Draft IDW Auditing Standard for Less Complex Entities: Engagement Acceptance and Preparatory Activities for a Financial Statement Audit (IDW AuSLCE 3)

IDW AuSLCE 3

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Within the context of the audit of financial statements of small and medium-sized entities (SMEs) as a model, the Hauptfachausschuss (HFA) [Auditing and Assurance Board] issued the following draft IDW Auditing Standard for Less Complex Entities: Engagement Acceptance and Preparatory Activities for a Financial Statement Audit.

1 Preconditions for an Audit

1 The engagement partner shall determine that the firm's policies or procedures for the continuance of client relationships and audit engagements have been followed, and that conclusions reached in this regard are appropriate.

2 The engagement partner shall take into account information obtained in the continuance process in planning and performing the audit engagement in accordance with the IDW AuSLCEs and complying with the requirements of the IDW AuSLCEs.

3 If the engagement team becomes aware of information that may have caused the firm to decline the audit engagement had that information been known by the firm prior to continuing the client relationship or specific engagement, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

4 The auditor shall include in the audit documentation matters identified, relevant discussions with personnel, and conclusions reached with respect to the continuance of the client relationship and audit engagement.

5 In order to establish whether the preconditions for an audit are present, the auditor shall obtain the agreement of management that it acknowledges and understands its responsibility:

(a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

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(b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide the auditor with:
   (i) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
   (ii) Additional information that the auditor may request from management for the purpose of the audit; and
   (iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

6 If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement.

7 If the preconditions for an audit are not present, the auditor shall discuss the matter with management. The auditor shall not accept the proposed audit engagement, if the agreement referred to in paragraph 5 has not been obtained.

2 Terms of Audit Engagements

8 The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

9 The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(a) The objective and scope of the audit of the financial statements, including that the audit in accordance with IDW AuSLCE is premised on the entity meeting the criteria for an LCE. If the entity does not meet the criteria for an LCE[2], the audit shall be performed in accordance with ISAs;
(b) The responsibilities of the auditor;
(c) The responsibilities of management;
(d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
(e) Reference to the expected form and content of any reports to be issued by the auditor; and
(f) A statement that there may be circumstances in which a report may differ from its expected form and content.

10 The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.

11 If the terms of the audit engagement are changed, the auditor and management and -if relevant those charged with governance - shall agree and record the new terms of the engagement in an engagement letter or other suitable form of written agreement. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

[2] See IDW Auditing Standard for Less Complex Entities: Scope and Preface (IDW AuSLCE 1).

12 If the terms of the audit engagement are changed, the auditor and management shall agree an and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

13 If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation; and
(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

14 On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

3 Planning an Audit of Financial Statements

15 The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members.

16 The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

17 In establishing the overall audit strategy, the auditor shall:

(a) Identify the characteristics of the engagement that define its scope;
(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

18 The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under IDW AuSLCE 4[3].
(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under IDW AuSLCE 5[4].
(c) Other planned audit procedures that are required to be carried out so that the engagement complies with IDW AuSLCEs.

19 The engagement partner shall determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the audit engagement, the firm’s policies or procedures, and any changes that may arise during the engagement.

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[3] See IDW Auditing Standard for Less Complex Entities: Identification and Assessment of Risks of Material Misstatement (IDW AuSLCE 4).
[4] See IDW Auditing Standard for Less Complex Entities: Responses to Assessed Risks (IDW AuSLCE 5)

20 The engagement partner shall determine that members of the engagement team have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement.

21 If, as a result of complying with the requirements in paragraphs 19 and 20, the engagement partner determines that resources assigned or made available are insufficient or inappropriate in the circumstances of the audit engagement, the engagement partner shall take appropriate action, including communicating with appropriate individuals about the need to assign or make available additional or alternative resources to the engagement.

22 The engagement partner shall take responsibility for using the resources assigned or made available to the engagement team appropriately, given the nature and circumstances of the audit engagement.

23 The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

24 The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

25 The auditor shall include in the audit documentation:

(a) The overall audit strategy;
(b) The audit plan; and
(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

4 Determining Materiality

26 When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- *Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;*
- *Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and*
- *Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.*

Such a discussion, if present in the applicable financial framework, provides a frame of references to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to above provide the auditor with such a frame of reference.

The auditor’s determination of materiality is a matter of professional judgement, and is affected by the auditor’s perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study information in the financial statements with reasonable diligence;

(b) *Understand that financial statements are prepared, presented and audited to levels of materiality;*
(c) *Recognize the uncertainties inherent in the measurement of amounts based on use of estimates, judgement and the consideration of future events; and*
(d) *Make reasonable economic decisions on the basis of the information in the financial statements.*

27 If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

28 The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

29 The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

30 If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

31 The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole (see paragraph 26);
(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 26);
(c) Performance materiality (see paragraph 27); and
(d) Any revision of (a)-(c) as the audit progressed.

5 Communication with Those Charged with Governance

32 The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

33 If the auditor communicates with some of those charged with governance, for example an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body.

34 The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion an the financial statements that have been prepared by management with the oversight of those charged with governance; and
(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

35 The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

36 The auditor shall communicate with those charged with governance the form, timing and expected general content of communications.