

Audit vs. independent review

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ABSTRACT

One of the provisions in the Companies Act of 2008 which is particularly significant to the auditing profession in South Africa is the introduction of the "independent review of financial statements of certain non-public interest companies" as an alternative to the conventional audit of financial statements which is required for public and public interest companies. However, no regulations have yet been provided regarding the manner, form and procedures for the conduct of an independent review, nor have the professional qualifications of persons who may conduct such reviews yet been defined. This study is a background study and analysis in order to provide a better understanding of this alternative to an audit of a company's annual financial statements. The outcome of the research could be instrumental in the development of relevant regulations for the independent review of company financial statements in South Africa.

Key words

Independent review; Companies Act No 71 of 2008; ISRE2400; assurance engagement; moderate assurance; limited assurance; inquiry, analytical procedures; professional judgement; negative opinion

The review engagement is an "under-utilised tool in the Chartered Accountant's tool box" although "it is an excellent, cost-effective means of providing assurance on financial statements..."
(Fischer 1998)

1 INTRODUCTION

A company's financial statements are the basic tools for monitoring the activities of the company's managers. Historically, annual financial statements are produced by the directors (as managers), and presented to the shareholders (as owners) as evidence of having fulfilled the terms of their employment. However, today a wider range of parties (stakeholders) are interested in the annual financial statements, and independent assurance as to the veracity of annual financial statements is needed by many different stakeholders for many different reasons. For example, shareholders want assurance that their investment remains viable; companies need credibility to attract funds; funding bodies want assurance of a company's "going concern" status before granting funding, and competitors and people interested in takeovers want information showing the effective performance of the company, amongst others. This independent assurance is usually provided by an audit of the company's annual financial statements (Millichamp & Taylor 2008:2-3). However, an audit is only one type of assurance engagement. A review may well be a more appropriate assurance engagement than an audit, depending upon the specific needs of the stakeholders.

Up to now, all companies in South Africa, both public and private, have had a statutory obligation to appoint an auditor at every annual general meeting and have the annual financial statements audited annually (South Africa 1973:sect 270&300). After the auditor has performed the audit function, he must then report to the directors and the annual general meeting on whether or not the annual financial statements fairly present the financial position of the company and the results of its operations (South Africa 1973:sect 301). The Companies Act also states that only persons who qualify in terms of the Auditing Profession Act 2005, can be appointed as auditors (South Africa 1973:sect 275).

In 2004 the Department of Trade and Industry in South Africa (DTI) published a policy paper, *Company law for the 21st century*. The paper promised a comprehensive review of company law. It proposed that company law should promote the competitiveness and development of the South African economy, and that the focus should therefore be on simplification, flexibility, corporate efficiency and transparency, overseen by predictable regulations (DTI 2007).

In line with this policy paper the DTI embarked on a process to completely reform the Companies Act 1973, which was already more than 30 years old. The

result was the signing into law of the Companies Act 2008 on 8 April 2009, with an expected commencement date of 1 July 2010 (South African Institute of Chartered Accountants (SAICA) 2009/04/15). The new Act is a significant departure from the existing statute and completely reforms the Companies Act 1973 in line with international trends. The aim of the redrafting of the Companies Act was to modernise the legislation, to align it with international best practice and to promote entrepreneurship and enterprise development. It attempts to achieve this by reducing the costs of registering and maintaining a company and by reducing the regulatory burden on smaller companies (SAICA 2007/04/02).

One of the new provisions which is of particular significance to the auditing profession in South Africa is the introduction of the independent review of financial statements of certain non-public interest companies as an alternative to the more familiar audit of financial statements which is required for public and public interest companies (South Africa 2008:sect 30(2)). (Audits are performed in terms of the International Standards on Auditing (ISAs) and review engagements in terms of the International Standard on Review Engagements (ISRE) 2400.)

2 PURPOSE OF AND NEED FOR THIS STUDY

The comprehensive review of company law in South Africa took place in two phases. Phase 1 only addressed certain urgent matters. The result was the publication of the Corporate Laws Amendment Act 2006 which introduced a number of amendments to the Companies Act 1973 and the Close Corporations Act 1984 (SAICA 2007/04/26). The second phase entailed a complete review of the Companies Act. The Companies Bill 2007 was issued by the DTI on 13 February 2007 for public comment (Gloeck 2007 & SAICA 2007/02/27). Then the DTI conducted meetings, workshops, discussions and conferences across the country in order to receive comments from the public. These oral submissions together with 134 written submissions from stakeholders, interest groups, government departments and agencies and individuals were taken into account in preparing the Companies Bill 2008, which was published on 27 June 2008. Thereafter it was further enriched by the public hearings conducted by the Portfolio Committee in August 2008 (DTI 2008 & SAICA 2008/07/01). The DTI then tabled the Companies Bill 2008 on 15 October 2008 for ratification and adoption (South African Government Information 2008). The Companies Act 2008 was finally signed on 8 April 2009 with an expected commencement date of 1 July 2010 (SAICA 2009/04/15).

