

AuditQuality<sup>®</sup>

## Fundamentals – Making global auditing standards local

In practice how can auditing standards have global reach yet deal with local challenges? This paper explores the qualities of auditing standards necessary to facilitate high-quality audits in the UK. The challenges of implementing global auditing standards in the UK are also explored.





The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The initial focus of the *Forum* was to improve audit transparency and support shareholder involvement in the audit process. At its meeting in May 2005 the *Forum* agreed to explore a broader agenda which examines the relationships between shareholders, management, auditors, regulators and other stakeholders in the audit.

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Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at **www.auditqualityforum.com** or telephone 020 7920 8493.

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# Contents

	Page
<b>Executive summary</b>	4
<b>Introduction</b>	10
<b>First-year implementation of ISAs in the UK and cost-benefit issues</b>	11
<b>The IAASB and the introduction of ISAs to the UK and the EU</b>	17
<b>The scope of ISAs to be adopted by the EC</b>	24
<b>Smaller and less complex audits</b>	26
<b>Appendix 1</b>	
Certain non-compliance pluses in existing ISAs (UK and Ireland) that may in future no longer be permitted as a result of the implementation of the revised 8th Directive	30
<b>Appendix 2</b>	
Extract from Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts	31
<b>Appendix 3</b>	
Glossary of abbreviations	32
<b>Appendix 4</b>	
Chronology of the introduction of ISAs to the UK	33
<b>Appendix 5</b>	
Members of the working group	34

## Executive summary

### Where are we now?

The last time auditing standards caught the attention of so many in the UK was probably when they were first introduced over 25 years ago. Since then much has changed. Globalisation and improved technology have rendered much of what used to be 'local', 'global'. But globalisation has not taken place in a vacuum. Boundaries may have shifted but we still live, day to day, in a 'local' world. Many aspects of the way we think and do business remain deeply rooted in local cultures and institutions. The most important challenge facing global standard-setters is in developing standards that can be adapted and made to work in the context of different traditions and jurisdictions. And for national standard-setters and practitioners the challenge is in implementing these global standards in a manner which, in the case of auditing standards, enhances audit quality. It is important that lessons are learned from the experience of jurisdictions such as the UK in which global auditing standards have already been adopted and implemented.

In November 2001, the European Federation of Accountants (FEE), at the request of the European Commission (EC), issued a discussion paper *Proposal on International Standards on Auditing in the EU*. In that paper FEE suggested that by 2005, national auditing standards in the EU should require auditors of financial statements to perform audits in compliance with International Standards on Auditing (ISAs). The publication of that paper was by no means the first move towards ISAs in the EU; the Auditing Practices Board (APB) in the UK had aligned its standards with international standards in the mid-1990s, for example. But the paper was probably the first significant milestone in the move towards ISAs in the EU and it was instrumental in commencing a European debate on the subject and moves in a number of jurisdictions towards, or further towards, the adoption of ISAs. The subsequent revision of the core risk and fraud ISAs by the International Auditing and Assurance Standards Board (IAASB), which recognise more fully expectations of auditors regarding risk and fraud, gave further impetus to the move towards ISAs as standard-setters in the EU, many of which had provided significant input into the revised ISAs, considered whether the adoption of ISAs as a body would be preferable to the major revisions to national standards that would otherwise have been required. These changes have culminated in the requirements of Article 26 of the Directive on Statutory Audits of Annual Accounts and Consolidated Accounts (the 'revised 8th Directive') for the adoption and implementation of ISAs across the EU.

This paper draws on the UK experience of the adoption and implementation of ISAs and considers what practitioners, standard-setters, governments and regulators can learn from this. There are significant logistical implications for the implementation of ISAs in Member States that have not yet adopted ISAs or made significant moves towards convergence with them. We hope that those with responsibility for the adoption of ISAs at the EC and their implementation across the EU will find this paper helpful.

It is important to emphasise the fact that the *implementation* of ISAs in the UK is in its early days. The APB adopted International Standards on Auditing (UK and Ireland) for use on audits for periods commencing on or after 15 December 2004, i.e. in general, for audits of December 2005 year-ends. The *adoption* process, which involved detailed consultations with a wide range of stakeholders, took place over several years in the UK and was only the start. Significant developments have taken place during the relatively short period during which this *Audit Quality Forum* working group has met and discussed the subject. Nevertheless, most practitioners have now completed their first ISA (UK and Ireland)

audits, some messages are beginning to emerge and research into the effects of implementation is now under way. To that extent, this paper represents a snapshot of the ISA implementation position in the UK in the autumn of 2006.

### **An important time for the EC and the IAASB**

The adoption and implementation of ISAs are being actively discussed by governments, regulators and investors as well as practitioners and standard-setters. The revised 8th Directive has now been published which means that the implementation of ISAs across the EU now depends on the timing of the adoption of ISAs. That said, many European countries have either already adopted ISAs or are well on the way to doing so. The IAASB's many other 'markets' include Canada and Australia, both of which have made recent moves towards convergence with ISAs. The US auditing standard-setters – the Auditing Standards Board of the AICPA for private company audits and the Public Company Accounting Oversight Board (PCAOB) for public company audits – have regard to IAASB developments in their standard-setting activities and it would appear that the AICPA has made some significant *de facto* moves towards convergence with certain ISAs.

In the UK, auditors have generally accepted ISAs (UK and Ireland). There has been no barrage of complaints from auditors, companies or regulators, probably because several key ISAs were already substantially aligned with UK Statements of Auditing Standards (SASs) and because UK representatives have had significant influence at the IAASB for many years. The transition to ISAs for all UK audits does not seem to have been as traumatic for auditors and their clients as the transition to IFRS by listed companies. Whilst it is still early days, informal soundings indicate that whilst cost may be an issue for the audit of some smaller and less complex entities, particularly where a largely substantive approach was taken in the past, there are benefits to audit quality in the form of the additional probing and risk assessment required by ISAs which is valued by clients. Research is needed to substantiate this.

ISAs seem most likely to be adopted by the EC after 2008, the intended completion date of the IAASB's clarity project. Significant progress has been made by the IAASB on its clarity project during the last two years. The project is intended to make auditing standards clearer and it is expected to make some of the most important structural changes to ISAs in recent years.

The adoption of ISAs by the EC and their implementation in the EU may nevertheless be affected by a variety of issues that have been raised concerning ISAs. These issues centre on the need for ISAs to be as free as possible of jurisdiction-specific legal, cultural and regulatory assumptions, i.e. to be truly framework-neutral. Issues include matters relating to the length and level of prescription in standards, the ability of auditors to use their judgement and the concepts of true and fair and reasonable assurance. Dealing with these issues and ensuring that auditing standards are framework-neutral is no easy task but significant changes have been made to the clarity project proposals as a result of the concerns expressed by, among others, stakeholders in the UK. Continued vigilance is of course necessary. The dialogue between standard-setters, those who oversee their work and those charged with implementing standards is important. All stakeholders in the auditing standard-setting process continue to act as the conscience of the IAASB.

## Key issues

The key objective of this working group was to:

*...identify the key criteria to drive the development of International Standards on Auditing so that those criteria can be promoted by the UK in the course of the standard-setting process.*

The conclusions below are taken from the body of this paper.

### First-year implementation of ISAs in the UK and cost-benefit issues

UK auditing standards were substantially aligned with previous versions of ISAs before ISAs were adopted in the UK and Ireland. Nevertheless, planning for the adoption and implementation of ISAs took place over a period of over three years and required co-operation between the APB, the professional bodies, the training consortia and software providers that service practitioners, and practitioners themselves. This planning co-operation, training and education helped ensure that when the change was implemented, practitioners were adequately prepared and ready for the change. The need for planning, co-operation, training and education continues.

The implementation of ISAs (UK and Ireland) is in its early days. Most practitioners have now performed their first audits under ISAs (UK and Ireland). The most significant changes have resulted from the implementation of the risk, fraud, quality control and documentation standards. Most of the remaining ISAs (UK and Ireland) involve fewer changes because of the historical alignment of UK auditing standards and ISAs.

Some practitioners and their clients believe there have been improvements to audit quality as a result of the implementation of ISAs in the UK. Further work performed by the professional bodies and standard-setters is now under way which will provide better and more comprehensive evidence. Evidence will also come to light as a result of inspections of practitioners' work in due course. The initial impressions gained from one professional body's monitoring of ISA (UK and Ireland) audits are that most practitioners are, with appropriate support, making reasonably successful attempts to apply ISAs (UK and Ireland). The requirements of the risk and fraud ISAs (UK and Ireland) have resulted in many practitioners rethinking their audit approach and such significant changes take time to bed in. It may also take time for the documentation requirements of ISAs (UK and Ireland) to be interpreted consistently. First-year implementation of ISAs (UK and Ireland) has added to many practitioners' costs. However, many practitioners acknowledge that the additional cost in year one will not necessarily recur in future years.

Regulatory impact assessments, pilot studies and similar techniques are now common at the highest levels among standard-setters and oversight bodies. They are particularly important for the audit of smaller and less complex entities. The APB's work on the Independent Professional Review (IPR), and its more recent work on the effects of proposed changes to ISA (UK and Ireland) 720 provide good examples for other standard-setters. Such techniques not only improve the quality of standards being produced but better enable firms of all sizes to understand the impact of changes on their clients and explain the resulting improvements to audit quality. Studies of what did and did not work well for firms of all sizes should be performed at regular intervals after the implementation of significant changes to ISAs not only in the UK, but internationally, to inform and improve the standard-setting process.



