

## Scalability and Proportionality in Standards Issued by the International Auditing and Assurance Standards Board

### Objectives of Paper

1. The objectives of the paper are to:
  - (a) Discuss the terms used to identify the approach by the International Audit and Assurance Standards Board (IAASB) when it refers to the ability of the International Standards on Auditing (ISAs) and the International Standard on Quality Control (ISQC 1) to be applied proportionately with the size and complexity of an entity and the degree of risk of material misstatement.<sup>1</sup>
  - (b) Set out a clear and concise definition of the terms “Scalability” and “Proportionality” so that there is a consistent and appropriate understanding of what is being referred to
  - (c) Set out an indicative framework for the application of “Scalability” and “Proportionality” when drafting the revisions to ISAs and ISQC 1.

### Introduction

2. The IAASB is currently working on a number of projects to revise existing standards, and may also include new standards, the requirements of which will be expected to be able to be applied appropriately in relation to the size and complexity of an entity. These projects include:
  - (a) ISA 540, *Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures*;
  - (b) ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*;
  - (c) ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Service Engagements*;
  - (d) ISA 220, *Quality Control for an Audit of Financial Statements*; and
  - (e) ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.
3. During the deliberations in connection with these and other projects, the task forces, working groups, and the Board, have identified two responses to address the application of the standards appropriately in relation to the size and complexity of the entity or the firm and the risk of material misstatement. The two responses are as follows:
  - (a) The conditional application of the requirements based on the existence of the circumstances addressed in the ISA or ISQC 1.
  - (b) The ability to calibrate the response to a requirement based on size and complexity of the entity or firm and the risk of material misstatement, where the circumstances addressed in the ISA exists.

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<sup>1</sup> Staff Questions & Answers: [Applying ISAs Proportionately with the Size and Complexity of an Entity](#)

4. While there would appear to be general agreement as to the appropriateness of the two responses in addressing both Scalability and Proportionality, there is no common understanding as to which of the terms addresses which response. Accordingly, the two terms, i.e., Scalability and Proportionality, are being used interchangeably in asserting either or both responses.
5. The alternative use of the two words, without clear meaning or common understanding, creates a challenge in maintaining consistency. Appropriate drafting of standards utilising these responses is expected to enhance understanding and application of the standards, by the auditor.
6. Small and medium practitioners (SMPs) have long been advocates of Scalability and Proportionality within the standards, in order to be responsive to the size and complexity of SME audits. The IAASB has supported the concept of Scalability and Proportionality and has integrated this thinking into the standard-setting process with “Considerations Specific to Smaller Entities” included in the extant ISAs and “Considerations for Smaller Firms” in ISQC 1. The recent projects being considered by the IAASB has, however, highlighted that Scalability and Proportionality extend beyond these considerations as both concepts are equally valid to subject matter across the spectrum of audits, from SMEs to listed entities and from small non-complex audits to very large and very complex audits, and in the application of quality control with in firms.
7. The recent exposure<sup>2</sup> draft from the Nordic Federation of Accountants’ has generated further discussion on the Scalability and Proportionality of the standards issued by the IAASB. The IAASB, in considering the exposure draft, noted that there was merit in the continued exploration of how this can be enhanced, in a responsive way, within the existing framework.
8. Scalability and Proportionality has also been discussed by other stakeholders such as the IAASB’s Consultative Advisory Group (CAG) at its September 2016 meeting<sup>3</sup>.

#### **Matter for IAASB Consideration**

1. The IAASB is asked for its views on the responses identified in paragraphs 3(a) and (b).

#### **Applying the ISAs and ISQC 1**

9. Scalability or Proportionality are not and cannot be a substitute for having a full knowledge and understanding of the ISAs and ISQC 1.

“The auditor shall have an understanding of the entire text of an ISA, including its application material, to understand its objectives and to apply its requirements properly.<sup>4</sup>”

10. Where this understanding exists the auditor is then in a position to apply the overall requirement in relation to the application of the ISAs.

“The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist.<sup>5</sup>”

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<sup>2</sup> Nordic Federation of Accountants [Standard for Audits of Smaller Entities](#)

<sup>3</sup> See CAG [Agenda Paper F](#) from the September CAG Meeting

<sup>4</sup> ISA 200, *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 19.

<sup>5</sup> ISA 200, paragraph 18

11. A clear understanding from both a drafting perspective and an application standpoint as to what each of the terms “Scalability” and “Proportionality” mean will aid in achieving consistency in the structure of the standards and in application of the standards, commensurate with the size and complexity of an entity.