From the above it is clear that the Companies Act 2008 is the culmination of a robust process that involved extensive consultation, as well as intense debate and discussion amongst various stakeholders over a five year period, with the aim of overhauling the current regulatory framework for companies, as enshrined in the Companies Act 1973.

The Companies Act 2008 requires that companies other than public companies only need to be audited

if it is desirable in the public interest (as indicated by its annual turnover, the size of its workforce or the nature and extent of its activities). Otherwise those companies can either be audited voluntarily or independently reviewed. (If it is a private company and securities issued by the company are held by one person, or every person who holds or has a beneficial interest in the securities issued by the company is also a director of the company, it is exempt from statutory audit.) (South Africa 2008:sect 30(2)). However the Companies Act 2008 (South Africa 2008:sect 30(7)) provides for regulations to be made by the Minister regarding:

- The categories of private companies that are required to have their annual financial statements audited (where it is in the public interest, as indicated by its annual turnover, the size of its workforce or the nature and extent of its activities);
- The manner, form and procedures for the conduct of an independent review other than an audit;
- The professional qualifications of persons who may conduct such reviews.

Against that background, this article will by means of a literature review, investigate international rules, regulations and laws regarding the independent review of the financial statements of a company in order to provide a better understanding of this alternative to an audit of a company's annual financial statements. More specifically the purpose of this study is firstly to research and determine what an independent review is, highlighting its differences from an audit. Its second purpose is to investigate the international demand for independent reviews, particularly because less assurance is provided than in an audit. Then the manner, form and procedures for independent reviews are examined, taking into account ISRE 2400, and the responses received to the Consultation Paper dealing with Review Engagements, issued by the National Standard Setters (NSS) Task Group in March 2008. Lastly, professional qualifications for practitioners to perform independent reviews are researched.

3 WHAT IS AN INDEPENDENT REVIEW?

According to the International Framework for Assurance Engagements the objective of any assurance engagement, be it an audit or a review, is to enhance the degree of confidence users of financial statements have in the statements (International Auditing and Assurance Standards Board (IAASB) 2005a par 7). In contrast to the objective of an audit of financial statements, which is to enable the auditor to express an opinion as to whether the financial statements have been prepared, in all material respects, in accordance with an applicable financial reporting framework (IAASB 2005c par 2), the objective of a review of financial statements is to enable a practitioner to reach a conclusion as to whether, on the basis of the performance of procedures which do not provide all the evidence that would be required in performing an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements have not been prepared, in

all material respects, in accordance with an applicable financial reporting framework (IAASB 2006b par 3). In other words, the practitioner is required to give negative assurance.

In contrast to audits, where a *reasonable level* of assurance that the information subject to audit is free of material misstatement is provided, a review engagement provides a *moderate level* of assurance that the information subject to review is free of material misstatement (IAASB 2005c par 17 & IAASB 2006b par 9). A review is an alternative assurance service situated in-between an audit and a compilation engagement. Moderate assurance is situated in-between reasonable assurance (derived from a higher investigative intensity audit), and no assurance, provided by a compilation engagement. Thus, from the auditor's point of view, the acceptable level of engagement risk for a review is higher than that of an audit, and the nature, timing and extent of procedures implemented to obtain evidence is limited relative to an audit. According to the International Federation of Accountants (IFAC) (2008) the main objective of a review is to provide assurance at a lower cost.

According to a study by the IAASB in 2002, conducted amongst more than fifty firms from around the world, the level of assurance in the case of an audit was found to be between 55% and 98%, while in the case of a review it was between 10% and 88% (IAASB 2002). These are similar to the results of a survey conducted in 1993 in Canada where the level of assurance in the case of an audit was between 60% and 100% and in the case of a review it was between 0% and 90% (NSS Task Group 2008:10). These results indicate that practitioners are not sure about the level of assurance they are providing, most dramatically in the case of a review, which can result in significant differences in the procedures they perform. The Independent Regulatory Board for Auditors (IRBA) (2008:3) is also of the opinion that the concept of a moderate level of assurance is not well understood by either practitioners or users of a review engagement report. IFAC (2008) confirms that there is confusion amongst practitioners as well as users with respect to the scope and nature of reviews.

Besides the fact that the level of assurance which a practitioner is giving is based on his professional judgement, an obvious reason for the apparent uncertainty about the required level of assurance in the case of reviews might be that the term *moderate assurance* is undefined. ISRE 2400 does not give a definition of the term. Additionally, the Glossary of Terms and the International Framework for Assurance Engagements (IAASB 2005a par 11&48 & IAASB 2006a), as well as International Standard on Assurance Engagements (ISAE) 3000 (IAASB 2005b par 2), use the term *limited assurance* and not *moderate assurance*. The Auditing and Assurance Standards Board in Canada (AASB Canada) (2008:2) also confirms that the lack of a clear definition is the reason that there is such a wide range of views.

