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Dear Hazel

Exposure Draft ISA Practice Note 26 (Revised) "Guidance on Smaller Entity Audit Documentation"

Thank you for the opportunity to comment on the APB's exposure draft on smaller entity audit documentation.

Our response to the specific question raised by the APB is included below together with more detailed comments on the examples and the exposure draft.

In summary, although we consider that the guidance in the exposure draft is helpful and includes some well thought out examples of audit documentation we have the following major concerns:

- 1. Who is the guidance aimed at?** – We are concerned that the APB might be aiming the guidance in the exposure draft at the wrong audience. Paragraph 2 of the exposure draft states that the guidance "is directed to auditors of companies that are exempt from audit but choose nevertheless to have a voluntary audit and other smaller entities such as charities". In our opinion concentrating on "voluntary" audits sets the wrong tone for the document and narrows the applicability of the guidance down to audit exempt companies that voluntarily have an audit when the determining factors should be the size and complexity of the entity being audited not whether the company voluntarily requests an audit.

We do not consider that it is appropriate to have additional guidance on documentation for instances where a company voluntarily opts to have an audit. The fact that an audit is voluntary should not mean that a lesser audit is performed and we do not think that the documentation for a voluntary audit should be any different to a situation where an audit is required by the Companies Act. As drafted we consider that the guidance would effectively deter auditors of simple entities that require an audit, for example charities and small subsidiaries of groups that are ineligible from taking the audit exemption, from taking advantage of the simplified documentation examples in the exposure draft.



The documentation for audits of “smaller entities” and “entities that have uncomplicated business and processes relevant to financial reporting” is also highlighted in paragraphs A131 to A133 of the proposed clarified ISA (UK and Ireland) 315. However, this is not addressed in the draft practice note which in paragraphs 17 to 19 concentrates just on audit documentation for “smaller entities”. In our opinion, it is both the size and complexity of the entity that are important and although smaller entities often have less complicated processes and structures this is not always the case and some smaller entities are quite complex whereas there are larger entities where ownership is concentrated in a small number of individuals which might have uncomplicated operations and relatively simple business processes and controls.

We recommend that the APB deletes the reference to audit exempt companies and combines the guidance in paragraphs 2 and 3 in the exposure draft, using the bulleted list in paragraph 3, to clarify that the guidance is applicable to smaller entities with less complicated businesses and processes relevant to financial reporting.

2. **“Illustrative” documentation examples** – Although we recognise that the illustrative examples included in the exposure draft and the previous version of PN 26 provide useful guidance to auditors of smaller less complicated entities we are concerned that the examples provided may soon be regarded by regulators and others as “best practice” and then be treated as “recommendations” and finally be regarded as “required”. For example the last sentence of paragraph 5 states that these “specific illustrative examples are not mandatory”, which although reassuring nevertheless leaves the impression that there are some examples of audit documentation that are mandatory.

We note that the APB states in paragraph 5 that “these specific illustrative examples are not mandatory” and in Appendix B each example is headed up “Example documentation: for illustrative purposes only” but in our opinion the APB could do more to clarify the fact that the examples are not to be regarded as mandatory and are only illustrative. **We recommend that the APB changes the title of the Practice Note to “Practice Note 26 – Guidance on illustrative documentation for smaller entity audits (Revised)”.**

We also recommend that as part of the finalisation process of the practice note the APB consults with regulators and inspectors of audit quality at the AIU and the Institutes to ensure that inspectors do not seek through their reviews to effectively mandate use of these documentation examples.



Specific question on the Draft Update to PN 26

The APB is now seeking views on the proposed updates to Practice Note 26 and in particular on whether the new illustrative examples properly reflect the requirements of the proposed ISAs (UK and Ireland) and are a realistic illustration of appropriate audit documentation? If not, how should the examples be amended?

We consider that the illustrative examples are very helpful for auditors of smaller less complicated entities but have the following comments:

Example	Comment
Example 1, page 36	<p>In the example financial statement materiality it is calculated simply as 5% of profit before tax and the calculation does not take into account the balance sheet figures. It is therefore based only on financial performance for the period and not on the position at the end of the period. Figures such as turnover should be considered individually it is not advisable to only consider the net of off all items of income and expenditure. We are concerned that the approach to determining financial statements materiality focuses too much on one figure to the exclusion of other figures in the financial statements.</p>
Example 1, page 38	<p>The last section of the audit strategy memorandum identifies two significant risks relating to property valuation and misappropriation of cash from cash sales but the general risk of management override of controls is not recorded as a significant risk.</p> <p>ISA 240 paragraph 31 states that “Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. <u>Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.</u>”</p>
Example 3, page 41	<p>Paragraphs 2 and 3 of the free-form notes of understanding the entity state that the company is a small company and the directors have voluntarily elected to have an audit. As we stated above we do not consider it appropriate to direct the guidance at companies that are exempt from audit but choose nevertheless to have a voluntary audit and other smaller entities such as charities”. In our opinion concentrating on “voluntary” audits sets the wrong tone for the document when the determining factors should be the size and complexity of the entity being audited not whether the company voluntarily requests an audit.</p> <p>Paragraph 4 contains a small typo, its states that “Food and Beverage (the wine bar, restaurant and function room) (70%) and Room revenue from the hotel (30%). %).” The last “%” should be deleted.</p>
Example 3, page 42	<p>The section on ownership and governance in the notes of understanding the entity lists out that the company has two directors and three non-</p>



