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Subject : IAASB Discussion Paper on Audits of Less Complex Entities

Dear Sir,

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to provide you with their comments on the IAASB's Discussion Paper on the "Audits of Less Complex Entities".

This matter is becoming a major and crucial issue for the audit market. As a matter of fact, smaller entities make a critical contribution to the world economy and, quantitatively, the majority of audits globally are audits of smaller entities. Besides, the practitioners have to face International Standards on Auditing (ISAs) which are becoming more and more complex and difficult to apply, especially when auditing smaller entities.

The time has come to take urgent action, i.e. think differently, with an open mind, and elaborate specific and appropriate solutions that will help all practitioners, not only those auditing smaller entities, but also those auditing entities where their nature and circumstances are less complex (LCEs).

France has always taken a leading role on the issue of the audit of SMEs,

- with the issuance of its first standard on the audit of small entities in March 2009;
- with the design of its audit pack for SMEs which has been adopted by many countries in Europe and Africa since June 2012;
- with the organization together with the IAASB of the first Paris Conference in January 2017.

France has now addressed the challenge of the audit of small entities with the issuance in June 2019 of two separate and standalone standards for the audit of SEs. We presented this work at the second Paris Conference in May 2019 and are pleased to promote this work as a possible way forward.

The French Institutes are convinced that, because of the urgency of the issue, the only practical way forward for the IAASB is to work on a separate and stand-alone standard for the audit of LCEs.

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Envoyer obligatoirement toute correspondance aux deux adresses ci-dessous :

This exercise could premise, in a second stage, a full in-depth revision of all the standards with a “think simple” or “think small first” approach that would serve the double objective of improving the clarity of the standards and taking into accounts the evolutions generated by the technology on the audit.


Responses to the specific questions raised in the Discussion Paper are set out below.

If you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours faithfully,



Jean Bouquot
President of CNCC



Charles-René Tandé
President of CSOEC

Questions

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

We fully support the approach retained by the IAASB to focus on LCEs. We consider that, at international level, it is not desirable to set quantitative criteria to define a small entity, since such criteria are intrinsically linked to the characteristics of the national markets. Thus, one entity can be considered small in one national market and not in another one. We believe that setting quantitative criteria to define specific groups of entities should remain the responsibility of the national authorities.

We therefore fully support the definition of an LCE that is based on qualitative characteristics. The qualitative characteristics listed in the discussion paper are those developed in ISA 200 to consider "smaller entities" (paragraph A66). However, we believe that the IAASB should also consider the following additional qualitative characteristics:

- Non-complex accounting estimates;
- Simple business model;
- Limited diversification of economic activities;
- Limited use of external service providers;
- Stability in the entity's business, i.e. the entity's strategy is not to be sold in the short term;
- Limited volume of transactions;
- Non complexity in the entity's environment, i.e. an entity may not be complex but may evolve in a complex environment (e.g. certain PIEs);
- Non complexity in the financing of the entity (e.g. no agreement with complex covenants, no complex loans with several banks, no banking pool);
- No cash flow difficulties with potential going concern issues;
- Whether the entity uses a professional accountant in public practice to assist in preparing its financial statements;

Finally, we have a concern concerning the criterion of ownership concentration which, in our view, should be analyzed carefully. As an example, some large State owned companies, cannot be considered as less complex entity even though they have just one shareholder: the State.

Question 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.

In our views, the particular aspects of the ISAs that are difficult to apply are:

- The volume of requirements: ISAs are a set of standards with too many requirements, i.e. around 1700.

- ISA 230 – Audit documentation

The ambiguity of the audit documentation requirements and application material in the ISAs and its implications in practice on auditor's behavior.

Auditors see it as a burden to document why they have not carried out an audit procedure linked to a requirement included in the ISAs. The practice of documenting the reasons why a requirement does not apply has created a compliance approach for ISA audits. Moreover, the lack of clarity on what needs to be done, especially when a requirement is not applicable, drives regulators' expectations and demands when they come to audit procedures and documentation. These expectations and demands seem to be disproportionate, especially for LCE audits. However, to avoid findings during the inspections, auditors often end up documenting more than necessary. To avoid such excessive documentation, it would be helpful to clearly state in the ISAs that the auditor does not have to document a requirement if it is not applicable in a particular audit. The ISAs should also state that it is not because something has not been documented that it has not been done. It is important in the context of an audit of LCE to provide a relief to the auditor on audit documentation requirements. All the time spent documenting is not spent gathering audit evidence. The auditor should be required to document the evidence that allowed him/her to obtain reasonable assurance and express his/her audit opinion, not to document compliance with the ISAs.

- ISA 315 – Identifying and assessing the risks of material misstatement through understanding the entity and its environment

The concept of "relevant to the audit" appears difficult to understand and difficult to address for the practitioners, especially in the audit of SMEs.

- ISA 540 (revised) – Auditing accounting estimates and related disclosures

The revised standard is still complex, despite the efforts done to develop specific support tools, i.e. 2 flowcharts and 1 diagram, to respectively explicit the flow of the requirements in the standards, provide an overview of the key requirements relating to the three testing approaches, including their linkages and explain the linkages between ISA 540 (revised) and other ISAs. The need for support tools to explain the standard may question the clarity and the understandability of the standard.

- ISA 550 – Related parties

ISA 550 is difficult to apply, especially in a context of small entities. As a matter of fact, the concept of "related parties" is defined by IAS 24. Other accounting standards and especially the French commercial code also refer to the definition provided by the IFRS. This is an issue for entities that do not use and, therefore, do not have not a good knowledge of IFRS.