## **The IAASB and the introduction of ISAs to the UK and the EU**

### ***The EU***

The regulatory mechanisms that are now being set up to determine when and how ISAs are to be adopted by the EC and the manner in which they are to be implemented in the EU will affect UK audits.

It is important that UK audit stakeholders seek out ways in which to further influence the adoption and implementation processes in the EU, not least because they are in a good position to pass ISA adoption and implementation lessons learned to other European jurisdictions in which ISAs have not yet been adopted. It is important for practitioners across the EU that the transition to ISAs takes place on a smooth and timely basis. The IAASB is making a concerted effort to complete its clarity project by 2008 in order to facilitate adoption by the EC which has already begun putting in place the necessary mechanisms to achieve this. All concerned need to work together with auditors, standard-setters and the professional bodies to ensure that the changeover is as seamless as possible.

Emphasis on the early consideration of implementation issues and the need for the EU and the IAASB to take account of the substantial logistical challenges in training and educating auditors in the new standards are important. Implementation of standards is a greater challenge than adoption, particularly in jurisdictions which have not yet adopted ISAs or made moves towards convergence with them.

### ***The IAASB***

Significant positive progress has been made in a relatively short period on the IAASB's clarity project, particularly with regard to the nature and status of objectives. The views of commentators, including those expressed in the UK, have been heard and heeded. The resources expended by the APB at the IAASB and by those who work alongside the APB in the UK are paying off. It is important to UK audit quality that UK representatives continue to exert influence at the IAASB.

### ***Involving stakeholders***

Auditing standards are important to investors and companies in the UK and the EU. In the UK, the increasing involvement of stakeholders other than practitioners, professional bodies and standard-setters in the standard-setting and implementation processes has added credibility. This is set to continue as the DTI implements the Companies Bill and consults on the implementation of the revised 8th Directive.

Some investors and the corporate sector are already represented at the European level and within the IAASB's governance mechanisms, but other investors and those in the corporate sector who have concerns about auditing standards need to engage more pro-actively with standard-setters. Equally, the IAASB, APB and European regulators should continue to seek out the participation of a wide range of investors and corporate representatives at an early stage of their standard-setting activities, and consider developing more formal mechanisms for doing so. The APB's efforts to promote to the IAASB and the EC the value of effective communications with such groups are important. This may not be an easy task but it is worth pursuing, not least in order to avoid subsequent difficulties.

### ***Governance and ISAs plus***

It is important for both the IAASB and the EC to recognise that ISAs must be developed and adopted in a manner that is sufficiently flexible to accommodate different legal and regulatory structures, governance arrangements and assumptions about the nature and

purpose of financial statements and the audit, i.e. in a manner that is truly framework-neutral.

The purpose of the adoption of ISAs in the EU is to raise standards of auditing in the EU and to increase transparency. The purpose should not be to limit audit quality or to iron out important differences in governance arrangements across the EU and it may be necessary for UK 'pluses' to ISAs to reinforce the UK's governance arrangements.

UK representatives have made significant progress in pressing for changes to the IAASB's standards on communicating with those charged with governance to accommodate the UK's governance arrangements. Nevertheless, concerns remain that the UK's governance arrangements, which are well-established in law and emphasise the stewardship function of financial statements and the audit, may not be recognised sufficiently within ISAs or at European level. Further work may also be necessary on the perceived lack of alignment between the decision-usefulness model on which IFRS are based, the UK's stewardship model, and auditor reporting considerations.

### **The scope of ISAs to be adopted by the EC**

To facilitate the smooth transition to ISAs in the EU, the scope of the IAASB material to be adopted should not extend beyond that which is essential for the purposes of the statutory audit.

The primary purpose of auditing standards is to enable auditors to conduct high-quality audits. This purpose is congruent with the needs of well-established and adequately resourced regulators who require clear standards against which to monitor the performance of auditors. High-quality auditing standards, designed with the need for auditors to conduct high-quality audits in mind, enable regulators to monitor auditors effectively. Whilst some regulators outside the UK may seek standards that are principally designed to facilitate ease of monitoring, the experience in the UK is that monitoring can be effective on the basis of principles-based standards and without excessive prescription, provided that the monitoring bodies are well resourced, competent and experienced. To require additional detailed audit documentation specifically for regulatory purposes would not only impose an unnecessary burden on business, it would shift the focus of audits away from audit quality.

### Smaller and less complex audits

Many users of ISAs are auditors of smaller and less complex entities. Such entities have a significant economic impact and their audit is a public interest issue. Papers recently presented to the IAASB by APB staff on documentation for smaller audits and on regulatory impact assessments recognise the needs of such entities. The establishment of an SMP group by the APB also evidences recognition of the needs of such entities. The IAASB has enhanced its processes for obtaining input from SMPs.

The most important factor contributing to the decline in the number of smaller UK practitioners performing audits in recent years is the increase in the audit exemption threshold. Nevertheless, there is a risk that the market for audit services and the choice of practitioners for smaller and less complex entities may be further reduced if the regulation of auditors and the concomitant cost of audit increase significantly. If auditing standards are thought to be unduly complex and expensive to implement because of excessive documentation requirements, practitioners who provide such audit services will eventually cease to provide them. Auditing standards need to be workable for smaller audits. If they are not, the 'an audit is an audit' approach to auditing standards may be called into question.

Further research will be needed in due course into the effects of regulatory change on the provision of audit services and in turn, on the quality of information on the public record for smaller and less complex entities.

There are some indicators of enhanced audit quality resulting from the introduction of ISAs (UK and Ireland) for the audit of smaller and less complex entities but there is also evidence that some practitioners and their clients are struggling.

The governance arrangements for smaller entities are different to those for larger entities: managers and owners may be the same. This needs to be taken into account during the development of ISAs. Currently, ISAs raise some of the problems in application guidance, but provide little in the way of suggested solutions. Projects such as the development of guidance and materials for the audit of SMEs by IFAC may go some way to alleviating these problems but more and better explanations in the application material of how requirements that are primarily designed for the audits of larger entities can be interpreted in the context of smaller and less complex audits are needed for the more complex recently issued standards. The 'virtually all' test for requirements in the clarity project must encompass the audit of smaller and less complex entities.

The auditors of smaller and less complex entities should be encouraged to provide more concrete, specific and constructive suggestions for improvements to ISAs. The FRC and the professional bodies should continue to make efforts to increase the level of input from this group.

# Introduction

## Key objective of the group

The key objective of the group was to identify the key criteria to drive the development of International Standards on Auditing so that those criteria can be promoted by the UK in the course of the standard-setting process.

The group considered and discussed the key issues set out below.

- > **implementation issues:** *the broad implementation issues faced by audit firms in respect of (a) small (b) medium and (c) larger entities;*
- > **regulatory impact assessments:** *views on the need for, and nature of, regulatory impact assessments for new standards by the IAASB and/or the APB;*
- > **8th Directive, Clarity and ISAs 'plus':** *how the EC's 8th Directive clauses are expected to interact with the IAASB clarity proposals and affect UK ISAs plus, and the scope of standards adopted by the APB;*
- > **scope:** *issues surrounding the scope of standards being adopted; and*
- > **think small first:** *views on the think small first approach and how the drafting of standards can be further improved to take account of the needs of smaller audits at an earlier stage.*

The group did not cover in detail the issue of principles-based standards and the associated judgement and accountability issues; these are dealt with by the *Principles-based auditing standards* working group.

# First-year implementation of ISAs in the UK and cost-benefit issues

## ISAs in the UK and audit quality

The Auditing Practices Board (APB) is responsible for setting auditing standards in the UK. Audit quality is not easy to define and depends to a great extent on the quality of the people performing audits. Nevertheless, auditing standards have a direct effect on the manner in which audits are performed, regardless of who performs them, and thereby on audit quality. In introducing ISAs into the UK, the APB sought, among other things, as in all of its activities, to maintain and enhance the quality of audits in the UK. However, there is a need to focus on the way in which the introduction of ISAs (UK and Ireland) has affected audit quality in the UK and on ways in which it can be further improved.

## The adoption of ISAs by the APB

The APB made the first moves towards aligning its output with that of ISAs in the mid-1990s. This fact inevitably has an important bearing on the adoption and implementation of ISAs in the UK, but the formal process of the adoption of ISAs in the UK still took over three years. The APB originally consulted on its intention to move fully to ISAs in the UK in 2002. Its deliberations were affected by recommendations in publications sponsored by the UK government and the EC's proposal to implement ISAs across the EU. A chronology of the process of the introduction of ISAs (UK and Ireland) is included in Appendix 4. The APB announced in its 2004 work programme its decision to adopt ISAs in the UK. The principal reasons given were the likely adoption of ISAs in the EU and the need to deal with the then recently issued revised risk ISAs which would have otherwise required an extensive rewrite of a substantial number of existing UK SASs.