If practitioners do not have a clear understanding of the concept of *moderate assurance* they will not be

able to explain the nature and purpose of their reviews to companies wanting their financial statements to be reviewed. The lack of a clear definition of what a moderate level of assurance means will also create an expectation gap between what users expect from a review and what practitioners can realistically deliver when performing a review (AASB Canada 2008:1).

The IAASB has listed the revision of ISRE 2400 as one of the items in its Strategy and Work Program, 2009-2011. Arising from a discussion at the IAASB's annual liaison meeting with major National Standards Setters (NSS), in March 2008 a Task Group was formed to prepare an international consultation paper the responses to which will form the basis for the proposal to the IAASB to revise ISRE 2400. The NSS Task Group comprises New Zealand, Canada and South Africa (NSS Task Group 2008:2). This NSS Task Group issued the Consultation Paper in 2008 with the aim to get feedback on a number of significant matters pertinent to the IAASB's planned revision of ISRE 2400 (Fischer 2008:29 & NSS Task Group 2008). Responses were received from nine NSS, namely: AASB Canada, Institut des Reviseurs d'Entreprises (IRE) (Luxembourg), Institute of Chartered Accountants in England and Wales (ICAEW), Association IEC (International), Auditing Practices Board in the United Kingdom (APB UK), IFAC, IRBA, Fédération des Experts Comptables Européens (FEE) and Compagnie Nationale des Commissaires aux Comptes (CNCC) and Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) (France).

From the responses to the Consultation Paper it appears that the use of the terms *moderate* and *limited assurance* varies from one jurisdiction to another. Some respondents prefer the term *limited assurance* (Association IEC 2008, ICAEW 2008:6, IFAC 2008, IRBA 2008:3 & IRE 2008:2) and in Denmark the recent revision of the translation of ISRE 2400 has incorporated this change (Association IEC 2008). IFAC (2008) is of the opinion that the use of the term *moderate assurance* is likely to create an expectation gap. However the term *moderate assurance* is used and preferred in France (CNCC & CSOEC 2008:2). According to the AASB Canada (2008:1) the term *limited assurance* is too vague. They favour the term *review level assurance*. The diversity of responses to the Consultation Paper emphasises the necessity to streamline and standardise the terminology.

It is clear that the terms, *moderate* and *limited assurance*, should be clarified. There should also be proper guidance on review engagements in the form of a review standard where the level of assurance should be defined. In order to distinguish an audit from a review the level of assurance in a review should be defined as an independent concept without comparing it to an audit level of assurance. Communication between the practitioner and the client is also critical in order to establish an understanding of the level of assurance being provided. Finally, the level of assurance should be set out clearly in an engagement letter, as well as in the review report.

4 DEMAND FOR INDEPENDENT REVIEWS

In South Africa, up to now, the audit has been a statutory requirement for all companies. However, the Companies Act 2008 has introduced exemptions from the audit for entities that would otherwise be required to have an audit (for example, based on the type of entity, its size, or other public interest consideration it might or might not be compelled to undergo audit) (South Africa 2008:sect 30(2)(b)). The same has happened in other countries, such as the UK, Australia and New Zealand, where legislative changes have removed the (statutory) audit requirement for certain types of entities (IAASB 2008:8 & NSS Task Group 2008:5).

Despite the exemption from being audited, experience in other countries shows that many companies continue to have their financial statements audited (Hickey 2007). According to Grant (2006) smaller companies may still need to undertake audits to satisfy banks and other creditors that they are still viable businesses and to secure investment money. According to a study by the UK's DTI in 2003 the factors which influenced the directors' decisions whether to have their financial statements audited or not, were (Collis 2003:8):

- The size of the company in terms of turnover
- The positive impact of the audit report on the company's credit rating
- The bank and other finance providers' need for a copy of the audited financial statements

On the other hand the main reason why directors of private companies would decide to take up the audit exemption was to save on audit fees (Collis 2003:8). Smaller clients appear to regard the audit as an administrative burden (FEE 2008:2). But in spite of there being no statutory requirement for these entities to have any form of third party assurance report on their financial statements, they often request their professional accountants to conduct a review or a compilation engagement (IAASB 2008:8). A study by the APB UK (2001:iv) confirmed that the independent review could, in some circumstances, give rise to significant cost savings when compared to an audit.

However, internationally the development of the review as an alternative to the audit shows great variety (NSS Task Group 2008:6). In some countries reviews have gained wide acceptance (NSS Task Group 2008:5&11). For example in the United States and Canada the independent review has a high degree of acceptance among user groups. In Canada reviews are common with many practitioners specialising in performing reviews exclusively (AASB Canada 2008:9).

Until now, reviews have not been widely used in many European jurisdictions because their regulatory structures have not required it, there are low statutory audit exemption thresholds, and because of perceptions that it is not relevant to their circumstances. The increases in the audit exemption thresholds in various European Union Member States in 2007 and 2008, with more expected in the future,

will result in fewer smaller entities being subject to a statutory audit, and this is likely to increase the demand for alternative assurance services, pitched somewhere between an audit and a compilation (FEE 2008:2&4).

