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Smaller audits: Challenges and Insights

Smaller audits are considered “a specialty”, with their own unique set of challenges for practitioners to address when engaging with smaller clients. This publication highlights some of those challenges and provides related insights that might be useful for practitioners, Small and Medium Sized Practices (SMPs) and Professional Accounting Organizations (PAOs) as they support their members.

What size are smaller audit clients?

There is no uniform definition of a smaller audit client. From the practitioner’s perspective, audit work for a smaller client usually requires less time to complete compared with larger clients, resulting in a lower fee.

The International Auditing and Assurance Standards Board (IAASB) Handbook of International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements defines a smaller entity by qualitative characteristics. These include concentration of ownership and management and exhibiting one or more of the following characteristics:

- Straightforward or uncomplicated transactions;

The EU Requirement

For implementing the requirements of the EU Accounting Directive, entities are classified as large, medium, small, and micro according to three criteria with numeric thresholds set in the directive.

A small company is one that has met two of the following criteria for two consecutive years: more than 10 but less than 50 employees, total balance sheet between Euro 0.35 – 4 million and net turnover in the range of Euro 0.7 – 8 million.

Small companies (including micro entities) are not required to undergo audit per the directive. But, under the principle of subsidiarity, member states can require (or continue to require) a financial statement audit from them.

- Simple record-keeping;
- Few lines of business and few products within business lines;
- Few internal controls;
- Few levels of management with responsibility for a broad range of controls;
- Few personnel, many having a wide range of duties.

Some jurisdictions have implemented size classifications for entities based on certain quantitative criteria, such as number of employees, revenues and average assets, however there is no international consensus.

Why are the audits of small clients “a specialty”?

Small audits have their own set of challenges, such as limited internal controls with the possibility of management override, or less sophisticated documentation and systems. It can be demanding to perform these engagements efficiently, with appropriate quality and at low cost. From the auditor’s perspective, the risk profile of a smaller client is quite different from that of a large one: large public clients carry higher engagement risk as more users are likely to rely on the financial statements, but then these usually have a well-developed internal control structure in place to mitigate some of the risks. Smaller clients usually have an “owner – manager configuration” and the importance of developing a “trusted advisor” relationship, without jeopardizing independence, is an additional factor of difficulty.

The skills of the auditor, their knowledge of auditing standards and the ability to make smart professional judgments are key. The auditor requires a depth of understanding of all the auditing standards to allow them to work quickly and effectively, performing the right amount of audit work and documentation to contribute to the sustainability of the small audit business. Teams are also usually smaller so individual practitioners must possess a broad set of skills, such as sufficient knowledge in tax, company law, IT and other relevant areas.

While small audits are not exclusive to SMPs, by customizing their audit process for the small client SMP auditors can have a natural advantage in this market segment. [Research by International Federation of Accountants \(IFAC\) SMP Committee](#) indicates that the main reasons Small and Medium Enterprises (SMEs) choose SMPs to provide professional services is their reputation for competency and trust, responsiveness, and geographical proximity.



Smaller Audits: Challenges and Insights

Challenge: One set of auditing standards applies for all audits

Policy makers usually assess the “regulatory burden” on smaller business in two key interrelated ways. Firstly, a cost/benefit equation determines whether the costs of regulation outweigh the benefits. Secondly, even if regulation provides net benefits, the costs must not fall disproportionately on smaller businesses.

For general purpose financial reporting this consideration of “regulatory burden” has led to development of simplified framework for producing financial statements, i.e. the International Financial Reporting Standards (IFRS) for SMEs. These reduce the complexity and streamline the financial reporting requirements for smaller businesses compared to “standard” IFRS and, therefore, the costs of preparation are lower.

The IAASB’s Clarity Project to revise and redraft its International Standards on Auditing (ISA) was completed in February 2009. The 36 Clarified ISAs and a Clarified International Standard on Quality Control (ISQC) are now effective and being adopted and implemented worldwide. Over 110 jurisdictions are using or are in the process of adopting or incorporating the clarified ISAs.

A practitioner needs to comply with all ISAs relevant to the audit and with all requirements in ISAs relevant to the audit. A complete knowledge of all the standards is essential in order to make a professional judgement as to what can be left out.

The auditor of a small business is required to be equally proficient in all relevant standards as an auditor of an entity with high levels of public accountability, such as a large, publicly listed entities. New and revised standards, including conforming amendments to other ISAs, still need to be understood by the auditors of smaller businesses (even if only to decide whether they apply to smaller audits). From an SMP perspective keeping up with changing requirements and maintaining the required knowledge base can be challenging.