## UK pluses

The APB consulted with a group convened by the ICAEW consisting of practitioners from firms of all sizes and representatives of CCAB and other bodies (the ISA Implementation Group) on the detail of ISAs to be adopted, including the compliance and non-compliance 'pluses' that would be needed to make ISAs workable in the UK. Compliance pluses are clearly defined additions that relate to UK specific legal and regulatory issues. These pluses will not be lost under the revised 8th Directive. Non-compliance pluses are clearly defined additions for situations in which UK standards are in advance of international practice, and/or where ISAs have not been recently revised. These pluses may in future no longer be permitted as a result of the implementation of the revised 8th Directive. It was believed that these non-compliance pluses would fall away over time as the IAASB revised its standards. To date, there have been no 'carve-outs', i.e. ISA minuses, so as to preserve the integrity of ISAs. In many cases, the APB has not yet had the opportunity to present its case to the IAASB for the inclusion of non-compliance pluses in the relevant ISA because it has not yet been revised by the IAASB. However, it seems possible that a few non-compliance pluses may in future no longer be permitted because the relevant ISA has been revised recently (or for other reasons) and because the revised 8th Directive does not permit their retention beyond 2010. Some of these current UK non-compliance pluses that may in future no longer be permitted are detailed in Appendix 1. Nevertheless, there may be a variety of mechanisms for ensuring that such pluses are not lost: by amendments to the Listing Rules, for example, or by turning non-compliance pluses into legal requirements in order to turn them into compliance pluses.

## The views of those consulted

When it exposed the proposed ISAs (UK and Ireland) in 2004 the APB stated that it anticipated that some auditors would be concerned at the volume of material involved in the adoption of ISAs and the educational and logistical challenge that this might give rise to. It emphasised, however, that with the exception of the new audit risk and fraud standards, it believed that the adoption of ISAs did not involve many changes of substance to SAs (the standards being superseded), or to the work undertaken by auditors, since the ISA requirements were to a large degree already addressed in SAs. The APB was pleased that in the responses received there was generally strong support for the proposed ISAs (UK and Ireland).

Those that the APB consulted were unanimous in the view that ISAs should not be introduced in the UK in a piecemeal fashion. It was considered that a ‘big bang’ approach whereby a suite of standards was introduced at a particular point in time for the audit of all UK entities avoided the potential problems of running two sets of standards together and a drip feed of new standards for which auditors would need to make constant adjustments, i.e. many of the problems associated with the ‘twin track’ introduction of IFRS. Such issues would have been particularly problematic for the auditors of smaller and less complex entities.

## Communications with practitioners, training and education

The APB consulted with the ISA Implementation Group on the detail of ISAs to be adopted. After the publication of the suite of ISAs to be adopted in the UK, the work of that group continued with a remit to facilitate the smooth transition to ISAs (UK and Ireland) in the UK under the auspices of the ICAEW’s main technical audit committee, TPAC (the Technical and Practical Auditing Committee). The ISA Implementation Group initiated, supported, advised on and organised the production of numerous articles, publications, newsletters, alerts and roadshows on ISAs and acted as a communication channel between the professional bodies, practitioners and technical staff from firms of all sizes. That group now also provides input to the APB on the work of the IAASB. A training providers group was also established to facilitate communication on ISAs (UK and Ireland) to the training providers and training consortia that service small and mid-tier firms and who provide them with audit methodologies and audit software as well as training. The work of both of these groups continues alongside the detailed work performed by the ICAEW and other CCAB bodies in preparing responses to the APB and the IAASB on their Exposure Drafts and other publications.

Adequate and timely training and education of auditors are needed when new ISAs are implemented, particularly those that may introduce significant changes to auditors’ methodologies. Training and education help ensure that auditors properly understand new requirements and their implications and should remove misconceptions that may have arisen. The examination syllabuses of professional bodies in the UK have incorporated international standards for some time. The providers of training to qualified accountants also run regular courses and updates on such standards and the ISA Implementation Group promoted the production of a great deal of material during the crucial implementation period in the UK. The need for such training and education in the UK continues and those with responsibility for this in EU Member States that have yet to adopt ISAs or move towards them also need to consider the logistical implications of this aspect of implementation.

UK auditing standards were substantially aligned with previous versions of ISAs before ISAs were adopted in the UK and Ireland. Nevertheless, planning for the adoption and implementation of ISAs took place over a period of over three years and required co-operation between the APB, the professional bodies, the training consortia and software providers that service practitioners, and practitioners themselves. This planning co-operation, training and education helped ensure that when the change was implemented, practitioners were adequately prepared and ready for the change. The need for planning, co-operation, training and education continues.

### First-year implementation of ISAs in the UK

The implementation of ISAs (UK and Ireland) is in its early days. ISAs (UK and Ireland) were implemented in the UK for audits of financial statements commencing on or after 15 December 2004 and for most practitioners that meant December 2005 audits. Most practitioners have now performed their first audits under ISAs (UK and Ireland). The most significant changes have resulted from the implementation of the risk, fraud, quality control and documentation standards but most of the remaining ISAs (UK and Ireland) involve fewer changes because of the historical alignment of UK auditing standards and ISAs.

There is some evidence to suggest that some practitioners and their clients believe that there have been improvements to audit quality as a result of the implementation of ISAs in the UK. The additional probing required by the risk and fraud ISAs, for example, have in some cases uncovered significant issues for both auditors and clients. Further work performed by the professional bodies and standard-setters is now under way which will provide better and more comprehensive evidence. A questionnaire sent to all delegates attending the ICAEW's Audit and Assurance Faculty 2006 Roadshow may provide some insights and it is expected that the APB will also conduct a post-implementation review with practitioners in due course. Evidence will also come to light as a result of inspections of audit practitioners' work. The initial impressions gained from monitoring of ISA (UK and Ireland) audits by the ICAEW are that most practitioners are, with the support of the ICAEW and the training consortia, making reasonably successful attempts to apply ISAs (UK and Ireland). Practitioners are encountering difficulties in fairly predictable areas. The requirements of the risk and fraud ISAs have resulted in many practitioners rethinking their audit approach and such significant changes do not always bed down immediately. It has also been observed that the documentation requirements of ISAs (UK and Ireland) are not consistently interpreted resulting in some practitioners being advised to increase the depth and relevance of documentation in areas such as risk assessment, engagement partner input to planning and communication with clients.

Firms of all sizes have also reported inconsistencies in the extent of controls testing, documentation and involvement of the audit team on similar audits, instances of over-reliance on and the excessive testing of systems, and the need for more focus on the assessment and mitigation of risk. But there also appears to be an expectation that these issues will be ironed out over time.

First-year implementation of ISAs has inevitably added to practitioners' costs and this is felt most acutely by smaller practitioners who have a smaller audit client base over which to spread the cost. The amount of additional cost attributable to ISAs is difficult to quantify but many firms acknowledge that the additional cost in year one will not necessarily recur in future years, although there will probably be an ongoing cost impact as the newer risk and fraud ISAs are more costly to implement than the standards they replaced.



Many larger firms have based their global methodologies, including those implemented in the UK and the US, on ISAs, for several years. The firms believe that their methodologies are adequate for regulatory purposes in most jurisdictions. Whilst larger firms are generally better able than smaller practitioners to deal with the changes to infrastructure required by changing standards generally, it is not yet clear whether larger or mid-tier firms have been able to explain to their clients the additional costs in terms of enhanced audit quality. This may depend on the size of the client and the extent to which changes have had to be made to the audit approach in individual cases.

The technical resources available to firms of all sizes are limited and the challenges of any major change relate overwhelmingly to implementation rather than development. To the extent that IFRS sit in the 'shop window' of larger and mid-tier firms, auditing standards as a 'back room' issue may not always get the attention that they deserve. There is a risk of bad practices developing in firms of all sizes which will come to light as a result of inspections. Undoing such practices after the event will be inefficient. For these reasons it is important that studies of what did and did not work well for firms of all sizes are performed at regular intervals after the implementation significant changes to ISAs both in the UK and internationally, to inform and improve the standard-setting and implementation processes going forward.

Hard evidence on how practitioners of all sizes have coped with the introduction of ISAs is only gradually becoming available. Monitoring bodies and other independent reviewers are only now beginning to review audits that have been completed under ISAs (UK and Ireland) and it is too soon to draw conclusions about the introduction of ISAs into the UK because post-implementation surveys have yet to be completed.

The implementation of ISAs (UK and Ireland) is in its early days. Most practitioners have now performed their first audits under ISAs (UK and Ireland). The most significant changes have resulted from the implementation of the risk, fraud, quality control and documentation standards. Most of the remaining ISAs (UK and Ireland) involve fewer changes because of the historical alignment of UK auditing standards and ISAs.

Some practitioners and their clients believe there have been improvements to audit quality as a result of the implementation of ISAs in the UK. Further work performed by the professional bodies and standard-setters is now under way which will provide better and more comprehensive evidence. Evidence will also come to light as a result of inspections of practitioners' work in due course. The initial impressions gained from one professional body's monitoring of ISA (UK and Ireland) audits are that most practitioners are, with appropriate support, making reasonably successful attempts to apply ISAs (UK and Ireland). The requirements of the risk and fraud ISAs (UK and Ireland) have resulted in many practitioners rethinking their audit approach and such significant changes take time to bed in. It may also take time for the documentation requirements of ISAs (UK and Ireland) to be interpreted consistently. First-year implementation of ISAs (UK and Ireland) has added to many practitioners' costs. However, many practitioners acknowledge that the additional cost in year one will not necessarily recur in future years.