In France the perception is that the demand for assurance engagements will remain at current levels. However, the statutory audit exemption thresholds for certain entities are increasing (CNCC & CSOEC 2008:2), so the demand for reviews might well increase.

In some countries only interim financial information of listed entities is subject to review (NSS Task Group 2008:6). In Australia reviews have largely been limited to interim financial statements, and are performed by the auditors of the entity. They are currently exploring the use of reviews in other contexts (Fischer 2008:29).

In the UK review engagements are not that common. However many small charities are subject to independent examinations which are similar to reviews (APB UK 2008). The Public Oversight Board for Accountancy in the UK issued a report in March 2006 in which it was reported that they had identified no interest among users for a new level of assurance opinion, and that such a form of assurance would only lead to confusion (NSS Task Group 2008:6). However, as part of a recent review of UK company law the government did consider requiring reviews to be performed for certain smaller companies, and the ICAEW developed interim guidance to support review engagements (APB UK 2008).

According to IRE (2008:1-2) an engagement which is neither an audit (reasonable assurance expressed) nor a related service (no assurance expressed) is not frequently used in practice, with the exception of a review executed by the auditor of the entity. According to them reviews will not be useful to the marketplace.

Some countries are currently considering an assurance service for Small and Medium Enterprises that would be an acceptable alternative to an audit. However, the IAASB's strategy review consultations did not suggest that it would be necessary to develop a completely new assurance service for this purpose. The IAASB's current thinking is that the revision of ISRE 2400 and International Standard on Related Services (ISRS) 4410, *Engagements to Compile Financial Statements*, should provide standards for services that provide acceptable alternatives to an audit (IAASB 2008:8). FEE (2008:1) stated that a review is necessary to fill the gap between the performance of an audit, which may be perceived as too costly for smaller entities not subject to a statutory audit, and the performance of a compilation engagement, which provides no assurance on the financial statements. IFAC stresses the fact that reviews should be very clearly distinguishable from audits, as well as being cost-effective, in order for them to be taken up by markets (IFAC 2008).

Although the demand for reviews as an alternative to audits varies considerably internationally, the demand

is likely to increase as the statutory thresholds for audit exemption are increasing. It seems that companies want some form of assurance on their financial statements but they also want to save on costs. Review engagements can fill this gap. When the (South African) Minister of Trade and Industry sets these thresholds his main considerations should therefore be exactly that: affordable assurance for small companies. A balance must be struck between the costs and the benefits for the interested parties.

5 PROCEDURES FOR INDEPENDENT REVIEWS

5.1 Approach

Engagement risk pervades all assurance engagements. A review of financial statements is an assurance engagement and the objective of an assurance engagement from the point of view of the practitioner is to reduce assurance engagement risk to an acceptably low level. The level of assurance engagement risk that is deemed "acceptable" to the practitioner is determined with reference to the level of assurance the practitioner can obtain from his tests and reviews of business and accounting processes. The level of assurance is therefore directly linked to the amount of money the client is prepared to pay for the time the auditor spends on the task. This is then the basis for expressing the conclusion for the engagement (IAASB 2005a par 48). An *audit* is a reasonable assurance engagement: therefore, reducing audit risk to an acceptable level involves obtaining an understanding of the business; performing a detailed and documented risk assessment, including an assessment of internal control; the testing of internal control, and obtaining audit evidence during substantive procedures, before a positive conclusion is expressed in the report (FEE 2008:6, IFAC 2008:4 & IRE 2008:3-4).

A *review* is a limited assurance engagement: therefore, the acceptable level of engagement risk is higher than in an audit; the nature, timing and extent of evidence-gathering procedures is limited when compared to an audit, and this limited basis from which to draw a conclusion is indicated by the expression of a negative review conclusion in the report (IAASB 2005a par 11).

According to IRBA (2008:3) the experience of practitioners in South Africa indicates that, on a scale of 1-10, the perceived level of assurance derived by users of an audit is between 8 and 9, while the level derived from a review performed by a practitioner who is not the auditor is between 3 and 4. It would thus appear that the level of assurance derived by users is dependent on the extent (in terms of depth and number) of procedures performed, and on the practitioner's assumed knowledge of the business. Also critical is the level of preparation of the financial statements – especially where prepared by owners who have limited if any knowledge of the Financial Reporting Standards and where underlying records may be inadequate.

According to ISRE 2400 there is no need, in the case of a review, to assess the risk that the financial

statements may be materially misstated. It is sufficient that a review be based on the performance of limited review procedures. This can create the perception that a review is merely a procedural approach as it does not require an explicit assessment of the risk of material misstatements. In contrast, IFAC (2008:5) is of the opinion that ISRE 2400 is not a procedural standard. However, ISRE 2400 does not clearly distinguish whether this is a procedural standard or a risk standard.

