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Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs

Dear Mr. Seidenstein,

We are pleased to provide you with our comments on the discussion paper Audits of Less Complex Entities.

On the 17th of March 2019, the Belgian legislator passed a law that will in the near future merge the Belgian Institute of Accountants and Tax Advisors (IAB-IEC) and the Belgian Professional Institute of Accredited Bookkeepers and Tax Consultants (BIBF-IPCF) into one Institute, the Belgian Institute for Tax Advisors and Accountants (ITAA).¹ A Transitional Council of both Institutes has been installed. Because of this, these comments are sent to you in name of this future Institute.

0. Preliminary observations

Although these observations could have been placed under question 5, the consequence of putting them in the last question would be that the answers of the Belgian Institute for Tax Advisors and Accountants (ITAA) regarding questions 1-4 would not be fully understood until question 5.

This discussion paper makes several assumptions that ITAA either contests or wishes to adjust. Therefore, before answering the following questions, it is necessary that ITAA first states its general observations concerning the audits of so called '*less complex entities*'.

In the discussion paper, following assumptions are made:

- The global community attaches an increasing importance to the ISAs;
- The ISAs in their present form are scalable because they are designed to be applied to a wide range of entities of all sizes and with varying complexity in a manner that is proportionate to the size and complexity of an entity;

¹ Loi relative aux professions d'expert-comptable et de conseiller fiscal

- Differences in legal culture have no significant effect on the design and application of the ISAs;

The IAASB states that, at present, 129 jurisdictions use or are committed to using the ISAs and that this is an increase from some 90 countries in the mid-2000's. According to the discussion paper, this increase proves the importance the global community attaches to the ISAs.

However, a few side notes should be made, concerning the non-adoption of the ISAs by the European Union (EU). Even though the Commission of the EU had the possibility to adopt the ISAs from the entry into force of the Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (hereafter: Audit directive), it did not yet do so.

There are two main reasons, that are linked, that can explain this.

The first cause has to do with the European legal culture. The following findings will at the same time invalidate the allegation that differences in legal culture have had no significant effect on the design and application of the ISAs.

The basis for the ISAs lies in the American standards on audit. The goal of these American standards is a normalization based on the most complex situations (*Think big first*). Regulation is justified because a company is listed.² This leads to a top-down concept, where standards are designed to suit PIE's, listed and large companies and need to be simplified, by carve-outs, SME-packages, guidelines, Q&A's, technical note's or other means to meet the needs of SME's. Although these trends may have evolved during the last decade, they are still a distinctive feature of the US auditing standards.

In the American tradition, it is preferred to enter into the details of the procedures to be implemented, even if it means reducing the domain of the auditor's judgment, without wanting to eliminate it.³ The fact of limiting the professional judgment could lead to a box-ticking approach.⁴ This is caused by the basic principle '*what is not written is not done*', that leads to detailed checklists, where the audit documentation serves more as evidence against any accountability or legal responsibility than as a record of the basis for the auditor's report.⁵ This is reinforced by the pyramidal model of large audit firms, *i.e.* a model for large companies that are organized internationally and that contain many requirements.⁶

Opposite of this American tradition is the European-continental tradition, that is based upon the principle '*Think small first*'. The EU and its Member States should design rules

² [H. OLIVIER, "Application des normes ISA dans les pays européens", *Tax, Audit & Accountancy* nr. 25, November 2010, 9.](#)

³ [H. OLIVIER, "Application des normes ISA dans les pays européens", *Tax, Audit & Accountancy* nr. 25, November 2010, 9.](#)

⁴ [I. DE BEELDE, in X, "Table ronde sur les conséquences des normes ISA pour l'enseignement", *Tax, Audit & Accountancy* nr. 25, November 2010, 37.](#)

⁵ [P. VAN IMPE, in X, "Table ronde sur les conséquences des normes ISA pour l'enseignement", *Tax, Audit & Accountancy* nr. 25, November 2010, 37.](#)

⁶ [H. OLIVIER, in X, "Table ronde sur les conséquences des normes ISA pour l'enseignement", *Tax, Audit & Accountancy* nr. 25, November 2010, 36-37.](#)

according to the "Think Small First" principle by taking into account SMEs' characteristics when designing legislation, and simplify the existing regulatory environment.⁷

Because of this, the EU has published a green paper 'Audit Policy: Lessons from the Crisis':

"While SMEs get value from an audit in terms of enhanced credibility of financial information, statutory audits have also been identified as a potential source of administrative burden. Serious efforts should be made to create a specific environment for the audit of SMEs. These could imply:

- *Discouraging the statutory audit of SMEs.*
- *Alternatively, where Member States want to maintain some form of assurance, introducing a new type of statutory service adapted to the needs of SMEs such as a "limited audit" or a "statutory review" where auditors would perform limited procedures so as to detect misstatements due to error or fraud. The approach of mandating a limited review for small companies has been followed by Estonia, and is being considered by Denmark. Switzerland also follows such an approach; limited reviews are generally accepted in the USA."⁸*

The Parliament of the EU considered that the existing accounting rules are often very burdensome for small and medium-sized companies, and in particular for micro-entities.⁹

The European Commission had previously uttered similar considerations.¹⁰

SME's make up 99,8% of entities in the EU in the non-financial sector, 57% of value added / Gross Domestic Product (GDP) and 67% of employment in the Europe Union.¹¹ To serve public interest, the standards must take SME's into account. To achieve that goal, some form of SME test could be used, such as the EU's SME test¹². The SME Test analyses the possible effects of EU legislative proposals on SMEs. By assessing the costs and benefits of policy options, it helps implement the 'Think Small Principle' and improve the business environment.

In this European tradition, a system based on generally applicable principles is developed, that will highlight the principles from which it is appropriate to implement a professional judgment (*'principles-based approach'*).¹³ The European legal tradition is more focused on principles and controls through sampling without collecting significant amounts of documentation.¹⁴

⁷ [4.III, Small Business Act, 25th of June 2008.](#)

⁸ [EU Commission, Green paper 'Audit Policy: Lessons from the Crisis', 13th October 2010, p. 21-22.](#)

⁹ [European Parliament resolution of 18 December 2008 on accounting requirements as regards small and medium-sized companies, particularly micro-entities.](#)

¹⁰ [Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing.](#)

¹¹ [Annual report on European SMEs 2016/2017](#)

¹² https://ec.europa.eu/growth/smes/business-friendly-environment/small-business-act/sme-test_en

¹³ [H. OLIVIER, "Application des normes ISA dans les pays européens", Tax, Audit & Accountancy nr. 25, November 2010, 9.](#)

¹⁴ [P. LAMBRECHT in X, « Table ronde sur les conséquences des normes ISA pour les entreprises », Tax, Audit & Accountancy nr. 25, November 2010, 18.](#)

For this reason, a bottom-up concept is required. It is about starting with requirements designed for small and simple entities and then adding requirements for larger, more complex entities, such as PIEs. Preferably, the more complex standards would be built or based on the less complex ones.

The second cause is a more legal-technical argument. Although the ISAs aren't drafted from a legislative point of view, by adopting them they will become part of the European legal system.¹⁵ The ISAs cannot be adopted in their entirety ('*en bloc*'). Every ISA needs to be adopted separately. The quality test of article 26, 3° of the Audit directive¹⁶ must be passed and a cost-benefit analysis must be carried out for each separate standard.¹⁷

These are the main reasons for explaining that 13 years after the adoption of the Audit Directive 2006/43/EC of 17 May 2006 (as amended by the Directive 2014/56/EU), and despite the clarification and revision of the ISAs, SME-packages, guidelines, Q&A's, technical note's or other means, the ISAs aren't adopted yet by the EU.

In the meantime, the audit exemption thresholds have been increased by the Directive 2013/34/EU of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC (Accounting Directive).

Consequently, in 2016 eleven countries had already increased their thresholds and only one country had decreased its thresholds.¹⁸ By 2019, another two countries increased their thresholds.

Four countries lowered theirs, however, only Italy did so significantly. Estonia only lowered the threshold for the number of employees from 60 to 50 (which is standard). Romania lowered the threshold for balance sheet total from € 3.650.000 tot € 3.500.000 and for net turnover from € 7.300.000 tot € 7.000.000. In Cyprus there wasn't any change in practice because, despite of the audit thresholds, the Cyprus tax laws still required audited financial statements. Therefore, the abolition of these thresholds only eliminated discrepancies in Cypriot law.

¹⁵ D. SCHOCKAERT, N. HOUYOUX, "International Standards on Auditing within the European Union", *Forum Financier / Revue Bancaire et Financière* 2007/8, 528.

¹⁶ "Art. 26, 3. The Commission shall be empowered to adopt, by means of delegated acts in accordance with Article 48a, the international auditing standards referred to in paragraph 1 in the area of audit practice, independence and internal quality controls of statutory auditors and audit firms for the purposes of the application of those standards within the Union. The Commission may adopt the international auditing standards only if they:

(a) have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;

(b) contribute a high level of credibility and quality to the annual or consolidated financial statements in conformity with the principles set out in Article 4(3) of Directive 2013/34/EC;

(c) are conducive to the Union public good; and

(d) do not amend any of the requirements of this Directive or supplement any of its requirements apart from those set out in Chapter IV and Articles 27 and 28."