### **Gaining momentum: regulatory impact assessments**

The IAASB is considering the use of regulatory impact assessments or cost-benefit analyses as part of its due process. Such assessments and analyses are now common at the highest levels among standard-setters and oversight bodies. The FRC's *Regulatory Philosophy* states that it will make effective use of regulatory impact assessments having particular regard to the impact of regulations on smaller entities. The SEC also performs such assessments.



At present, implementation issues may not necessarily be picked up during the standard-setting process for ISAs. One of the effects of a similar problem with accounting standard-setting is in the apparent need for continuous minor technical changes to IFRS during implementation. There is some evidence that similar problems may be experienced with ISAs.<sup>1</sup> There are many ways in which such technical and more major problems can be avoided or minimised. These include regulatory impact assessments or cost-benefit analyses, the use of pilot projects, such as that performed by the APB on the IPR which resulted in the proposals being abandoned, and the use of questionnaires, such as the questionnaire used by IASB in its fair values project.

The APB held a meeting in July 2006 with representatives of large and mid-tier firms and shareholders from investor bodies to discuss the likely implementation issues relating to ISA 600 (Revised) on group audits. This went extremely well and should be a useful template for auditing standard-setting bodies generally.

Assessments of the practical consequences of regulatory changes, including consideration of the broad spectrum of those likely to be affected, need to be performed during the planning of regulatory changes, as well as at later stages. Regulatory changes are best effected on an iterative basis in which at each stage, the likely, possible, and possibly unintended consequences of the changes need to be considered in the context of the objectives of the changes and the different constituencies affected.

The different constituencies affected by the IAASB include a very large number of audits of smaller and less complex entities, particularly in the EU in which the number of audits of larger entities form a minority of the audits performed.

Assessments of qualitative effects highlight the behavioural consequences of proposed regulatory changes. Those effects will not be the same for all of the constituencies affected and, for the IAASB, the effects on auditors of smaller and less complex entities will be different to the effects on auditors of larger entities. In general it is believed that such assessments have a tempering effect because they act as a brake on the proliferation of processes that will not actually achieve the intended objectives for all of the constituencies affected, and focus attention on unintended consequences. However, assessments can also highlight areas in which further process or guidance is needed because the proposed changes are inadequate to achieve the intended objective, will not reach those they are intended to affect, or have perverse or unintended consequences for some constituencies.

It is by no means always necessary to quantify the effects of proposed changes. The regulatory impact assessment performed as part of the UK *Review of the Turnbull Guidance on Internal Control* is a good example of an effective impact assessment in which few hard numbers were found to be necessary. Only where there is significant uncertainty about an effect is quantification of costs desirable, and it is widely recognised that cost estimations are always difficult, often wrong (or at least wide of the mark) and should therefore be used with caution.

It is easier to promote the acceptance of change and increases in costs if costs are transparent and practitioners and business believe they are justified by the related benefits. Practitioners would generally prefer to deal with a large worst case view than uncertainty, which breeds resistance.

It should be borne in mind that costs and benefits will be different in different jurisdictions and for different sizes and types of entity. It may therefore be necessary for the IAASB to engage national standard-setters and IFAC member bodies in conducting such exercises. The recent initiative by the APB in the UK in performing an assessment of the costs of the

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<sup>1</sup> such as IAASB's deferral of the effective dates of amendments to ISAs 200 and 210 dated 4 November, 2005.

application of certain elements of ISA 720 on other information included in documents containing audited financial statements, to entities of different sizes in the UK, is a good example of how such exercises might be carried out.

Regulatory impact assessments, pilot studies and similar techniques are now common at the highest levels among standard-setters and oversight bodies. They are particularly important for the audit of smaller and less complex entities. The APB's work on the Independent Professional Review (IPR), and its more recent work on the effects of proposed changes to ISA (UK and Ireland) 720 provide good examples for other standard-setters. Such techniques not only improve the quality of standards being produced but better enable firms of all sizes to understand the impact of changes on their clients and explain the resulting improvements to audit quality. Studies of what did and did not work well for firms of all sizes should be performed at regular intervals after the implementation of significant changes to ISAs not only in the UK, but internationally, to inform and improve the standard-setting process.

# The IAASB and the introduction of ISAs to the UK and the EU

## *The EU*

The background to the adoption of ISAs in the UK is the long-standing European desire to harmonise auditing and accounting standards. Article 26 of the revised 8th Directive deals with auditing standards and is reproduced in Appendix 2. Broadly, Member States are required to implement the requirements of the Directive within two years, although it appears that ISAs cannot be implemented under Article 26 until they have been adopted by the EC. Two years after implementation, the transitional period during which non-compliance pluses will be permitted will end. Certain carve-outs (ISA 'minuses') will be permitted beyond then but only in certain exceptional circumstances where they arise from conflicts with national law.

Deadlines may slip and, unlike accounting standards, there is no set date on which ISAs must be adopted, but the current intention of the IAASB appears to be to complete its clarity project during 2008 and for ISAs to be adopted by the EC for use in the EU at that point.

Article 26 permits ISAs to be adopted by the EC under its complex comitology procedures. In the ISA adoption process, the EC will be advised by the Auditing Regulatory Committee (AuRC) which is in turn advised by the European Group of Auditing Oversight Bodies (EGAOB). Practitioners may not be represented on either body but the EGAOB has an ISAs sub-group on which practitioners are represented. Article 26 requires that the ISAs to be adopted satisfy three tests. They must: be generally accepted internationally and developed with proper due process, public oversight and transparency; contribute to a high level of credibility and quality in accounts; and be conducive to the European public good. Article 26 refers to 'international auditing standards' rather than ISAs and, in theory, another set of auditing standards could be adopted (such as those of the PCAOB in the US) although this seems highly unlikely. Some consider that the 'European public good' test might be used as a pretext for political interference in the adoption of ISAs, a precedent for which exists in the context of the adoption of IFRS. ISAs are unlikely to be adopted en bloc and there is always the possibility that 'ISAs as adopted by the EC', like 'IFRS as adopted by the EU', will become problematic, but probably not to the same extent.

Attitudes towards ISAs in the EU are mixed, although there have been some recent improvements, particularly with regard to the IAASB's governance arrangements. There were concerns that despite recent changes in the IAASB's governance arrangements, it remained overly influenced by practitioners and that US auditing standards and the US regulatory model were being introduced into the EU (albeit unintentionally) via the back door. It is likely, however, that some of these concerns reflect an out of date understanding of how the IAASB works. An EC representative at a FEE conference on audit regulation held in October 2006 announced that all outstanding governance issues in respect of the IAASB had been resolved. This paves the way for EC nominees to take a more active role in the oversight of IAASB's standard-setting.

## **Accounting and auditing standards**

The APB tried to avoid the problems associated with IFRS in its introduction of ISAs, but auditing and accounting standards do not in any case present the same issues. Firstly, auditing standards are more closely interconnected than accounting standards, particularly

since the recent major revisions to the risk, fraud and quality control standards. As noted above, ISAs are unlikely to be adopted en bloc for use in the EU but this does not mean that ISAs would be implemented by individual Member States on a piecemeal basis. The IAASB has an ambitious timetable for the revision and clarification of ISAs with a view to ensuring that they will be available in their entirety, and suitable for adoption in line with the needs of the EU, by 2008. All concerned need to work together to develop a coherent and practical implementation strategy for the adoption of ISAs in the EC and their implementation in the EU.

Secondly, whereas accounting standards affect the bottom line, are referred to on a regular basis by a wide range of stakeholders (preparers, auditors, analysts and investors for example) and are therefore rightly regarded as ‘public’ property, the detail of auditing standards is only of interest to a minority of such stakeholders. Such stakeholders are primarily interested in the quality of the output of the audit, i.e. the audit opinion, and less with the means by which auditors arrive at their opinion. This should mean that the scrutiny of individual ISAs prior to their adoption by the EC need not be excessively detailed.

The adoption of ISAs by the EC, if implemented properly, will enhance the quality of audit in the EU provided that the adoption process is not unduly bureaucratic, maintains the integrity of ISAs, avoids the problems with IFRS implementation, and that the EC sets up the mechanisms to achieve this quickly and builds in appropriate practitioner involvement.

The regulatory mechanisms that are now being set up to determine when and how ISAs are to be adopted by the EC and the manner in which they are to be implemented in the EU will affect UK audits.

It is important that UK audit stakeholders seek out ways in which to further influence the adoption and implementation processes in the EU, not least because they are in a good position to pass ISA adoption and implementation lessons learned to other European jurisdictions in which ISAs have not yet been adopted. It is important for practitioners across the EU that the transition to ISAs takes place on a smooth and timely basis. The IAASB is making a concerted effort to complete its clarity project by 2008 in order to facilitate adoption by the EC which has already begun putting in place the necessary mechanisms to achieve this. All concerned need to work together with auditors, standard-setters and the professional bodies to ensure that the changeover is as seamless as possible.