## Definitions

12. The dictionary definition of the terms of Scalability and Proportionality are as follows<sup>6</sup>:
- *Scalable: capable of being easily expanded or upgraded on demand.*
  - *Proportional:*
    - *corresponding in size, degree or intensity.*
    - *having the same or a constant ratio.*
13. While the concepts that the definitions are conveying are similar, they are not as self-evident as the responses detailed in Paragraph 5. How these definitions align to the responses can be informed by the attributes of the responses.
14. The attributes of the two responses can be identified as follows:
- (a) A requirement is conditional when specific defined circumstance must exist for the requirement to be applicable. When drafting or revising a standard, the identification of the circumstances that trigger the requirement, the conditionality, and the requirement to be applied when the conditions exist, may be presented in two ways within the standards:
- i. Present the conditionality in one standard (the sponsoring standard), where appropriate, with a reference to a further standard (the subsidiary standard) which details the requirements when the circumstances of the conditionality exist. The positioning of the circumstances between the sponsoring and the subsidiary standard will be informed by the conditionality, circumstances and subject matter.
- An example of this is the requirement in relation to external confirmation in ISA 330.<sup>7</sup> The conditionality is “*whether external confirmation procedures are to be performed as substantive audit procedures.*” Where the circumstances in respect of the conditionality exist, in this instance the requirement for external confirmations, the requirements are dealt with in another standard. The auditor’s use of external confirmation procedures to obtain audit evidence in accordance with the requirements of ISA 330 are dealt with in ISA 505.<sup>8</sup>
- ii. Present the conditionality and ensuing requirements in one standard, clearly delineated and separate from other, non- conditional, requirements in the standard. The associated application material would also be subject to a similar delineation.
- An example of a conditional requirement included in a standard is the requirement “*In the case of listed entities, the auditor shall communicate with those charged with governance:.....*”<sup>9</sup> Where the circumstances in respect of the conditionality exist, in this instance the requirement to communicate in respect of Auditor Independence, the requirements are dealt with in that standard.

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<sup>6</sup> Marriam-Webster

<sup>7</sup> ISA 330, The Auditors Responses to Assessed Risks, Paragraph 19.

<sup>8</sup> ISA 505, External Confirmations.

<sup>9</sup> ISA 260 (Revised) Communication with Those Charged With Governance, Paragraph 17.

- (b) Where the requirement is a generally applicable requirement and, based on the subject matter, the response may require calibration to reflect the size and complexity of an entity and the degree of risk of material misstatement. Application material could clearly illustrate how this can be achieved, with examples. The application material would be clearly signposted in this regard.

15. A suggested alignment for the concepts, definition, response and elements is as follows:

| <b>Concept</b>      | <b>Definition</b>  | <b>Response</b>   | <b>Elements</b>   |
|---------------------|--|---|---|
| <b>Scalable</b>     | <i>Capable of being easily expanded or upgraded on demand</i>  | The conditional application of the requirements based on the existence circumstances addressed in the standard.               | <ul style="list-style-type: none"> <li>a. The requirements are presented in a separate standard; or</li> <li>b. The requirements and application material are clearly identified as conditional on the existence of specific circumstances.</li> </ul>  |
| <b>Proportional</b> | <ul style="list-style-type: none"> <li>a. <i>Corresponding in size, degree or intensity.</i></li> <li>b. <i>Having the same or a constant ratio</i></li> </ul> | The ability to calibrate the response, based on size and complexity, where the circumstances addressed in the standard exist. | <ul style="list-style-type: none"> <li>a. The requirements worded to facilitate the intensity and magnitude of the response; and</li> <li>b. Specific application material included to clearly illustrate how, based on the circumstances, the response to the requirements can be calibrated.</li> </ul> |

16. Articulating the concepts of Scalability and Proportionality, in the context of standard setting and application, through definitions that incorporate the elements discussed above will clarify the meaning and potentially result in more clarity and consistency when addressing the issues in both drafting the standards and in their application. This will enhance the ability of the IAASB to demonstrate how standards are Scalable and Proportionate.

17. The terms Scalability and Proportionality, in the context of the IAASB standards, could therefore be defined, as follows:

(a) **Scalability**

Where, resulting from the conditional nature of a requirement, that requirement:

- is clearly and appropriately identified in the standard as a conditional requirement with appropriate signposting and application material; or
- is dealt with in a separate standard dealing with the requirement and response based on the existence of the circumstances which are the subject of the conditionality with appropriate cross referencing from the sponsoring standard.