Between the many European jurisdictions the approaches to reviews and the scope and extent of review procedures varies considerably (FEE 2008:4). Some jurisdictions are in favour of a risk-based approach (CNCC & CSOEC 2008:4, FEE 2008:6, ICAEW 2008:9, IFAC 2008:5, IRBA 2008:6 & IRE 2008:4) while some are in favour of a procedure-based approach (APB UK 2008, Association IEC 2008 & FEE 2008:4).

Risk-based approach

In any assurance engagement the risk of material misstatement should be considered (IAASB 2005a par 48). The risk-based approach is therefore in accordance with the International Framework for Assurance Engagements. According to IRBA (2008:6) a practitioner should address engagement risk by assessing the risks of material misstatement occurring in the financial statements, and by designing procedures to respond to the assessed risks. Thus the practitioner performing a review of financial statements must make an assessment of engagement risk in order to determine whether that engagement risk has been reduced to an acceptable level, appropriate for the engagement, by performing review procedures that take into account that a review engagement provides assurance at a lower cost than an audit and that limited assurance should be achievable (ICAEW 2008:9).

In an audit, although an assessment of risk of misstatement is an integral part of the audit process, an explicit assessment of risk of misstatement is required, while in a review no explicit assessment of risk of misstatement is required it takes place throughout the review (ICAEW 2008:9). In a review a consideration of risk comprises gaining knowledge of the entity, including its internal control, and the development of expectations about risks of material misstatement through inquiry and analytical procedures, rather than as a separate exercise (ICAEW 2008:9, IFAC 2008:4 & IRE 2008:4). A consideration of risk is thus an integral part of the inquiry and analytical procedures (FEE 2008:6 & IFAC 2008:5) and therefore drives review procedures. The consideration of risk as part of the inquiry and analytical procedures is essential as these components of the review cannot be performed adequately without an appropriate understanding of the entity, including consideration of the risk of material misstatement of the financial statements. Without such an understanding it would be impossible for reviewers to know what to inquire about, nor to make rational predictions that are an integral part of analytical procedures. In a review, reducing risk to an

acceptable level takes place when the practitioner obtains an understanding of the business, which involves consideration of the risk of material misstatement of the financial statements (FEE 2008:6 & IRE 2008:4).

In summary IFAC (2008) states that risk should be considered in the context of inquiry and analytical procedures, analysis of the procedures performed, determination of whether the data supports the conclusions reached and in reporting. CNCC & CSOEC (2008:4) are of the opinion that the practitioner should merely adapt the risk assessment procedures that are usually implemented in an audit engagement. The benefit of adopting a risk-based approach would be that it delivers a tailored procedural approach which would be more relevant to the engagement, as it has been developed in response to recognised risks (IFAC 2008:5). The risk-based approach would have an effect on the nature, timing and extent of the procedures and could have a positive impact on the cost of the engagement (IRBA 2008:6).

Canadian standards do not require a risk-based approach but according to the AASB Canada (2008:4) many practitioners do follow such an approach. They believe a risk-based approach is an effective and efficient approach as the nature of the procedures performed would largely be the same in both approaches. However, the procedures in a risk-based approach would be appropriately more responsive when addressing areas of higher risk. According to the AASB, the cost of a risk-based review should not significantly differ from that of a procedure-based review. The emphasis, using a risk-based approach, would be on high risk areas, but the nature and extent of the procedures would effectively be the same as in a procedural approach.

Procedure-based approach

The APB UK (2008) questions the applicability of a risk-based approach for reviews. They believe that the standards need to be specific about the nature and extent of the procedures that need to be performed in order to give a moderate level of assurance. The more judgemental the standards, the more difficult it will be for practitioners to know what work needs to be performed and the more difficult it will be to distinguish an audit from a review. The nature and extent of procedures should not be flexed to respond to risk assessments. According to the APB UK the advantages of a procedural approach are that it will help practitioners, entities and users understand moderate assurance and to distinguish a review from an audit.

FEE (2008:4) is of the opinion that a review is a procedure-based engagement reliant on professional judgement. Association IEC (2008) states that a practitioner will often have some knowledge of the entity being reviewed and will often perform more work in areas at risk of significant errors, but warns that conducting a general risk assessment when doing a review, requires a greater knowledge of the entity and its internal controls on the part of the

practitioner, which will involve more work and increase costs. IRBA (2008:5) also warns that the risk-based approach increases the risk that the work effort required may be extended beyond analytical reviews and inquiries and will align it more with an audit engagement. This would defeat the purpose of a review which is to reduce the extent of work effort so that costs are commensurate with the lower level of assurance required and provided. If the need for assessing risk of material misstatement is given undue prominence in the standard, the level of work may increase and the review would start to resemble an audit. This would have cost implications and possibly lead to users taking more comfort from a review than intended (ICAEW 2008:9).