Emphasis on the early consideration of implementation issues and the need for the EU and the IAASB to take account of the substantial logistical challenges in training and educating auditors in the new standards are important. Implementation of standards is a greater challenge than adoption, particularly in jurisdictions which have not yet adopted ISAs or made moves towards convergence with them.

### ***The IAASB***

The IAASB is an independent standard-setting body operating under the auspices of IFAC. Unlike the IASB which is based in London, IFAC and the IAASB are based in New York. Members of IFAC are professional bodies from all over the world. Both IFAC and the IAASB have been through an extended process of governance reform in recent years. Many of IFAC’s boards and committees now have more non-practitioner members and additional, independent oversight bodies. The set-up of IFAC’s Public Interest Oversight Board (PIOB) and the IAASB’s Consultative Advisory Group (CAG) are particularly worthy of note.

The PIOB was established in February 2005 to oversee, among other things, IFAC's Public Interest Activity Committees (PIACs) including the IAASB and the International Ethics Standards Board for Accountants (IESBA). Its establishment was the result of a collaborative effort by the international financial regulatory community to ensure that standards for the accounting profession are set in a transparent manner that reflects the public interest. The PIOB is based in Madrid and, among other things, it evaluates the PIACs' due process procedures, approves their terms of reference and nominations to their boards, and it suggests projects to be added to work programmes. The PIOB's eight members are nominated by the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS) and the World Bank. The EC nominates two observers to the PIOB and it seems likely that the EC will take a more active role going forward.

The IAASB's CAG provides advice on the IAASB's work programme and technical advice on its projects. It comprises member organizations with an interest in the development of auditing standards in the public interest. Membership is intended to provide a balance of geographical representation and between regulators, international organizations, users and preparers. The Basel Committee on Banking Supervision, the EC, IOSCO, IAIS and the World Bank are permanent members. This group currently has significant investor and corporate representation.

The issues relating to the IAASB set out below emphasise the difficulties involved in standard-setting internationally and the reasons for some resistance to international standards. But this should be set in context. The recent efforts made by IFAC to improve its governance and due process have a bearing on the adoption of ISAs in the EU and the 8th Directive requirement for standards to be adopted to be developed with proper due process, public oversight and transparency. These reforms are particularly relevant in civil law jurisdictions where there may be concerns about auditing standards set by a private body being incorporated into legislation. It is easy to underestimate the efforts made by the IAASB to raise the quality of auditing standards and thereby the quality of audits performed globally over the last 10 years. The same is true of the recent efforts made by the leadership of the IAASB's CAG to emphasise strong investor and corporate representation and to support the IAASB and provide input into its work.

There is clear recognition at the IAASB of the value of the contribution made by UK representatives and the experience they bring to the table. This is reflected perhaps in the fact that the current (and several recent) presidents of IFAC, the chairs of the IAASB and its CAG are from the UK and that the UK is well-represented on many of the IAASB's working parties. The UK has a substantial investment in, and a major commitment to, the international auditing standard-setting process.

### **To whom do ISAs belong?**

A variety of conflicting perceptions exist regarding the ownership and purpose of ISAs:

- > the changing regulatory landscape across the world means that there are many more regulators overseeing the activities of auditors than there were 10 years ago and there are concerns that the IAASB has gone too far in meeting the needs of some relatively inexperienced regulators who seek greater prescription in auditing standards so as to facilitate the oversight of auditors;
- > auditors use auditing standards to hide behind when things go wrong and auditing standards therefore need to be very specific about what auditors are required to do; auditing standards are, or should be, a stick with which to beat errant auditors;

- > the IAASB is appeasing some regulators;
- > the IAASB is over-influenced by practitioners.

The IAASB points to the fact that its members, who represent a wide range of stakeholders, are truly global, that it meets all over the world and that it has relatively few US staff which should mean that the fact that it is based in New York is irrelevant. It also has to deal with the fact that in a number of cases recently, it has commenced a project before the PCAOB in the US, but has taken longer than the PCOAB to complete it. It has taken a significantly different line to the PCAOB but because its publication appeared after the PCAOB publication, some perceive, entirely erroneously, that the IAASB must have 'followed' the PCAOB. Perceptions are as important as facts, even if they are wrong.

### Recent developments in ISAs

The IAASB commenced its major revisions to the risk and fraud ISAs before the demise of Enron. The revision of these ISAs had a profound effect on the subsequent revision of other ISAs. These standards were both longer and more prescriptive than existing ISAs, required more questioning and documentation by auditors, and there were greater explicit requirements for the use of judgement. The ICAEW commented at the time that whilst enhanced requirements for questioning and the use of judgement were desirable, the level of prescription accompanied by these requirements was in danger of straitjacketing the very judgements the standards were intended to promote, although changes made to the clarity project proposals (see below) have gone some way to alleviate these concerns. As noted above, the revision of these ISAs was one of the important factors in the APB's decision to adopt ISAs in the UK. Much of the IAASB's work after the publication of these standards centred on conforming the older ISAs to the newer ISAs but there have also been major revisions to other important standards.

The revision of ISA 240 *The Auditors' Responsibility to Consider Fraud in an Audit of Financial Statements* was particularly significant. The revision raises expectations of auditors and ensures that the audit includes an in-depth assessment of the risk of material misstatement due to fraud. It also presumes that there is a risk of fraud arising from revenue recognition and requires audit procedures that respond to the possible override of controls by management. The result is a more robust standard which should overcome any perceptions that an audit is only directed at unintentional error.

### The 'clarity' project: proposed changes and timetable

The IAASB's clarity project is its most important restructuring project in recent years. It is designed to make the requirements of ISAs clearer. It became apparent that different jurisdictions understood the 'present tense' statements ('auditors do this or that') in existing ISAs in different ways; some jurisdictions regarded the statements as mandatory, others regarded them as optional. The IAASB has taken the opportunity to clarify standards in other ways, to make use of shorter sentences and bullet points and to eliminate repetition, for example. The IAASB published its initial proposals in 2004, modified its approach as a result of comments received, and exposed the current set of detailed proposals in October 2005. The comment deadline was 28 February 2006.

The most recent version of the proposals involve an overarching objective which auditors 'must achieve' and the division of existing ISAs into objectives (which auditors 'aim to achieve'), requirements (with which auditors 'shall' comply in all but very exceptional cases – the hurdle for departure is quite high) together with essential explanatory material, and application guidance in a separate section of the ISA. Significant developments

regarding objectives took place just prior to publication of this document that took much greater account of UK views on the subject and the situation at the time of publication seemed much improved. References to auditors obtaining 'reasonable assurance' within audit objectives have been replaced by references to the more familiar and less contentious obtaining 'sufficient, appropriate audit evidence', for example.

New requirements are derived largely from existing present tense statements and much of the focus has been on the extent to which the IAASB has properly applied its own criteria for requirements: in order for a present tense statement to become a requirement, rather than to become part of the application material, it is necessary, among other things, for it to be applicable in 'virtually all cases'.

Debate continues on documentation requirements and how the standards can be applied by the auditors of smaller and less complex entities, but there seems to be general agreement that clarified standards are in fact shorter and more readable.

The IAASB has exposed a number of clarified ISAs, including the long and complex risk and fraud ISAs showing how clarification will affect standards and requesting detailed comments thereon. The IAASB's published timetable for the clarification of all extant ISAs originally extended to 2011 although its timetable now envisages completion by 2008, so as to facilitate adoption by the EC.

### **The risks associated with the clarity project**

The IAASB and, to a lesser but not insignificant extent, the EC, have a great deal of capital invested in the clarity project. A rushed project might compromise the quality of standards but delay, pending perfection, might play into the hands of those who oppose the adoption of ISAs. There are also risks with regard to the lead time needed for consistent implementation across jurisdictions and firms. Furthermore, in order to meet the deadlines, it is likely that some out of date ISAs will be clarified without being revised and there may also be a tendency of drafters to take an 'if in doubt, mandate' approach. Once 'rules' are set up they can be hard to remove. That said, as noted above, the clarified standards are in fact shorter and more readable.

Significant positive progress has been made in a relatively short period on the IAASB's clarity project, particularly with regard to the nature and status of objectives. The views of commentators, including those expressed in the UK, have been heard and heeded. The resources expended by the APB at the IAASB and by those who work alongside the APB in the UK are paying off. It is important to UK audit quality that UK representatives continue to exert influence at the IAASB.

### ***Involving stakeholders***

The APB recognises the advantages and disadvantages of ISAs for the UK markets. Many of the concerns about ISAs in the UK originate with certain members of the investor community and some representatives of the corporate sector. A further concern is a perception that the APB has, or is in danger of, *effectively* giving up control of standard-setting in the UK, which is certainly not the case legally, but the perception persists. To date, respondents to the APB's proposals have been self-selecting and have been largely confined to practitioners and others directly involved with or affected by auditing standards. The same is true of the IAASB's standard-setting activities. Recent UK initiatives which have pro-actively sought a higher level of engagement between auditors, standard-setters, a wide group of investors and the corporate sector provide a good example of how



standard-setters can involve investors and others at an early stage to prevent unbalanced perceptions arising and ensure that the necessary level of consensus is obtained among those concerned with the standard-setting process.