Example	Comment
	<p>executive directors. We do not consider that a small audit exempt company such as this would have three non-executive directors and recommend that only the directors are listed. This would help to emphasise the importance of identifying the transactions with the related parties, for example Terry Bull.</p>
Example 3, page 43	<p>The section on sources of information refers to the “company website”. We consider that when referring to websites in audit documentation it is helpful to give the address of the specific website pages that were consulted and the date the pages were accessed.</p> <p>Material on website pages can be changed with no notification to the people who had previously viewed the website pages. In some cases, for example when the original access date is known, it is possible to view an archived version of the page and therefore view the source document used to prepare the audit papers.</p>
Example 5, page 51	<p>The overall conclusion in the excerpt from the team planning meeting states that “There is a limited risk of material misstatement at the financial statement level as there are few external users of the financial statements, the business is well-controlled and <u>there are not many related parties.</u>”</p> <p>We consider that there is too much emphasis on the number of related parties and do not agree with the conclusion that there are “not many related parties”. The company is a family-owned and family controlled business with family members acting as employees, customers and suppliers. The section on related parties on page 42 states that a “number of large functions have been held at the hotel for family and friends of the directors in the past”. Although the paragraph concludes that these are not material it does appear that there are a number of related parties.</p> <p>The conclusion that there are “not many related parties” is also inconsistent with the conclusion on page 36 in the characteristics of the engagement that there are “a number of related party transactions during the year”.</p>
Example 6, page 53	<p>The section on monitoring controls states that the bank reconciliation is reviewed by one of the non-executive directors. We do not consider that this is realistic when there are two executive directors involved in running the business on a day to day basis. We recommend that one of the executive directors is listed as responsible for reviewing the bank reconciliations.</p>

Further detailed comments

In addition to the main comments raised above and the comments on the examples we have the following detailed comments on the exposure draft:



Reference	Comment
Page 7, Para 5	The last sentence of paragraph 5 states that these “specific illustrative examples are not mandatory” which gives the impression that there are some examples of audit documentation that are mandatory. We are not aware that there are any mandatory audit documentation examples and recommend that the word “specific” is deleted. The equivalent paragraph in the extant PN 26 did not use the word “specific”.
Page 7, para 6	<p>Paragraph 6 includes a cross reference to ISA (UK and Ireland) 230 “Audit Documentation” and quotes from paragraph 5 of the ISA. We consider that it would be more helpful if in this and other cases where there are cross references to wording in the ISA that the paragraph number is included in the cross reference for example ISA (UK and Ireland) 230.5 “Audit Documentation”.</p> <p>Paragraph 6 states that the objective of an auditor is to prepare “audit documentation” but the objective in the exposure draft of proposed ISA (UK&I) 230 just refers to “documentation”.</p> <p>As a general comment we recommend that where text is quoted from the ISAs it should be extracted without change from the ISAs otherwise it could introduce unintended differences in meaning.</p>
Page 7, para 10	The last sentence in paragraph 10 states that “Documentation prepared at the time when the audit work is performed is likely to provide a more accurate record than documentation prepared after such work has been performed and this is also likely to be a more efficient approach.” This reverses the order in the last sentence of paragraph A1 in the proposed clarified ISA which states that “Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed” and as a result puts more emphasis on documentation being prepared “at the time when the audit work is performed” rather than on a “timely basis” which is the requirement in paragraph 7 of the proposed clarified ISA.
Page 8, para 11	The last bullet of the list refers to audit documentation serving the additional purpose of “being able to demonstrate the adequacy of the work performed in any complaint situation”. This is a new bullet that was not included in the list of additional purposes in paragraph 3 of the proposed clarified ISA. Although audit documentation may prove useful in demonstrating the adequacy of work performed in a complaints situation we do not consider that this should be given such prominence and we recommend that this final bullet is deleted from paragraph 11 so that the bulleted list is consistent with the list shown in paragraph 3 of the ISA.
Page 9, para 17	There is an inconsistency between paragraph 17 which says that audit documentation “ <u>is likely to be simple in form and relatively brief</u> ” and paragraph 19 which says that it “ <u>may be simple in form and relatively brief</u> ” [bold added]. We recommend that the wording in paragraph 17 of the draft PN be amended to “may” because this is consistent with paragraph A132 of the proposed clarified ISA.



Reference	Comment
	In addition, where in paragraph 17 the proposed PN refers to ISA (UK and Ireland) 315 it would more helpful if in this and other cases the paragraph number was used for example ISA (UK and Ireland) 315.A132.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

Hugh Morgan
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