From the above it appears that there is controversy among practitioners about whether a risk-based or a procedure-based approach should be followed when performing a review. The NSS Task Group (2008:14) confirms that in jurisdictions where reviews have been performed for many years, there is a longstanding controversy among practitioners about whether or not reviews should be risk-based. Practitioners in favour of a procedure-based approach feel that the risk-based approach would require greater work effort and would therefore increase costs. Those in favour of a risk-based approach believe that it can be followed without an escalation of costs, and that the quality of reviews will be increased.

For reviews to be distinguishable from audits and to be cost-effective, the distinction between engagement risk in an audit and in a review needs to be clear, otherwise expectation gaps will be created. There should be a clearly defined standard for the treatment of engagement risk in a review. Unless practitioners are consistent in their approach to the procedures to be performed in a review, the extent of work performed is likely to vary substantially from one practitioner to another, resulting in different levels of assurance and disparate costs reflecting the diversity of the work performed.

5.2 Inquiry and analytical procedures

In planning the review, the practitioner should obtain an adequate knowledge and understanding of the client's business. Association IEC (2008) is of opinion that it is sufficient that this knowledge is obtained through inquiries and analysis because of the limited assurance provided. If the practitioner does not have enough knowledge of the business there is a risk that the results of the analytical procedures may not be interpreted correctly (IRBA 2008:8).

According to ISRE 2400 (IAASB 2006b par 14&7) the primary procedures during a review are inquiry and analysis only, so that the costs of performing a review do not outweigh the benefits (IRBA 2008:7). Inquiry, analysis and discussion should be used in combination so that an appropriate level of corroborative evidence will be obtained. However, the evidence collected by conducting inquiries and analytical procedures is not "strong" and might not reduce the risk of there being significant errors in the financial statements. Inquiry and analysis are

considered a “weak” or less reliable class of evidence, or “circumstantial evidence”, as Association IEC (2008) says, in that they do not cause one to believe that the financial statements give a true and fair view of the client’s business. However, this may be deemed sufficient since a high level of assurance is not being sought nor given.

During a review inquiries are more focused than in an audit. In contrast to an audit, where the auditor will corroborate responses to inquiry, in a review the fact that inquiry has been made is sufficiently important (FEE 2008:8 & IRE 2008:5). Inquiries are used to determine the reasonableness of the analytical procedures performed. The focus would be on detecting material errors based on the analytical reviews performed (IRBA 2008:7).

According to a study conducted by the APB UK (2001:28) performing inquiries, however, proved to be an ineffective approach for the smallest of companies, as many of the clients could not answer the practitioner’s questions. According to the same study (APB UK 2001:23-24), practitioners also encountered difficulties in performing analytical procedures on the smaller clients, where detailed accounting information is not maintained, industry data is not available and budgetary information is sparse. Practitioners also found it difficult to obtain explanations from the management and staff of companies for trends or operational variations.

According to ICAEW (2008:11) the use of inquiry and analytical procedures in a review and in an audit should be the same, but the level of reliance placed on inquiry and analytical procedures as primary evidence is likely to be higher in a review than in an audit. In a review reliance can be placed on the results of inquiry to express negative assurance and the extent of corroboration may not be as comprehensive as is found in an audit.

Some of the respondents to the Consultation Paper (CNCC & CSOEC 2008:3 & IRE 2008:5) asked for further guidance than what is at present in ISRE 2400 regarding the procedures to be performed by practitioners. There should be specific guidance where the practitioner receives a negative response to inquiries, as to whether he should extend his procedures or simply modify the review report (IRBA 2008:8). According to Association IEC (2008) it is not clear what additional actions need to be considered and they requested that the standard be revised to clarify this. Most of the respondents to the Consultation Paper agree that the procedures contained in Appendix 2 of ISRE 2400 should be used as a guide or as application material, and not be treated as mandatory procedures (Association IEC 2008, CNCC & CSOEC 2008:4, FEE 2008:5, IFAC 2008 & IRE 2008:3). According to the APB UK (2008) the status of the appendix is unclear. In their own standards they were more specific on the procedures to be performed. Despite this, feedback from a study they performed suggested that further specification was required and that practitioners needed more guidance.

FEE (2008:8) and IRE (2008:5) warned that the users of the review report should understand that the practitioner needs only be superficially satisfied with the responses (“on the basis of probability” correct, rather than correct “beyond reasonable doubt”). Furthermore, a description of the practitioner’s responsibilities and the procedures performed is essential to an understanding of the level of assurance presented by a review (IRE 2008:3). In the engagement letter the respective responsibilities of practitioner and client should be described in order to avoid any misunderstandings. As Reimer (2008:24) reiterates, an engagement letter is a critical element in avoiding expectation gap problems and possible claims for damages.

In summary, there should be clear guidelines on the procedures that need to be performed. Without these there is the risk that either very little work will be performed (and the value of the opinion will be very low), or the level of work performed will be similar to that of an audit (with associated high costs), while the opinion provided by the review will still provide much lower assurance than that of an audit.