Insight: ISAs can be applied proportionally in smaller audits

- ISAs are principle-based, allowing practitioners to apply professional judgement and tailor audit procedures. Because the audit procedures are not prescribed in the ISA, the auditor’s work program can be adjusted to the risks and other characteristics specific to the smaller audit client.
- Practitioners need a thorough understanding of the standards in order to avoid performing work that is not required for the auditor to express an opinion.
- Requirements in the auditing standards can be “scaled down” in order to be more proportionate for smaller audits (e.g. some of the ISAs include sections entitled “Considerations specific to Smaller Entities”).
- Some ISAs may only apply to larger entity audits (e.g. ISA 610 (Revised) *Using the Work of Internal Auditors* as the small client is unlikely to have an internal audit function, or ISA 701 *Communicating Key Audit Matters in the Independent Auditor’s Report*¹ that applies for listed entities).

Many successful smaller audits are performed under ISAs. There is guidance within ISQC 1 on application for smaller audit firms² and there is extensive guidance on how to conduct an efficient audit for smaller businesses following the ISAs (e.g. publications of IFAC SMP Committee, IAASB, and various leading PAOs around the world).

¹ Effective for audits of financial statements for periods ending on or after December 15, 2016.

² The IAASB has published a Staff Questions and Answers - Applying ISQC 1 Proportionately with the Nature and Size of a Firm



Challenge: A simpler business doesn't necessarily mean an easier audit

Some assume that auditing a small business must be relatively easy. The IT environment is typically simple; business transactions are few and generally straight-forward; and shareholders are fewer.

In a number of ways, however, smaller businesses are harder to audit. Undertaking the smaller audit efficiently requires a very good knowledge of the business and an extremely good knowledge of auditing standards. Small businesses tend to have particular characteristics that require increased attention, for example:

- Fewer financial controls (e.g. unable to segregate duties)
- Lower capacity to "close the books" (i.e. accuracy of accruals and provisions)
- More related parties transactions
- Can be subject to some complex taxation requirements

Insight: Practitioners skill, experience and ISA knowledge is key for efficient and effective small audits

- Audits of smaller businesses may be less complex than larger audits but can be difficult.
- In depth understanding of the auditing standards allows the practitioner to work quickly and effectively, performing the right amount of audit work and avoiding becoming over-burdened by excessive documentation.
- Having fewer more experienced professionals involved in the audit can increase efficiency because these professionals have fine-tuned their ability to make effective professional judgements on small audits.
- Different industries/sectors carry different audit risks. Specialization by industry/sector allows a practitioner to develop tailored approaches which can be applied to several engagements, thus helping absorb the significant development costs.
- Using technology in the audit process and introducing automation (e.g. audit software solutions) can bring many benefits and efficiencies to the audit process, including introducing a competitive edge and increased speed and access to audit documentation and evidence.



Emerging SMP "Practice Models"

Many SMPs are revisiting their practice models to adjust to the changing needs of their clients and the changing business environment. Adapting the practice model can help SMPs meet the challenge of performing quality audits with relatively limited fees.

For some SMPs this has meant increased specialization (i.e. audit vs advisory) and a different way of operating, including:

- Specializing in non-audit services and moving away from traditional audit services focused practices
- Innovative ways to lower costs (e.g. outsourcing, home-based work or shared office space, paperless office etc.)
- Considering fees as the value provided and not the number of hours x rate





Challenge: From commoditization to differentiation

The downward pressure on audit fees for small businesses is largely due to the market viewing the auditor's opinion as highly standardized - if any given auditor will produce the same output, price becomes the focus.


One of the key challenges arising from this commoditization of the small audit market is ongoing compliance with the requisite standards (i.e. ISAs) notwithstanding low price elasticity in quality.

Auditors are subject to initial and continuing education requirements and the audit process is labor intensive so the impact of declining audit fees can be exacerbated by increasing labor market costs. The challenge at the forefront of many auditors of smaller business, therefore, is how they can grow revenues in their audit practices while maintaining audit quality.

Insight: Smaller clients are ready to pay for audits that they perceive add value

- An audit strengthens the credibility of the information in the financial statements.
- A quality audit is expected regardless of fees.
- Small businesses do pay their auditors for good business advice. By learning how to operate a "trusted business advisor" practice model, auditors can learn how to bill their clients for the value, over-and-above the audit, that their advice provides.
- The management letter can provide insights regarding identified weaknesses in the internal control of the entity and outline recommendations for improvement.
- By undertaking the audit as efficiently as possible the amount of "unbilled" work reduces. Automating the audit process can significantly contribute to efficiency.
- It is particularly important, in countries where SMEs are at the core of economic growth strategies, that smaller businesses with growth potential are able to source appropriate financial capital. By providing good business advice and mentorship, auditors can support small business growth including accessing finance.
- In some circumstances the cost of the assurance engagement can be reduced provided the level of assurance needed is reduced (i.e. an audit versus a review³).