(b) **Proportionality**

Where a requirement or the application material in relation to a requirement is supported by further application material which clearly illustrates how the intensity of the response can be modified in accordance with the size and complexity of the subject matter and the degree of risk of material misstatement.

### **Matters for IAASB Consideration**

2. Does the IAASB agree that a definition of Scalability and Proportionality will assist in the consistent application of the responses identified in paragraphs 3(a) and (b) in the standard setting process?
3. The IAASB is asked for its views on the definitions set out in paragraphs 17(a) and (b).

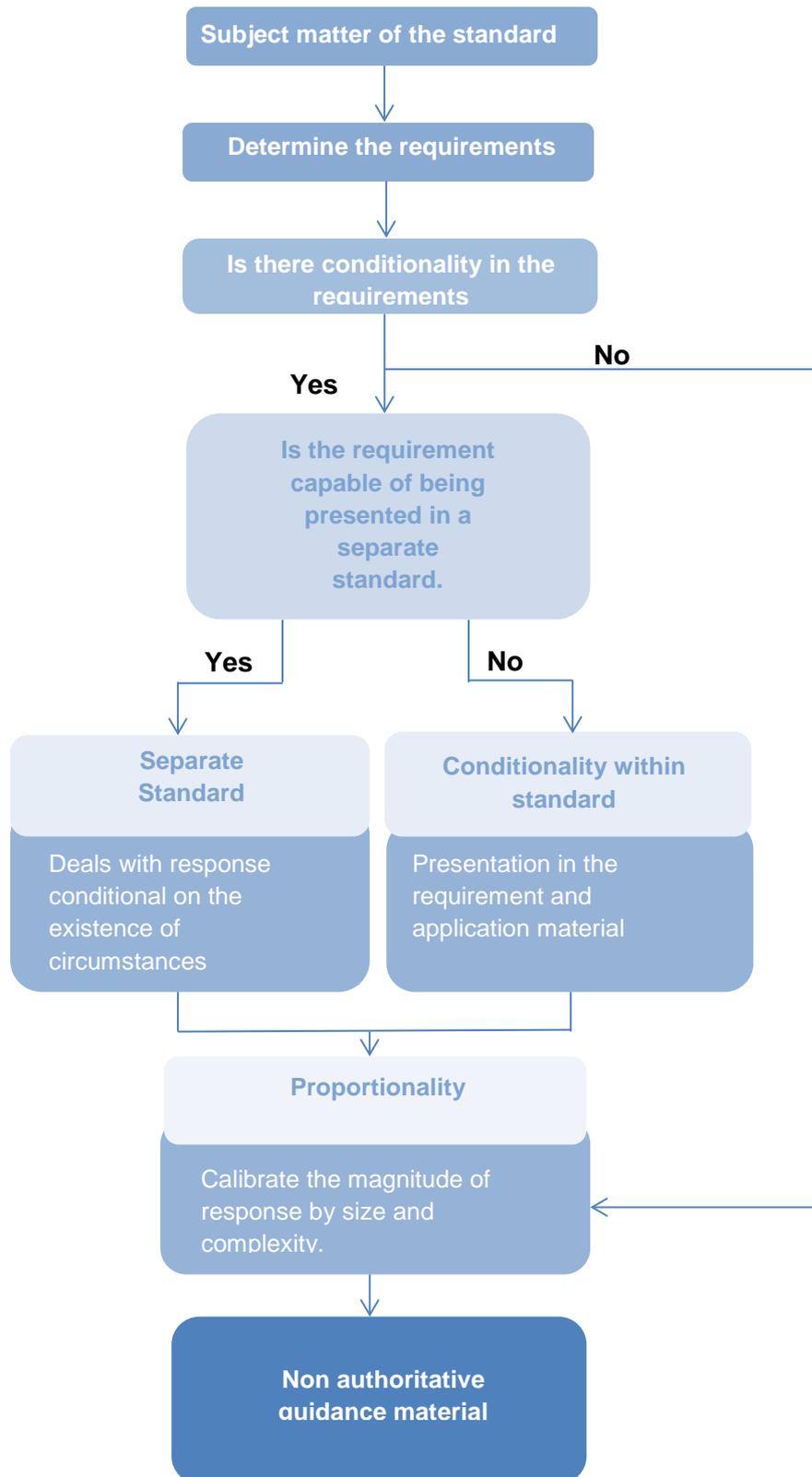
### **Enhancing Audit Quality**

18. The IAASB's Work Plan for 2015–2016<sup>10</sup> has a focused on enhancing audit quality. An appropriate understanding of the standards, and the ease application to the subject matter, may enhance compliance with those standards and therefore enhance audit quality.
19. Enhanced compliance, understanding and application of the standards may also be achieved with appropriate Scalability and Proportionality, as this will aid a focus on the ISAs relevant to the audit, while also demonstrating how a response to the requirements may be calibrated based on size, complexity and subject matter.
20. In order to ensure that there is a consistent and transparent approach to embedding Scalability and Proportionality in the standards, a common understanding of the concepts is required and there needs to be a framework which delivers the consistency across all working groups, task forces and the Board itself, throughout the drafting process.
21. The considerations and decision making process in determining Scalability and Proportionality in the standard setting process can be illustrated as follows:

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<sup>10</sup> <http://www.ifac.org/publications-resources/iaasb-work-plan-2015-2016>

**Determining Scalability or Proportionality in drafting standards**



### Scalability

22. Decisions on Scalability and Proportionality should be a step that follows the determination of the requirements. This step should be represented, in the drafting process, by a stand-back assessment following the determination of the requirements. This will also facilitate communication of the rationale for the existence or non-existence of Scalability in a standard, which can then be articulated in an exposure draft or basis of conclusions.
23. In order to incorporate Scalability into the standards conditionality must be present. Conditionality will be present where there are requirements, in respect of the subject matter, which are dependent on the existence of specific identified circumstances in relation to that subject matter.
24. How Scalability will be addressed in the context of the conditionality, whether within the standard or through a separate standard, will be dependent on the extent to which that conditionality is integrated or dependent on the totality of the requirements.

| Conditionality within a Standard  | Conditionality in a Separate Standard  |
|---|--|
| <p>Notwithstanding the conditionality of a requirement it is dependent on the other requirements in the standard for interpretation, application and response.</p> <p>Signpost and positioning within standard of the particular sections that are only applicable in certain circumstances in respect of both requirements and application material.</p> <p>The provisions within standards apply to all entities, therefore conditional requirements add to complexity and may be confusing to users. Signposting within standard allows for a more precise articulation of procedures that apply in specific circumstances.</p> <p>Example: ISA 220 paragraph 21 is applicable to the audits of listed entities.</p> | <p>The requirement(s) are not dependent and are capable of being presented on a standalone basis with sufficient critical mass that it can be addressed in a standalone standard.</p> <p>Scoping using the standards themselves has the benefit of simplicity, as practitioners can use the standards that are relevant to their audit and ignore those that are not.</p> <p>Example: ISA 701<sup>11</sup> is conditional on the entity being listed and is optional for other audits. The auditor of non-listed entities can determine from the scope of ISA 700<sup>12</sup> that the standard is or is not a relevant standard in the context of their audit.</p> |

### Proportionality

25. Proportionality facilitates the extent to which the response to the requirements can be calibrated based on the size and complexity of the subject matter and the degree of risk of material misstatement.
26. Scalability and Proportionality are not mutually exclusive. Where the standards are scalable as a result of conditionality, once a requirement necessitates a response that response can vary in intensity and magnitude depending on the circumstances. A scalable response can therefore

<sup>11</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>12</sup> ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, Paragraphs 30-31.

include further proportionality, however a proportionate response will not include scalability as the requirement is a response to a uniform requirement to match the complexity of the subject matter and the degree of risk of material misstatement.

27. An example of a proportionate standard is ISA 540 given the uniform requirement which can be intensified to match the complexity of the assertions and balances being tested.
28. While proportionality is included in the requirements themselves, such as ISA 220<sup>13</sup> regarding the requirement for the engagement partner to take action to reduce threats to independence, providing further guidance within application material explains how the requirement may be applied on a proportionate basis and how the IAASB expects particular standards to be applied to the audits in the spectrum of size and complexity.
29. Where a standard claims proportionality there should be an appropriate signposting within the both the requirements and the application material highlighting how this is achieved.
30. It is therefore appropriate that there should be a further step in the drafting process which requires a specific consideration in relation to the presentation of the standard and adequacy of application material in relation to proportionality.
31. Guidance can also be provided, in relation to proportionality, outside of the standards as has been done in respect of ISA 540<sup>14</sup> with the staff publication. Such guidance would not be authoritative or subject to public consultation.

**Matter for IAASB Consideration**

4. The IAASB is asked for its views on:
  - a. A framework to ensure the consistent understanding and drafting of Scalability and proportionality.
  - b. Should criteria be established for the identification or inclusion of conditionality within the standards?

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<sup>13</sup> ISA 220, Paragraph 11 (c)

<sup>14</sup> An update on the project and initial thinking on auditing challenges arising from the adoption of expected credit loss models.