5.3 Reporting

The three-party relationship is not as obvious in a review as it is in the case of an audit engagement (ICAEW 2008:7). In contrast to the audit report, whose users are defined by statute, the needs of the users of a review report are far more diverse. In order to address this diversity, the work performed by the practitioner should be adequately disclosed in the review report, thus enabling the users to evaluate whether the limited assurance provided is appropriate for their needs (IRBA 2008:3). The APB UK (2008) also emphasised that the characteristics of a review and its distinction from an audit should be communicated to users as part of the review report. The report should also describe the scope of the engagement so that it is clear that an audit has not been performed, that the procedures undertaken provide less assurance than those that form part of an audit, and that therefore an audit opinion has not been expressed (IAASB 2006b par 25-26).

In contrast to an audit, where a positive opinion is expressed, a review report expresses a negative opinion (IAASB 2006b par 23). In some European jurisdictions the negative form of conclusion is widely used and accepted while in others such reporting is poorly understood (FEE 2008:3). The IAASB (2002) also raised concerns as to whether the negative form of assurance contained in the review report is the best way to communicate the level of assurance that has been derived from the engagement. Some respondents to the Consultation Paper (CNCC & CSOEC 2008:8, ICAEW 2008:14 & IRBA 2008:10) were of the opinion that the negative form of expressing a conclusion is appropriate because this limited assurance is in clear contrast with the reasonable (positive) assurance provided by an audit. According to ICAEW (2008:6&14) users appear to be reasonably familiar with negative conclusions and stakeholders do not appear to have difficulties in understanding the negative form of assurance.

Although IRBA (2008:10) favours a flexible format for the review report, most respondents to the Consultation Paper were not in favour of a flexible report as they believed it would make it more complex (AASB Canada 2008:9, CNCC & CSOEC 2008:8, ICAEW 2008:14 & IFAC 2008). It would also reduce the consistency of review reports, thus potentially misleading and confusing the market with respect to the extent of work performed and the extent of comfort given by this form of work (AASB Canada 2008:9 & ICAEW 2008:14). IFAC (2008) confirms that flexible reports would lead to further inconsistencies in practice and more confusion in the marketplace. Where additional work is undertaken by the practitioner, the use of optional wording within a flexible report is potentially ambiguous: some users may consider that additional work indicates that there were concerns about the financial statements, while others may consider that the risk of material misstatement is reduced as a result of the performance of this additional work (ICAEW 2008:15).

Thus the review report should describe the scope of the engagement so that it is clear that an audit has not been performed, that the procedures undertaken provide less assurance than those of an audit, and therefore that an audit opinion has not been expressed. There should be proper guidance on the format of the review report and the negative form of assurance expressed in the review report. Users of review reports should also be educated as to the level of assurance provided in a review report.

6 GUIDANCE ON INDEPENDENT REVIEWS

The importance of proper standards on assurance engagements is endorsed by the IAASB (2002) in their statement that the accurate determination and effective communication of levels of assurance provided in assurance engagements is a critical issue for the well-being of the profession and the future development of assurance services. Many practitioners need more guidance on the performance of reviews because this type of engagement is still new to them (ICAEW 2008:7). According to the IAASB (2008:5) successfully applying ISAs to audits of Small and Medium Enterprises remains a matter of concern, but it seems likely that revisions to the standards regarding compilation and review engagements could assist professional accountants in this market.

While ISRE 2400 provides some guidance, it appears that more is required particularly regarding the level of assurance; the treatment of engagement risk; the nature, scope and extent of the procedures to be performed by a practitioner; and the review report. It is important that the review standards make a clear distinction between a review and an audit. The ICAEW (2008:7) confirms the necessity for guidance on evidence-gathering and documentation, and for a separate section on user communication. According to IAASB (2006b) guidance as to the procedures to be performed, would be helpful when a practitioner is required to exercise his professional judgement in determining what constitutes the

provision of moderate assurance.

Association IEC (2008) however states that the ISRE standards should not lead to an over-regulation of work to be conducted by a review, as this would lead to increasing demands for documentation of the process, which tends to be costly. The ICAEW (2008:5) also warns that providing too much detail in a review standard will reduce flexibility and cost-effectiveness. ICAEW (2008:8) supports principle-based guidance because a detailed work programme does not encourage the exercise of professional judgement, which is important in performing reviews. According to a study the ICAEW performed, practitioners have also expressed concerns over prescriptive guidance and standards as these may result in the performance of procedures irrelevant to the objective of the engagement. The use of professional judgement appears to be fundamental to the review's need to be flexible and cost effective.