³ International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*.



Emerging SMP "Practice Models" (continued)

- Greater focus on branding and marketing

An interesting development in the "advisory type" of practice model is the emergence of cloud-based accounting software. This technology helps to lower the cost of producing information from transactional data and makes this information more business-friendly and more accessible to the business owner /manager. SMPs are looking to leverage the improved relationship this technology can bring by being more of an advisor (i.e. in addition to tax services) and business mentor - turning this information into insight and action.

The "trusted business advisor" relationship with small businesses is heavily contested, so it is important that SMPs continue to revisit their practice models in order to grow.



Challenge: Raising audit exemption thresholds

An audit may be undertaken for one or a number of reasons, for example: because of a legal requirement; a fiduciary requires assurances in fulfilling their obligations; a contractual requirement (e.g. financing agreement); and/or owners/managers request one to gain confidence in the assessment of financial performance and financial position, etc.

Governments increasingly have no legal requirement for the audit of general purpose financial statements of "micro" and "small" businesses - mandating such regulatory obligation is not seen as adding value to the small business owner and allowing a simplified regulatory environment that fosters small business growth. In some countries there is no requirement for these businesses even to prepare general purpose financial statements. This lower regulatory burden is generally well received by the business world because it is viewed as minimizing compliance costs. However, this "shrinks" the size of the market for audits of smaller businesses and is leading audit firms to change their practice models.

Insight: Expanding the services offered

- The services that auditors provide are used by Governments as a regulatory tool and also by market participants as part of their decision making process.
- Small audit clients, and their business partners, find value in the relationship with an audit professional and the assurances that the audit opinion provides.
- Business advice and other structured non-assurance services (i.e. agreed upon procedures, compilations etc.)⁴ can provide small business stakeholders with some confidence even where no audit or review opinion is provided.
- The IAASB has recently revised its standards on Review Engagements and Other Assurance⁵, these may increasingly be used by standards setters. There may be increased demand for the performance of review engagements arising from Governments looking for a regulatory response that is perceived to be proportionate for small entities.
- PAOs should engage in a process to educate their members on these assurance and non-assurance offerings. The International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants (the Code) imposes certain requirements for practitioners when non audit services are being provided to audit clients, however some aspects of the Code are less restrictive compared to requirements for large public clients.

⁴ International Standards on Related Services (ISRS) 4400, *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*, and ISRS 4410 (Revised), *Compilation Engagements*

⁵ For example, International Standard on Assurance Engagements (ISAE) 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*





Challenge: Evolving markets and new services require practitioners to make significant investments in skills and technology

To undertake audits of smaller businesses efficiently, the auditor needs to make investments in two key areas. Firstly, the auditor needs to have the skills and judgement necessary to perform the minimum amount of audit work while complying with the auditing standards. Secondly, the auditor needs the technology to enable an efficient methodological approach to performing the audit and documenting the outcome of work performed.

Since investing in IT and skills development can be expensive, audit practices that have declining audit revenues or are just too small may not have the scale to maximize the economic benefits possible from such investment.

Insight: Adapt, innovate and find new ways to operate

- Not all off-the-shelf technology solutions can enable auditors to minimize the amount of work required to perform a small audit. Some additional customization and retooling may be required.
- Some practitioners may choose to specialize in non-audit services and move away from audit services. In other cases, market consolidation may help smaller audit firms to achieve scale. Mergers of audit practices operating at the smaller end of the market may become increasingly common.
- In order to attract talent into the profession it will be important that audit practices are profitable. Smaller audit practices around the world are increasingly moving away from the traditional practice model and developing new ways of operating. This innovation is essential to maintaining profitability in light of fee pressure for smaller audits and the need to provide other value-added services in order to grow revenue.
- Some PAOs, as education and quality assurance providers, are increasingly focused on how small business auditors obtain the knowledge they require to be trusted business advisors and aim to develop related education solutions at scale.



Resources


This material is sourced from IFAC. See link.

- [IFAC Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities, Third Edition \(www.ifac.org/smp\)](http://www.ifac.org/smp)
- [IAASB 2015 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements \(www.iaasb.org\)](http://www.iaasb.org)
- [IFAC Guide to Quality Control for Small- and Medium-Sized Practices, Third Edition \(www.ifac.org/smp\)](http://www.ifac.org/smp)
- [IFAC Global Knowledge Gateway \(www.ifac.org/gateway\)](http://www.ifac.org/gateway)



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