¹⁷ [H. VAN DAMME, "Common auditing standards in Europe", *Tax, Audit & Accountancy* nr. 25, November 2010, 5.](#)

¹⁸ [Accountancy Europe, 2016, Audit exemption thresholds in Europe.](#)

Interestingly, despite recent studies concerning the consequences of the abolition of audit obligation for SMEs in Sweden and Denmark, Denmark nevertheless decided to increase their thresholds and Sweden decided to not raise them any further. Neither country lowered its thresholds.¹⁹

Another strategy that is being used by different countries, together with increasing audit thresholds, is the drafting of standalone standards (such as the Nordic SASE, the Belgian Common Standard on SMEs and the Sri Lanka SLAuS) and the emergence of alternative assurance engagements (e.g. the extended review in Denmark and the presentation engagement NP 2300 in France).

The development of these standards cannot be viewed separately from the continuing increase of the audit thresholds. SMEs still need assurance engagements, either audit or other. For example, when Denmark increased its audit thresholds, it set lower standards for a mandatory extended review. Exempting SMEs from audit, does not mean exempting SMEs from assurance engagements.

Indeed, an audit has benefits for an SME. But SMEs need to be convinced of its benefits. Therefore, we need standards that are tailored for SMEs.²⁰ Most SMEs are not required to have an audit and choose not to have one, opting instead for some other assurance or related service provided by an accounting firm. It is becoming increasingly difficult to set the same standards for listed/PIEs and consequently more complex entity audits as for non-listed and less complex entity audits. It seems necessary to consider whether there is a need for different requirements for listed/PIE audits as compared to unlisted/less complex audits to address the issues of complexity and the difficulties of scalability.

While ITAA in principle agrees with the idea of a single set of standards applicable to all entities no matter their size or complexity, it has doubts as to whether the currently existing standards are suitable for SME audits. These doubts rest on the apparent lack of inherent scalability of these standards. Scalability is a critical ingredient for standards to be suitable for SMEs and for the principle of cost effectiveness.

It is impossible to summarize this problem and its only plausible solution more coherently than the Chartered Accountants of Australia and New Zealand have done:

"A fundamental change in standard setting mind-set and approach. That is, to start drafting standards for the simplest situations, and then providing additional detail for more complex situations when these apply. Currently ISAs are written to apply to all situations and hence tend to mean that an SMP/SME auditor needs to wade through a lot of detail. On top of this there is additional guidance for SMPs in applying to SMEs so, ironically, the auditors of a small entity may actually have to read more of the standard than those of a large entity."²¹

1. We are looking for views about how LCEs could be described (see page 4). In your view, is the description appropriate for the types of entities

¹⁹ [Accountancy Europe, 2019, Audit exemption thresholds in Europe.](#)

²⁰ [B. VANDERSTICHELEN, Audit of SMEs. Between opportunity and necessity \(FIDEF Congress of the 4th of November 2017\).](#)

²¹ [Chartered Accountants Australia and New Zealand, 2017. Perspective: Are International Auditing Standards suitable for small audits?](#)

that would be the focus of our work in relation to audits of LCEs, and are there any other characteristics that should be included?

Although ITAA understands the reasoning behind the choice for a qualitative criterion instead of a quantitative criterion, it must be pointed out that the IAASB itself does not give an example of an existing definition that is being used anywhere in the world as an audit threshold. This qualitative criterion is a new and unproven concept. It appears to be subjective and hard to define.

Furthermore, in the discussion paper there are only references to quantitative criteria that are being used in different parts of the world (EU, Australia²²).

ITAA therefore favors quantitative criteria (balance sheet, net turnover, number of employees), that can be adjusted and may vary according to the scale of the companies of the region, i.e. the (international) area in which the envisaged regulations will be applicable. The quantitative criteria should be set by national or regional standard setters. A quantitative criterion will be more objective than a qualitative criterion.

Finally, SMEs will in general be less complex than larger entities. Because of this correlation between size and complexity, ITAA favors quantitative criteria.

2. Section II describes challenges related to audits of LCEs, including those challenges that are within the scope of our work in relation to audits of LCEs. In relation to the challenges that we are looking to address:

- a. What are the particular aspects of the ISAs that are difficult to apply? It would be most helpful if your answer includes references to the specific ISAs and the particular requirements in these ISAs that are most problematic in an audit of an LCE.*

According to a survey conducted Accountancy Europe among its members, 76% think that the documentation requirements are too demanding, including non-applicable items, 62% have difficulty in determining the extent of work required, 49% are of the opinion that there is insufficient consideration of the small entity environment and 46% have difficulty in determining whether the requirements are applicable in the circumstances.²³

ITAA agrees with this analysis, but nevertheless wishes to emphasize that it are not individual factors but their combination that makes the application of the ISAs difficult. The length, often unclear language and prescriptive details aggravate the situation.