Most respondents to the Consultation Paper are in favour of the proposal that the standards on review engagements should stand alone (AASB Canada 2008:9, Association IEC 2008, CNCC & CSOEC 2008:6, FEE 2008:10, ICAEW 2008:15, IFAC 2008, IRBA 2008:10 & IRE 2008:7). According to the AASB Canada (2008:9), a separate set of review standards would avoid the need for practitioners who only perform reviews to refer to and understand auditing standards in order to perform a review. According to McKenney (2008) there are many firms that no longer perform audit engagements, or never did, but have an accounting practice and perform reviews. A stand-alone set of standards is likely to enhance the quality of reviews because they would be simple to refer to and would obviate the need to analyse the ISAs (AASB Canada 2008:9). A stand-alone set of standards would also clearly distinguish a review from an audit.

Proper guidance on the performance of reviews is crucial. This guidance should be in the form of a unique set of assurance standards which would establish the review as a distinct alternative to an audit of financial statements. The standards should provide guidance regarding the level of assurance; the treatment of engagement risk; the nature, scope and extent of the procedures to be performed by a practitioner; and the review report's form and content. Without this guidance the risk is that the work performed will either be insufficient to support a useful opinion, or the level and intensity of the work performed will be similar to that required by an audit, resulting in audit-size costs, but with a much lower assurance level opinion.

7 PROFESSIONAL QUALIFICATIONS FOR PRACTITIONERS PERFORMING INDEPENDENT REVIEWS

ISRE 2400 (IAASB 2006b) lists the following attributes or abilities required of practitioners performing reviews [emphasis added]:

- The review should be planned and performed with an attitude of *professional scepticism* (par 6).

- *Judgement* should be applied in determining the nature, timing and extent of review procedures (par 18).
- *Judgement* should be applied as to what is material; the same materiality considerations apply as in the case of an audit (par 19).
- Based on the work performed, an *assessment* should be made as to whether there is any evidence that the financial statements are not presented fairly and in accordance with the identified financial reporting framework (par 24).

A study by the APB UK (2001:ix) suggested that the ability to perform a review well is dependent on those undertaking the work having the *skills* and *experience* necessary to provide a deep understanding of the client's business, and the *self confidence* to challenge directors' explanations [emphasis added].

Some of the respondents to the Consultation Paper (CNCC & CSOEC 2008:5 & FEE 2008:7) were of the opinion that a practitioner should not agree to perform a review of an entity in which weaknesses in internal financial reporting controls are so pervasive that he may not be able to complete the review. A practitioner must use his *professional judgement* to determine how to deal with a situation where an entity lacks coherent and enterprise-wide internal financial reporting controls [emphasis added].

According to ICAEW (2008:11) the use of inquiry and analytical procedures in a review and in an audit should be the same but the level of reliance placed on inquiry and analytical procedures as primary evidence is likely to be higher in a review than in an audit. If the practitioner does not have enough knowledge of the business there is a risk that the results of the analytical procedures may not be interpreted correctly (IRBA 2008:8). The challenge lies in determining the level of knowledge that a practitioner needs in order to be able to perform the procedures effectively (APB UK 2008). Again it is a matter of judgement.

According to CNCC and CSOEC (2008:6) and FEE (2008:8) the emphasis on inquiry needs to be strengthened but warned that inquiry is a powerful procedure for obtaining evidence in reviews, only if it has been properly managed: i.e. performed by *experienced practitioners* who can identify the right questions to ask, analyse the answers obtained with sufficient *professional scepticism* and to *intelligently challenge* the answers obtained [emphasis added]. The APB UK (2008) also stresses the need for appropriate *competence* and *scepticism* on the part of

the practitioner making the inquiries [emphasis added]. IFAC (2008) states that the standard needs to make it clear that the decision to perform any additional procedures should be a matter of *professional judgement* [emphasis added].

Furthermore, the practitioner performing a review has to comply with the Code of Ethics for Professional Accountants issued by the IAASB (2006b par 4). The same ethical principles governing auditors apply, namely independence, integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and technical standards.

It is clear that a review can only be performed by a practitioner with appropriate knowledge, skills and experience. Furthermore, the practitioner should possess the necessary professional qualifications in support of his professional scepticism and judgement during the review engagement. When South Africa's Minister of Trade and Industry determines who can perform review engagements, the main considerations should therefore be the practitioner's possession of appropriate qualifications and current membership of an accredited professional body. FEE (2008:1) confirms the necessity that there should be a statutory requirement to prevent unqualified "accountants" from carrying out assurance engagements.

8 CONCLUSION

It is hoped that this study has provided a better insight into the use of independent reviews as an alternative to traditional audits of financial statements. This in turn should provide guidance to those involved in the development of regulations controlling the proposed independent reviews of companies' financial statements, and who should perform these reviews in South Africa. It is important to keep in mind that the market for reviews is the small entity end of the enterprise spectrum. They seek some form of assurance on their financial statements' veracity, but balk at the cost of obtaining the high level of assurance provided by an audit. The regulations should reflect a balance between assurance and marketplace needs.

A robust and well designed set of assurance standards for independent reviews will provide the necessary guidance to practitioners intending to conduct independent reviews.

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