The APB may need to consider ways in which awareness of auditing standards can be raised and, in particular, its approach to pluses that may in future no longer be permitted when ISAs are adopted in the EU, pluses in standards which have been recently debated at the IAASB, possible carve-outs and the deferral of ISAs. Dialogue may be needed over the possible loss of UK pluses, although there are probably a number of ways in which this loss can be prevented. A proper understanding of the significance of the influence of UK representatives over the development of a number of key ISAs in recent years might have prevented misconceptions arising.

The need for investor and corporate involvement is as acute at the IAASB and at European level as it is in the UK. ISAs are perceived by some investors as a US export which may not fit in other jurisdictions including the UK and that this, combined with other incremental changes including liability reform, is not necessarily to their benefit. There is a perceived need for all those concerned with the regulation of auditors to address these concerns and to consider incremental regulatory change over the last 10 years and where it is taking us, in the round.

Auditing standards are important to investors and companies in the UK and the EU. In the UK, the increasing involvement of stakeholders other than practitioners, professional bodies and standard-setters in the standard-setting and implementation processes has added credibility. This is set to continue as the DTI implements the Companies Bill and consults on the implementation of the revised 8th Directive.

Some investors and the corporate sector are already represented at the European level and within the IAASB's governance mechanisms, but other investors and those in the corporate sector who have concerns about auditing standards need to engage more pro-actively with standard-setters. Equally, the IAASB, APB and European regulators should continue to seek out the participation of a wide range of investors and corporate representatives at an early stage of their standard-setting activities, and consider developing more formal mechanisms for doing so. The APB's efforts to promote to the IAASB and the EC the value of effective communications with such groups are important. This may not be an easy task but it is worth pursuing, not least in order to avoid subsequent difficulties.

### ***Governance and ISAs plus***

Different regulatory and governance processes treat auditors in different ways in different jurisdictions. This affects the perceived purposes of audit and accounting and, in turn, the nature and content of auditing and accounting standards. The similarities and differences between the governance models in the US, the UK and Continental Europe are complex. It is as hard for some in North America to accept European governance models as it is for some in Europe to accept the US model.

The long-standing UK link between shareholders and auditors under the familiar stewardship model is not present in the US, or in certain parts of the EU. Whilst there are superficial similarities between US and UK governance models, US, UK and Continental European regulatory structures have developed historically in different ways. In the UK, auditors' reports are addressed to shareholders; in the US, they are often addressed to directors and stockholders. In the US, shareholder 'democracy' has recently been described as a 'cruelly misleading word to describe the situation of the American shareholder...'<sup>2</sup>

<sup>2</sup> *The Economist*, Special Report *Shareholder Democracy*, 11 March 2006.



US investors cannot remove or appoint directors or auditors in many States. Shareholders' interests, or rather the interests of the market as a whole, are represented by the SEC as a proxy for shareholders. This is not the case in the UK where investors, and particularly institutional investors, now take a much more direct and active role in the appointment of directors and sometimes auditors. The US SEC-led model emphasises compulsion, in the form of the Sarbanes-Oxley Act, for example, rather than co-operation (with compulsion as a last resort) as exemplified by the UK (and increasingly European) 'comply or explain' approach to corporate governance embodied in the Combined Code. The markets, rather than regulatory pressures, are perceived as the more effective mechanism for raising standards in the UK. In the US, the dialogue is between companies and the SEC (pre-clearance procedures, for example). In the UK, the dialogue is between auditors, companies, non-executive directors and investors, and is only conducted via the market regulator where matters have gone badly wrong.

The effect on auditing standards is direct: US auditing standards, such as those issued by the PCAOB, are widely perceived as excessively prescriptive and much of the criticism of ISAs derives from a perception that they are too heavily influenced by the US model. But in the US, ISAs are just as easily perceived as 'looking like' European standards. Awareness of preconceptions often only arises as a result of hammering out misunderstandings during detailed debate in highly technical areas. During the 2003 revision of the IAASB's guidance on communications with those charged with governance, it became clear that the language being used reflected fundamentally different approaches on the part of the US, the UK and Continental Europe. UK representatives were among those who successfully pressed for changes to be made but the ISA (UK and Ireland) still required a number of pluses in order for it to be applied in the UK.

There are concerns about a perceived misalignment between the decision-usefulness objective embedded in the joint IASB/FASB framework, the rather more familiar UK stewardship model (included in the IASB/FASB framework as a secondary objective), the purported framework-neutrality of ISAs, and the requirements of UK and European law regarding financial statements and auditor reporting thereon. This is a particularly complex area which may warrant further work.

It is important for both the IAASB and the EC to recognise that ISAs must be developed and adopted in a manner that is sufficiently flexible to accommodate different legal and regulatory structures, governance arrangements and assumptions about the nature and purpose of financial statements and the audit, i.e. in a manner that is truly framework-neutral.

The purpose of the adoption of ISAs in the EU is to raise standards of auditing in the EU and to increase transparency. The purpose should not be to limit audit quality or to iron out important differences in governance arrangements across the EU and it may be necessary for UK 'pluses' to ISAs to reinforce the UK's governance arrangements.

UK representatives have made significant progress in pressing for changes to the IAASB's standards on communicating with those charged with governance to accommodate the UK's governance arrangements. Nevertheless, concerns remain that the UK's governance arrangements, which are well-established in law and emphasise the stewardship function of financial statements and the audit, may not be recognised sufficiently within ISAs or at European level. Further work may also be necessary on the perceived lack of alignment between the decision-usefulness model on which IFRS are based, the UK's stewardship model, and auditor reporting considerations.

## The scope of ISAs to be adopted by the EC

The scope of ISAs to be adopted by the EC requires careful thought. ISAs will be adopted individually and they must be capable of implementation by Member States if they are to be adopted. There are questions about what will be adopted, what will be implemented, and how. ISAs will be written directly onto the statute books of some Member States which has given rise to concerns in the EU about the way in which differing legal systems will handle the substance of ISAs, and the effect that will have on the regulatory process. At the time of writing, four key issues were causing concern. All of these issues are of more significance elsewhere in the EU than they are in the UK but they are nevertheless relevant in the UK.

The first relates to the status of certain material within ISAs that have been ‘clarified’ under the IAASB’s clarity project. Clarified ISAs will comprise objectives, requirements, essential explanatory material and application material. Application material forms part of ISAs and ISAs must be read in conjunction with it, but the material is to be contained in a separate section. The EC is not clear as to whether the application material should be included in the material to be adopted because application material is not to be ‘mandatory’ and to include it will require significant additional resources for many jurisdictions, not least simply to translate it, as the material is extensive. But to exclude it causes concerns about the maintenance of the integrity of ISAs and to regulators in particular, with regard to their ability to enforce ISAs.

Secondly, there is much important material in the IAASB’s *Preface* on the status of material in ISAs and how it is to be interpreted. The *Preface* is not to be adopted at European level as part of the corpus of ISAs and there are calls for much of its content to be replicated in, or moved to, ISA 200<sup>3</sup> which is to be adopted. The IAASB is considering proposals to achieve this.

Thirdly, there are concerns over the IAASB’s other pronouncements, such as the *Framework*, International Standards on Related Services (ISRSs), International Standards on Assurance Engagements (ISAEs) and International Auditing Practices Statements (IAPs). Some believe that these documents should be adopted to maintain the integrity of the corpus of ‘ISAs’ but others believe that such documents are not relevant to the statutory audit in the EU, not necessary, that their scope is too wide to be included in European legislation and/or that some such material (particularly in IAPs) is out of date and not suitable for inclusion. Furthermore, some consider that some material already in ISAs should not be there, such as the material on summary financial statements.

Finally, some regulators are concerned that the requirements of ISA 230 *Documentation* are inadequate for the purposes of monitoring auditors. They believe that the requirement for documentation to be prepared to a standard that is reviewable by a suitably ‘experienced’ auditor<sup>4</sup> for regulatory purposes effectively excludes them.

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<sup>3</sup> ISA 200 *Objective and General Principles Governing an Audit of Financial Statements*.

<sup>4</sup> ISA 230 para 5(f).

To facilitate the smooth transition to ISAs in the EU, the scope of the IAASB material to be adopted should not extend beyond that which is essential for the purposes of the statutory audit.

The primary purpose of auditing standards is to enable auditors to conduct high-quality audits. This purpose is congruent with the needs of well-established and adequately resourced regulators who require clear standards against which to monitor the performance of auditors. High-quality auditing standards, designed with the need for auditors to conduct high-quality audits in mind, enable regulators to monitor auditors effectively. Whilst some regulators outside the UK may seek standards that are principally designed to facilitate ease of monitoring, the experience in the UK is that monitoring can be effective on the basis of principles-based standards and without excessive prescription, provided that the monitoring bodies are well resourced, competent and experienced. To require additional detailed audit documentation specifically for regulatory purposes would not only impose an unnecessary burden on business, it would shift the focus of audits away from audit quality.

## Smaller and less complex audits

### Background

Practitioners have been particularly concerned about the effect of auditing standards on smaller and less complex audits generally for some time. In recognition of this, standard-setters have made a number of recent moves to further recognise the particular needs of SMPs. Papers have recently been presented to the IAASB by APB staff on documentation for smaller audits and on regulatory impact assessments, for example. The APB has established an SMP group and the IAASB has enhanced its processes for obtaining input from SMPs. Nevertheless, it is important to understand clearly the needs of SMPs and why they need to be taken into account in developing auditing standards.

