "an audit is an audit".

IFAC and IAASB views

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. It also serves the **public interest** by allowing users of financial statements to have a common understanding about the reliability of financial statements. 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 and negatively impact markets' confidence. IFAC, therefore, strongly supports the approach taken by the IAASB to develop a single set of standards that can be applied to all audits.

At the end of 2008, FEE developed proposals to support its member bodies with the implementation of the ISAs over the next couple of years. Now that the IAASB clarity project has been completed, FEE is set to start the execution of this work with a focus on sharing information to help smaller FEE Member Bodies and SMPs with the implementation of the clarified ISAs.

For FEE Member Bodies and audit firms, the implementation of clarified ISAs entails at least:

- The translation of the clarified ISAs into local languages;
- The need for new or updated audit policy manuals and audit methodologies to be developed;
- The need for new or updated audit software to be available; and
- The need for new or updated training material to be prepared and delivered.

There are also further actions which FEE can take and that are already under consideration. In order to alleviate the concerns related to the applicability and relevance of clarified ISAs to the audits of SMEs and related to the documentation requirements in an SME environment, especially in relation to the expectations of the public oversight bodies, FEE is calling upon the members of the European Group of Auditors' Oversight Bodies (EGAOB) as well as on the IAASB to consider and respond to such concerns. FEE is prepared to actively contribute to this work and assist wherever possible.

⁶ http://www.ifac.org/Members/Downloads/ISA_Audit_Guide.pdf
⁷ <http://www.ifac.org/Members/Downloads/guide-to-quality-control-fo.pdf>

⁸ <http://www.frc.co.uk/images/uploaded/documents/PN26%20Web%20Sep%2020071.pdf>