

Public Consultation

Standard for audits of small entities

Issued by the Nordic Accounting Institutes

Background

An independent, high quality, audit of the financial statements is considered to be a valuable contribution, allowing the users of such financial information to obtain reasonable assurance that such financial information is free from material error or omission. An audit opinion that reflects such assurance goes a long way towards heightening the credibility of the financial information on which creditors and other users will base their decisions regarding the relationship that they will have with the entity concerned.

As global auditing standards become more comprehensive and complex the challenge of adapting them to the audits of small entities becomes more time consuming and difficult. In addition, the criteria on which an audit is judged to be of a high quality is often based on evidence that certain mandatory audit procedures have been performed, often without adequate consideration for the size and complexity of the entity that is being audited.

There is a growing concern that the performance of the audit is increasingly characterized by a compliance “tick the box” mentality, at the risk of demotivating the auditor, compromising the exercise of professional judgment and the application of professional skepticism.

Thus more time is being spent on documenting compliance, sometimes at the expense of documenting and evidencing identified risks and those audit procedures that are specifically designed to mitigate identified risks, as well as documenting the exercise of professional judgment needed to support the conclusions for the audit opinion.

The accompanying draft standard for the audits of small entities has been developed by the professional accounting and audit institutes in the five Nordic countries for the purpose of addressing some of these concerns. The institutes firmly believe that the Draft Standard is compatible with the International Standards for Audit (ISAs), as issued by the IAASB. However, the Draft Standard is not considered to be, nor is it intended to be, in compliance with the ISAs.

Furthermore, the Nordic institutes firmly believe that an application of this standard for the audits of small, less complex entities, will not compromise the quality of the audit process or the independence of the auditor. Consequently, those international standards that address these areas – ISQC 1 and the IESBA Code of Ethics – are still fully applicable when an audit is performed, based on this audit standard.

Expected Benefits from the Proposed Standard

The primary beneficiaries of the Nordic institutes work on this draft standard for the audit of small entities will be the owners and managers of the entities preparing the financial information to be audited. There will be less focus on mindless compliance and more focus on having an in-depth dialogue with the manager and owner of the business.

As the exercise of professional judgment becomes more significant, the involvement of experienced auditors in the performance of the audit will often increase. This, in turn, will lead to a more fruitful interaction between the auditor and the manager and owner of the entity.

The efficiency of the audit will be improved, even though there may not be any significant cost reductions due to the increased involvement of more experienced auditors.

The exercise of independent oversight over the quality of the audit will continue to be a cornerstone in the determination of audit quality. The independent oversight can focus on the auditor's identification and documentation of risk, the audit procedures that have been designed to mitigate those risks and the conclusions reached to support the audit opinion.

This in turn may increase the confidence that users have in the audit and the financial statements

In addition, the Nordic institutes believe that the following additional benefits, among others, could be realized as a result of the proposed standard:

1. Reduction of unnecessary compliance and focus on the entity being audited will increase auditor motivation and professional pride, "putting the fun back in auditing" and improving the quality of the audit.
2. The focus on exercising independent professional judgment and on in depth knowledge of the entity being audited will significantly improve work quality and the attractiveness of audit. This will make the performance of the audit more attractive to young talented professionals and further improve the quality of the future intake into the accounting profession.
3. Strengthened focus of the auditor on audit risk, documentation of audit judgment and on critical audit matters could result in an increase in professional scepticism, which will further contribute to audit quality.
4. A significant improvement in the relevance of the independent audit for SMEs, rather than simply a reliance on the statutory need for an audit.
5. A focus on performing a high quality and efficient audit, rather than on regulations and compliance that have not demonstrated their efficacy on audits of entities of this size and limited complexity, will allow SMPs to develop and apply audit methodologies that are directly applicable to these types of audit engagements, thus allowing them to stay in the audit market despite increasing deregulation of the statutory audit.

Feedback

The Nordic institutes welcome comments on all matters addressed in this Draft Standard.

Broadly, the Nordic Federation is interested in feedback regarding the following points:

1. Whether the Draft Standard is appropriate for the audits of small and less complex entities.
2. Whether in their opinion, the quality of the audit will be enhanced, maintained or reduced as a result of the application of this Draft Standard.
3. Whether there is a need for specific guidance
4. Whether guidance should be developed at a national level, taking into account possible national needs or whether guidance should be developed at the Nordic level.
5. Whether the Draft Standard can be easily incorporated into existing audit methodologies
6. Whether the Draft Standard, if adopted, can be considered to be complementary to the requirements in Article 26 of the Directive on Auditing, as adopted by the European Union and currently being implemented in the EU Member States.
7. Whether an application of the Draft Standard will require significant additional training for those who are already conversant with the principles of auditing

Respondents are strongly encouraged to respond to the above points and to raise any other points or issues that they consider to be pertinent to the further development and adoption of this audit standard.