In North America, accommodating the needs of auditors of smaller and less complex entities is regarded by some as a lower priority as there is no requirement for the audit of smaller entities, at least in the European sense, although the number of voluntary audits of smaller entities in the US is substantial.

ISAs do not operate in a vacuum and ISA audits can only be conducted in the context of a statutory, regulatory or contractual framework. The US contractual framework for voluntary audits of smaller entities can be relatively easily adapted to match the needs of smaller entities and the requirements of auditing standards. The exercise is not so straightforward where audits are conducted in a statutory or regulatory framework because such frameworks are less flexible. This is important for IAASB because auditing is a public policy issue in many parts of the world and governments and regulators need appropriate public policy tools, such as audits, at their disposal to govern their economies. It is unhelpful if audits are difficult to apply to large swathes of small businesses, particularly in developing economies.

Audit exemption in the UK and in the EU is about relieving unnecessary burdens on smaller entities. The vast majority of UK companies are now audit-exempt and even more will be if the audit exemption limit is raised to companies with a turnover of £7m. It is arguable then that any audit-exempt entity undertaking an audit takes on that burden voluntarily. On the other hand, there are many small public interest entities that are not audit-exempt, and it is arguable that there are or will be pressures on audit-exempt companies to have an audit in the future, and that the audit is a valuable service that should not be effectively restricted to larger entities. In any case, auditing standards issued by the APB apply to all audits and there is a substantial number of smaller non-complex audits that fail the audit exemption test for technical reasons, such as property companies.

There are approximately one million audits conducted in the EU and the EU may be the IAASB's biggest market. Despite the fact that maximum audit exemption levels are set at EU level there is little evidence on how many audit-exempt entities do in fact have an audit. The differences between the legal 'vehicles' used by smaller businesses, and between public and private businesses in different jurisdictions, complicate the issue. And some jurisdictions have different auditing standards for unlisted entities, but not all unlisted entities can be described as smaller or less complex.

Furthermore, some argue that the audit of smaller and less complex entities presents an entirely different set of issues, even in the UK, because the agency relationship on which the audit premise is based, in which ownership and management are separated, does not exist. The audits of such entities take place for other reasons. And from time to time, support is expressed for different auditing standards for entities of different sizes, even

though the problem of defining a 'smaller' or 'less complex' entity will probably always be with us. The argument suggests that there will often be more than one way of arriving at an audit opinion and that ISAs do not currently reflect this.

The main concern of practitioners regarding ISAs as they apply to smaller and less complex audits is that whilst the basic principles apply to all audits, ISAs appear to be drafted for the audit of larger entities, with an inadequate level of smaller entity considerations bolted on as an afterthought. Such ISAs may be perceived as expensive and difficult for auditors of smaller and less complex entities to implement because of excessive documentation requirements. These requirements can create difficulties for clients as well as auditors.

The number of registered auditors is falling mostly as a result of audit exemption in the UK, but the market for the smaller audit may be further reduced as a result of increasing regulation generally. This has led some, including some in the EU, to question whether a 'one size fits all' approach to auditing standards is the right one, although there is opposition to this and in September 2006, FEE issued a briefing paper to MEPs strongly advising against any such approach.

### **The risk ISAs, clarity, and their effects on smaller and less complex audits**

The constituency that the IAASB serves includes the auditors of a very large number of smaller and less complex entities. Whilst ISAs as they stand may not always deal with smaller and less complex audits on an adequate basis, both the IAASB and the APB have made efforts to deal with this by obtaining input from SMP groups. Nevertheless, the risk ISAs in particular were developed using methodologies that represented best practice among large firms for larger audits in response to the concerns of regulators, most of whom have an obligation to serve the capital markets, but with no obligation to consider the needs of smaller or less complex entities.

The considerable accumulated knowledge and experience practitioners typically have of their smaller and less complex clients may appear to be discounted whilst documentation requirements in particular can seem excessive, with little or no corresponding improvement to audit quality. The best examples of this are in the risk and documentation ISAs in which smaller entity considerations are dealt with by means of a relatively small number of paragraphs that often highlight problems but provide no solutions. Documentation requirements in particular may have less value for smaller and less complex audits than for larger audits because the communication mechanisms within the smaller firms that perform the majority of such audits are often informal but effective. Documentation requirements for such audits are primarily required for monitoring purposes. If they are followed to the letter solely for monitoring purposes, they may represent a disproportionate and unnecessary cost with no apparent benefit. It is difficult for the IAASB to respond to complaints from practitioners to the effect that ISAs are not suitable for the audit of smaller entities, because practitioners find it difficult to provide specific examples of which particular requirements are excessive, inapplicable or burdensome. It often seems to be the totality of the requirements that presents a problem. Nevertheless, the IAASB already has processes for obtaining input from SMPs and IFAC has recently commissioned the development of guidance material for smaller audits. The needs of regulators and the capital markets should not be ignored or take second place to the needs of those auditing smaller and less complex entities. But the recent efforts made by the IAASB to accommodate smaller and less complex audits on a holistic basis need to be encouraged.

In the two years prior to the implementation of ISAs in the UK, a number of reports were published in the UK professional press anticipating increases in audit costs. These estimates

almost certainly reflected a certain level of nervousness about the changes and first-year costs are always an issue. Further assessments regarding costs will need to be made in due course. But additional costs seem likely, particularly where a substantive approach was taken in the past. The risk and fraud ISAs have requirements to understand and document controls regardless of the intended audit approach. If work on systems in the past was very limited, the additional resources required to meet these new requirements may in some cases be significant.

### **Dealing with clients**

Practitioners dealing with smaller and less complex audits may perceive that any additional costs will be difficult to pass on to clients. But despite the problems noted above, some practitioners from firms of all sizes taking a positive attitude towards the changes have been able to justify fees increases, including increases for smaller and less complex audits, on the basis of the enhanced value provided by the audit.

Practitioners who explain to clients that the new standards will require more effort have in some cases been pleasantly surprised to discover that the additional probing and analysis required by the risk and fraud ISAs, for example, have been appreciated. This seems to be partly because some clients welcome the opportunity to voice their fears about the vulnerability of their systems and because additional questioning and audit documentation help to identify how they can be made more secure, and partly because the changes have brought to light redundant audit procedures and documentation which can be replaced with more effective tests.

Nevertheless, because of economies of scale, it is likely that auditors of smaller and less complex entities in the UK will find it harder to pass on the costs of improved audit quality to their clients than auditors of larger entities. This problem is compounded by other recent regulatory changes affecting smaller practitioners, including money laundering and ethical requirements. The inevitable consequence of this is that some practitioners will, sooner or later, find it uneconomic to continue to provide audit services, reducing the range of services available to smaller and less complex entities, which cannot be in the public interest. There is a risk that the quality of information will deteriorate as a result of this. Research should be conducted in due course into the effects of regulatory change on the provision of audit services and in turn, on the quality of information on the public record.

Many users of ISAs are auditors of smaller and less complex entities. Such entities have a significant economic impact and their audit is a public interest issue. Papers recently presented to the IAASB by APB staff on documentation for smaller audits and on regulatory impact assessments recognise the needs of such entities. The establishment of an SMP group by the APB also evidences recognition of the needs of such entities. The IAASB has enhanced its processes for obtaining input from SMPs.

The most important factor contributing to the decline in the number of smaller UK practitioners performing audits in recent years is the increase in the audit exemption threshold. Nevertheless, there is a risk that the market for audit services and the choice of practitioners for smaller and less complex entities may be further reduced if the regulation of auditors and the concomitant cost of audit increase significantly. If auditing standards are thought to be unduly complex and expensive to implement because of excessive documentation requirements, practitioners who provide such audit services will eventually cease to provide them. Auditing standards need to be workable for smaller audits. If they are not, the 'an audit is an audit' approach to auditing standards may be called into question.

Further research will be needed in due course into the effects of regulatory change on the provision of audit services and in turn, on the quality of information on the public record for smaller and less complex entities.

There are some indicators of enhanced audit quality resulting from the introduction of ISAs (UK and Ireland) for the audit of smaller and less complex entities but there is also evidence that some practitioners and their clients are struggling.

The governance arrangements for smaller entities are different to those for larger entities: managers and owners may be the same. This needs to be taken into account during the development of ISAs. Currently, ISAs raise some of the problems in application guidance, but provide little in the way of suggested solutions. Projects such as the development of guidance and materials for the audit of SMEs by IFAC may go some way to alleviating these problems but more and better explanations in the application material of how requirements that are primarily designed for the audits of larger entities can be interpreted in the context of smaller and less complex audits are needed for the more complex recently issued standards. The 'virtually all' test for requirements in the clarity project must encompass the audit of smaller and less complex entities.

The auditors of smaller and less complex entities should be encouraged to provide more concrete, specific and constructive suggestions for improvements to ISAs. The FRC and the professional bodies should continue to make efforts to increase the level of input from this group.

# Appendix 1

**Certain non-compliance pluses in existing ISAs (UK and Ireland) that may in future no longer be permitted as a result of the implementation of the revised 8th Directive**

## **ISA (UK and Ireland) 260 *Communications of Audit Matters with those Charged with Governance***

This ISA is in the process of revision at the IAASB. It seems likely that the following UK pluses will not survive. However, it seems possible that the substance of some of these items may be included in the revised ISA but within the application material.