- b. In relation to 2a above, what, in your view, is the underlying cause(s) of these challenges and how have you managed or addressed these challenges? Are there any other broad challenges that have not been identified that should be considered as we progress our work on audits of LCEs?*

²² [Treasury Australia, 2018. Reducing the financial reporting burden by increasing the thresholds for large proprietary companies.](#)

²³ [Accountancy Europe, 2018. Simplifying Audit: A call for action](#)

The underlying cause is the top-down concept is the ISAs and the fact that SMEs and SMPs are not being represented enough in the standard setting boards and are as such not enough involved in the standard setting process.

IAB-IEC (currently ITAA) has commented on the paper from the Monitoring Group 'Reforms to The Global Audit Standard-Setting Process' to discuss this issue.²⁴ Any solution for the problem concerning audit of less complex entities may depend on the outcome of the Monitoring Group's reform of the standard setting environment.

Finally, IAB-IEC (currently ITAA) and the Belgian Institute of Auditors (IBR-IRE) have developed a common SME audit standard together, which was published in the Belgian Official Gazette on the 12th of March 2019.²⁵

3. With regard to the factors driving challenges that are not within our control, or have been scoped out of our exploratory information gathering activities (as set out in Section II), if the IAASB were to focus on encouraging others to act, where should this focus be, and why?

The IAASB should focus on the reform of the global audit standard-setting process and on the impact of the differences between the main legal systems in force in the world, such as roman civil law, common law, or religious based law systems (for example Islamic finance). It should stay in a continuing dialogue with the national or regional authorities, such as the CEAOB of the EU. What should not be forgotten, is the promotion of the value and the benefits of audit for SMEs.

4. To be able to develop an appropriate way forward, it is important that we understand our stakeholders' views about each of the possible actions. In relation to the potential possible actions that may be undertaken as set out in Section III:

a. For each of the possible actions (either individually or in combination):

- i. Would the possible action appropriately address the challenges that have been identified?

As Accountancy Europe had already analyzed, there are 3 different options built within the ISAs.

- Develop more guidance.
- Revise the ISAs to deal with complex language.
- Revise the ISAs applying a 'think small first' approach.

Developing more guidance will not help in solving the issue. There is currently so much guidance written that the auditors of a small entity may have to read more of the standard than those of a large entity when applying the ISAs.

²⁴ [Reply IAB-IEC 9 February 2018 to Monitoring Group.](#)

²⁵ [Norme relative au contrôle contractuel des PME et des petites A\(I\)SBL et fondations \(French\)](#)

Revising the ISAs to deal with complex language will not be sufficient. Over the last ten years the ISAs have already been clarified and revised.

Only a total revision applying a 'think small first' approach will suffice. This is, however, time consuming.

In the meantime, audit thresholds can be raised further and a standalone standard can be developed, together with new forms of assurance engagements and other engagements, to bridge the gap between the current situation and the adapted ISAs.

This standalone standard will not be outside the ISAs but will be based on the ISAs. The only current examples of a standalone standard (the Nordic SASE, the Belgian Common Standard on SMEs and the Sri Lanka SLAuS) are all based on the ISAs.

The drafting of a global standalone standard based on the same principles as the ISAs will be less time consuming than redrafting the entire ISAs. This standalone standard for SMEs would become the core standard of the 'new ISAs', which would take a building block approach, adding blocks with additional requirements for larger and more complex entities, that will only have to be applied when applicable.

- ii. What could the implications or consequences be if the possible action(s) is undertaken? This may include if, in your view, it would not be appropriate to pursue a particular possible action, and why.

The ISAs could be adopted in the EU, SMEs would choose more voluntary audits and audit thresholds can be lowered. This will help support growth, tax recovery, financial crime deterrence

- b. *Are there any other possible actions that have not been identified that should be considered as we progress our work on audits of LCEs?*

Nihil.

- c. *In your view, what possible actions should be pursued by us as a priority, and why? This may include one or more of the possible actions, or aspects of those actions, set out in Section III, or noted in response to 4b above.*

The drafting of a global standalone standard based on the same principles as the ISAs, is a priority to start a total revision of the ISAs applying a 'think small first' approach.

5. Are there any other matters that should be considered by us as we deliberate on the way forward in relation to audits of LCEs?

ITAA refers to the above preliminary observations.

Yours sincerely,



o/s Bart Van Coile
President
E. STEGHERS