Introduction

Purpose

The purpose of this standard is to establish a high quality, principles based, stand-alone audit standard, tailored specifically to audits of small entities. The purpose of this standard is to enable the auditor to issue an audit opinion with reasonable assurance by conducting an audit in accordance with this standard.

When developing this standard, the characteristics of smaller entities (below the mandatory audit threshold in the EU auditing directive), has been in focus. These thresholds are currently:

Size	Headcount	Annual turnover	Balance sheet - Total Assets
Medium-sized	< 250	≤ €50 million	≤ €43 million
Small	< 50	≤ €10 million	≤ €10 million
Micro	< 10	≤ €2 million	≤ €2 million

Small entities of this nature are often (but not always) characterized by having less complex business models and operations. Internal controls are often informal and not always well documented. Ownership is not wide spread and often the entity is managed by the owner and the immediate family.

This standard is not designed to be applied for the audit of Public Interest Entities (PIEs) irrespective of size, industry or characteristics.

More complex entities, entities with complex ownership structures, complex transactions, or extensive fair/market based valued assets and liabilities and groups, irrespective of size, will often require the application of more extensive and complex audit procedures. Support for the performance of audit procedures in these situations can be found in the relevant International Standards for Audit (ISAs). The auditor must, at all times, exercise professional judgment to determine the level and extent of audit procedures that must be performed in order to obtain reasonable assurance regarding the absence of material error or omission in the financial statements, which form the basis of the auditor's report and conclusion.

This standard uses core “risk based” auditing principles that rely on the auditor's judgment and professional skepticism regarding how best to apply the audit risk model and materiality concepts. This standard has requirements to ensure that the auditor obtains an understanding of the business to be audited. During this process, the auditor will identify, document and assess risks. On this basis, the auditor will design and perform audit procedures to respond to assessed risk by obtaining appropriate and sufficient audit evidence as basis for the issuance of an audit opinion. The auditor will apply professional judgment throughout this process and will ensure that the work done and conclusions reached are evidenced and well documented.

Timing

The issuance of the Draft Standard is linked to a fairly ambitious timeline. The intention is to have your feedback, in the form of your reflections and answers to the points raised above, or in whatever form you consider helpful, before the 19th October. Please do not feel that you are limited to simply answering the questions. All other comments, reflections, criticisms and suggestions for improvements will be

carefully considered by the Project Group of the Nordic Federation of Public Accountants.

Your input will be considered together with the input derived from a number of Focus Groups of practicing auditors in the various Nordic countries. Your answers, comments and observations in response to this consultation will be analyzed to determine whether there is consistency in the comments received and to further consider what changes, if any, are required to be made to the Draft Standard.

Why is your input important?

It is important that this standard is not simply perceived as being the product of an academic exercise or seen as an attempt to circumnavigate the complexities of the audit process. It must add value to the performance of the audit by improving the efficiency of the audit process without compromising the quality and credibility of the audit.

In order for this standard to be successful, it must achieve the following objectives:

1. be operational without major modifications to existing audit methodologies
2. practitioners must feel confident that the performance of the audit is more efficient
3. The achievement of reasonable assurance has not been compromised.
4. The emphasis on the exercise of professional judgment and the wider scope for choice in the audit process leads to an enhancement of the audit as a unique service product to the benefit of the end user, rather than being stigmatized as being simply a commodity, required by law.
5. The Draft Standard must result in an audit that is sufficiently evidenced to allow for the conduct of independent quality controls by the relevant oversight boards

Your input will be of considerable importance in helping us, as well as regulators and legislators, to determine whether this standard will achieve the above objectives.

Issuing Member Organizations:

The Nordic Federation of Public Accountants (NRF)
Den norske Revisorforening, Norway
FAR SRS, Sweden
Félag Löggiltra Endurskoðenda, Iceland
FSR - danske revisorer, Denmark
Suomen Tilintarkastajat Ry., Finland

Illustrative Questions and Answers

Below are some of the questions that have been received during the development of the Draft Standard with corresponding answers to help your understanding of the standard.

1. Can you explain the main differences with this standard compared to the ISAs?

The purpose of developing the SASE standard was to establish a high quality, principles based, stand-alone audit standard, tailored specifically to audits of small entities.