- > provision of a copy of the engagement letter to those charged with governance;
- > planning the form and timing of communications with those charged with governance;
- > limitations in the scope of the audit.

## **ISA (UK and Ireland) 570 *Going Concern***

This plus relates to UK GAAP requirements in that the time period for consideration of going concern issues runs from the date of approval of the financial statements rather than the balance sheet date.

## **ISA (UK and Ireland) 402 *Audit Considerations Relevant to Entities Using Service Organisations***

There are significant pluses in this ISA taken from the guidance in the SAS. A project to revise the relevant ISA has recently commenced.

## **ISA (UK and Ireland) 550 *Related Parties***

There is a plus in this ISA regarding the disclosure of information omitted from financial statements on related parties in the auditor's report 'where practicable'. Current discussions by the IAASB may include similar wording.



## Appendix 2

### Extract from Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts

#### Article 26

##### Auditing standards

1. Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 48(2). Member States may apply a national auditing standard as long as the Commission has not adopted an international auditing standard covering the same subject-matter. Adopted international auditing standards shall be published in full in each of the official languages of the Community in the *Official Journal of the European Union*
2. The Commission may decide, in accordance with the procedure referred to in Article 48(2), on the applicability of international auditing standards within the Community. The Commission shall adopt international auditing standards for application in the Community only if they:
  - (a) have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;
  - (b) contribute a high level of credibility and quality to the annual or consolidated accounts in conformity with the principles set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC; and
  - (c) are conducive to the European public good.
3. Member States may impose audit procedures or requirements in addition to — or, in exceptional cases, by carving out parts of — the international auditing standards only if these stem from specific national legal requirements relating to the scope of statutory audits. Member States shall ensure that these audit procedures or requirements comply with the provisions laid down in points (b) and (c) of paragraph 2 and shall communicate them to the Commission and Member States before their adoption. In the exceptional case of the carving out of parts of an international auditing standard, Member States shall communicate their specific national legal requirements, as well as the grounds for maintaining them, to the Commission and the other Member States at least six months before their national adoption or, in the case of requirements already existing at the time of adoption of an international auditing standard, at the latest within three months of the adoption of the relevant international auditing standard.
4. Member States may impose additional requirements relating to the statutory audits of annual and consolidated accounts for a period expiring on 29 June 2010.

## Appendix 3

### Glossary of abbreviations

APB	Auditing Practices Board: the UK auditing standard-setter, operating under the auspices of the Financial Reporting Council (FRC)
AuRC	The Auditing Regulatory Committee of the EC
CCAB	Consultative Committee of Accountancy Bodies (representing the ICAEW, ACCA, CIPFA, CIMA, ICAS and ICAI)
EC	European Commission
EGAOB	European Group of Auditing Oversight Bodies
EU	European Union
FEE	Fédération des Experts Comptables Européen (the European Federation of Accountants)
FRC	Financial Reporting Council
IAASB	International Auditing and Assurance Standards Board: the international auditing standard-setter, operating under the auspices of the International Federation of Accountants (IFAC)
IAPs	International Auditing Practice Statements issued by the IAASB
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards issued by the International Accounting Standards Board (IASB)
IOSCO	International Organisation of Securities Commissions
ISAs	International Standards on Auditing issued by the IAASB
ISAEs	International Standards on Assurance Engagements issued by the IAASB
ISRSs	International Standards on Related Services issued by the IAASB
PCAOB	Public Company Accounting Oversight Board (the US auditing standard-setter for public company audits)
SASs	Statements of Auditing Standards: UK auditing standards formerly issued by the APB and now replaced by ISAs (UK and Ireland)
SEC	The US Securities and Exchange Commission
SMPs	Small and Medium-sized Practices

## Appendix 4

### Chronology of the introduction of ISAs to the UK

November 2001	Publication of FEE Discussion Paper <i>Proposal on International Standards on Auditing in the EU</i> at the request of the EC in which FEE proposes that by 2005, national auditing standards in the EU should require auditors of financial statements to perform audits and report on financial statements in compliance with ISAs.
September 2002	Issue of APB consultation paper <i>Priorities and Future Work Programme</i> describing APB's intentions in the context of the EC move towards ISAs and asking the question, 'do you consider APB's plans to adopt ISAs at the start of 2005 to be appropriate?'
January 2003	Publication of the UK Government's final CGAA report supporting the move towards ISAs and welcoming APB's commitment to work with the IAASB to improve auditing standards on an international basis provided that this would not lead to a dilution of UK standards.
February 2003	APB Annual Review 2002 explains the status of ISA implementation in EU and signals APB's intention to adopt ISAs.
March 2004	APB press release announces its decision to adopt ISAs 220, 240, 315, 330 and ISQC 1. This notes that APB was still looking at how to integrate these with other UK auditing standards.
May 2004	<p>APB press release announces the decision to adopt ISAs using the ISA plus model, the main reasons being that it would:</p> <ul style="list-style-type: none"> <li>&gt; facilitate the adoption of recent improved international standards. UK auditing standards needed to be reviewed in the context of recent financial reporting irregularities to ensure they were as effective as possible in addressing fraudulent financial reporting and aggressive earnings management. Rather than working in isolation, APB decided that it would be more effective to contribute to the international effort through the IAASB;</li> <li>&gt; allow APB to benefit efficiently from future improvements to ISAs; and</li> <li>&gt; help maintain the stature of UK standards internationally.</li> </ul>
June 2004	Issue of Exposure Drafts of the majority of ISAs (UK and Ireland) with a consultation paper explaining the background and reasons for the initiative.
August 2004	Issue of Exposure Draft of ISA (UK and Ireland) 300 on planning.
October 2004	Issue of Exposure Draft of ISA (UK and Ireland) 700 on audit reports.
December 2004	Approval and publication on APB's website of final ISAs (UK and Ireland).
January 2005	Publication of final ISAs (UK and Ireland) in hard copy.

## Appendix 5

### Working group membership

We are grateful to the following people for their input to this paper issued to the *Audit Quality Forum*. Their input does not necessarily reflect the views of the organisations they work for or are attached to.

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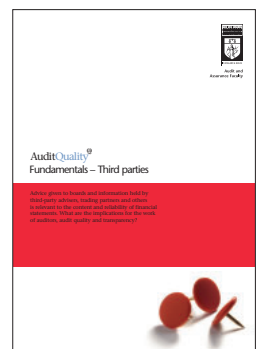
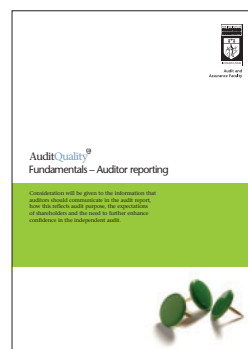
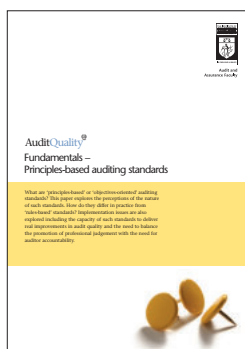
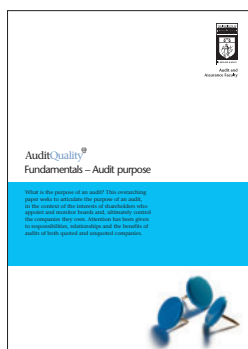
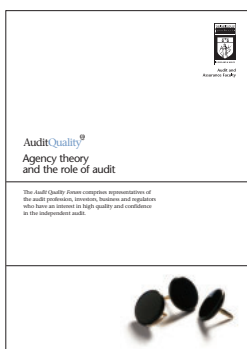
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*Department of Trade and Industry*





# AuditQuality<sup>®</sup>

## Fundamentals



### Agency theory and the role of audit

*This paper focuses on the role and importance of the agency relationship in the development of audit historically and how the relationship may be useful in understanding the role of the statutory audit in the UK today. It also introduces other issues, interests and relationships, which impact on the application of this theory and point to potential alternative purposes of an audit.*

### Audit purpose

#### **What is the purpose of an audit?**

*This overarching paper seeks to articulate the purpose of an audit, in the context of the interests of shareholders who appoint and monitor boards and, ultimately control the companies they own. Attention has been given to responsibilities, relationships and the benefits of audits of both quoted and unquoted companies.*

### Principles-based auditing standards

*What are 'principles-based' or 'objectives-oriented' auditing standards? This paper explores the perceptions of the nature of such standards. How do they differ in practice from 'rules-based' standards? Implementation issues are also explored including the capacity of such standards to deliver real improvements in audit quality and the need to balance the promotion of professional judgement with the need for auditor accountability.*

### FORTHCOMING TITLE

#### **Auditor reporting**

*Is current auditor reporting, in particular the audit report, helpful to shareholders? This paper will consider the information that auditors should communicate and how this reflects audit purpose, the expectations of shareholders and the need for further enhancement of confidence in the independent audit.*

### FORTHCOMING TITLE

#### **Third parties**

*How does the extent of disclosure of third-party information and advice to the board impact on audit quality? Advice given to boards and information held by third-party advisers, trading partners and others is relevant to the content and reliability of financial statements. What are the implications for the work of auditors, audit quality and transparency?*