The standard is built using the same core audit principles (obtain knowledge of the audited entity, identify audit risk (incl. internal control), determine materiality, gather sufficient appropriate audit evidence and reasonable assurance) as in most audit standards used today. The standard has more generic documentation requirements than the ISAs but must demonstrate sufficient and appropriate evidence as the basis for the auditor's report; and evidence that the audit was planned and performed in accordance with this standard and applicable legal and regulatory requirements.

This standard has less detailed requirements than the ISAs and puts greater emphasis on the use of the auditors professional judgement, this was done as part of developing a principles based standard tailored for small entities. This is reflected in the standard with more generic requirements and that the auditor will have to consider certain specific circumstances when designing audit procedures rather than having to perform specific predefined procedure.

Examples of areas where this standard places greater emphasis on the use of professional judgement;

- *Attendance at inventory count*
In this standard attendance at the inventory count is not mandated, it is left up to the auditor's professional judgement to decide which procedures are most effective and efficient to address the risks identified. This may include attendance at the inventory count but based judgement and not because of requirements.
- *Management representation letter*
Rather than always requiring a management representation letter the standard requires the auditor to evaluate the need to obtain written representation to confirm certain matters or to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements. In addition, the auditor is given considerations to help perform this evaluation.
- *Revenue recognition*
As revenue recognition may not always be a risk for all audits it is not a presumed risk. Instead, the auditor shall as part of the risk assessment, evaluate existence of fraud relating to revenue recognition.

2. What kind of audits is the standard designed for?

The SASE standard has been developed for audits of financial statements of small entities. Characteristics of entities that are below the mandatory audit threshold in the EU auditing directive have served as a baseline when developing the standard. Some of these characteristics are normally reflected by less complex business models and operations, informal internal controls, few and not complex IT-systems and few owners. These characteristics do not limit the use of the standard but have been used to develop the requirements and tailor the standard.

3. How does this standard deal with ethical requirements and the firm's responsibility for quality control?

When applying the SASEs standard the auditor shall comply with relevant ethical requirements (for example IESBA code of ethics), including those pertaining to independence, relating to financial statement audit engagements. In addition, the International Standards on Quality Control (ISQCs) must be applied for audits performed in accordance with this standard.

4. Is this standard ISA compliant?

The SASE standard is an audit standard that has as a goal to provide an audit report with reasonable assurance, in the same way as the ISAs. The ISAs have not served as a starting point for developing the standard. The starting point has been to identify the requirements that are necessary to perform an audit of high quality for small entities.

The standard is based on the same core risk based audit principles that support ISAs. Therefore the standard can be said to be ISA compatible, but not ISA compliant. The SASE standard is tailored for audit of small entities and therefore does not have specific requirements that are considered to be not relevant for those entities. Instead, this standard is more principles based and gives the auditor more room for professional judgement in performing the audit.

5. How does this standard deal with important issues where there is an expectation that the auditor applies independent actions and procedures? For example: Fraud, going concern and estimates.

The SASE standard is, as the ISAs, risk based but is more conceptual than in the ISAs and tailored specifically for small entities. Therefore, instead of requiring specific procedures to identify risks the auditor shall perform "Those procedures deemed necessary, using professional judgment to be able to identify risk...". When it comes to designing the specific procedures responding to identified risk, the auditor is given considerations to aid the design of such procedures, together with use of professional judgement in designing the most effective and efficient procedures.

Example – Fraud

Risk Assessment

"... The risk assessment procedures shall include those procedures deemed necessary, using professional judgment, to be able to; identify potential fraud risk, including the

risk of management override of controls also when no fraud risk factors have been identified”

Considerations when designing substantive procedures to address fraud risks:

- *“the appropriateness of journal entries in the general ledger and other adjustments made in the preparation of the financial statements, and consider the need to test journal entries in the general ledger and other adjustments made throughout the period,*
- *The business rationales for significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.”*

6. The SASE standard appears to be biased towards use of substantive procedures compared to test of controls, why?

As part of tailoring the standard to audits of small entities and their characteristics, less focus has been put on internal controls, since these in many cases are fewer and less formal. The standard is therefore built on the assumption that substantive procedures in most cases will be the auditor’s response to the identified risk. However, this does not restrict use of tests of controls. The decision on whether to test controls or to perform substantive procedures, or a combination of both, is up to the auditor’s professional judgement, based on the risk assessment and understanding of the entity. The audit shall be designed, planned and performed to ensure that identified risk is reduced to an acceptable level.

7. Why is the audit report different than the one we use today?

The illustrative audit report for the SASE standard is tailored specifically to audits of small entities and the users of their financial statement. The audit report is based on the minimum requirements in the EU directive and may be modified for specific national requirements.