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?

In our view, the underlying causes of these challenges are mainly coming from:

- the absence of a "stable platform" for the standards;
- the complexity of the language used in the standards;
- the length of the standards;
- the lack of support tools to assist the practitioners, especially in less complex entities context;
- the lack of accessibility of the standards. We therefore welcome the commitment of the IAASB to convert the IAASB's Handbook into an electronic format (we refer to the footnote 12 of the discussion paper).

One of the root causes leading to difficulties to apply the ISAs is their continuous process of revision since the clarity project. Without a "stable platform", the situation became more and more complex for the practitioners. This required considerable efforts from them to update their knowledge and methodologies.

Another root cause is the way the standards were revised. Instead of being more precise and principles based, the IAASB went into greater and greater level of detail (sometimes to deal with particular situations), and so kept adding requirements and also unnecessary contextual information. The standards have become very heavy to read, sometimes "indigestible", difficult to understand and more rules-based than principles-based.

Moreover, we consider that even if difficulties with application of the ISAs are more prominent in an audit of LCEs, they are also encountered in audits of other entities too. Therefore, tackling these issues should have a positive impact on all ISA audits.

Question 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?*

In general, we encourage the IAASB to appreciate with relevant stakeholders desirable changes in these areas. We welcome the collaboration launched between the IAASB and national standard setters. We agree that the IAASB should engage in closer cooperation and better coordination with national standard setters, regulators and audit oversights. We believe that the IAASB should also contribute to greater collaboration with educational bodies at national level, including providing support to them.

We consider that we need clearer standards for all audits, i.e. more understandable, that can be used by small and large firms.

We therefore recommend a "sanity check" of the complete set of the standards (for all the requirements, at a first step). This work could be performed jointly with the NSS. The aim would be to check:

- the understandability of the requirements;
- the clarity of the objectives;
- the relevance of each standard;
- the need for additional standards.

Question 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?

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.

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?

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.

It is essential that the IAASB develop an appropriate action for LCE audits. The retained solution should not deviate from the objectives of principles-based standards.

Concerning the **possible actions** mentioned in the discussion paper, we have the following comments:

– **Revising the ISA**

Ideally, revising all the ISAs to make the auditor's work effort clearer to benefit all audits, and in particular audits where the circumstances and characteristics of the entity are less complex, would be the most relevant solution. However, in practice, it would take a long time and might come too late into the market to be useful.

– **Developing a separate auditing standard for audits of LCEs**

From previous outreach undertaken to date, it is clear that the level of assurance for the audit opinion issued in accordance with any separate standard should be the same as the ISAs (i.e. reasonable assurance). The separate standard for audits of LCEs should retain a similar robustness as the ISAs.

In this context, the challenge for the IAASB will be to avoid the pitfall of generating two sets of standards and creating a two-tier auditing profession. The solution should also be acceptable to all auditors, regardless of the size of the audit firm.

The French institutes fully support the option that consists in developing a separate and stand alone auditing standard for audits of LCEs.

In France, we have already issued two specific and standalone standards for the audit of small entities, i.e. NEP 911 – *Standard for engagements when auditor has been engaged for a period of three years as defined in article L. 823-12-1 of the French commercial code* and NEP 912 – *Standard for engagement when auditor has been engaged for a period of six years*.

Small entities are defined by the French law that retains criteria of size (thresholds) and not of complexity. Under French law, a small entity is a person or an entity that does not exceed, at year-end, two of the three following criteria: 4 million € total balance sheet, 8 million € total revenue, 50 employees.

"NEP 911" applies to the following cases, i.e.

- in situations where there is no legal requirement to appoint a statutory auditor, a company that meets the criteria of "small entity" may voluntarily appoint an auditor;
- a "parent" company that is not required to publish consolidated accounts, but that is not a public interest entity, or that is not controlled by another person or entity that appointed an auditor, and constitutes, along with the companies it controls, a group that meets at least two of the three criteria of the small entity;
- small companies that are controlled by a parent company when these companies meet two of the following criteria at year-end: 2 million € total balance sheet, 4 million € total revenue, 25 employees.

NEP 912 is simply an adaptation of the NEP 911 for a 6 years engagement.

The objective of such standards is to define a proportionate audit approach and to set only the basic, principles based, requirements which are necessary in an audit of a SE. The standards are short, i.e. only 10 pages and standalone, i.e. with no reference to other standards. They use the same notion and lead to the same final product as the "traditional" audit, i.e. reasonable assurance, sufficient appropriate audit evidence, professional skepticism, professional judgment, full compliance with the Code of Ethics.

In addition to the audit report which is aimed primarily at the shareholders but which is aimed more widely at the Public as a whole, like in a traditional audit, the NEP 911 also requires an annual auditor's supplemental report to Management on the risks of the entity ("financial, accounting and management risks") and includes some simplifications in terms of other legal requirements, compared to a "traditional" audit in France, to simplify the "legal compliance" dimension of the audit.

As in any "traditional" audits, these standards include the following concepts:

- Engagement letter;
- Materiality threshold(s)
- Notion of clearly inconsequential errors;
- Risks analysis of material misstatements;
- Audit planning;
- Audit requirements in response to risks analysis;
- Going concern;
- Management representation letter;
- Probing sampling, ...

but are adapted to small entities with, in particular, the following principles:

- Importance of the implication of the engagement partner as the principal and privileged interlocutor of the manager of the entity;
- Importance of considering professional ethics and behavior of the manager of the entity as part of the risk approach;
- No "assertions" defined or mentioned in the standard since in fact they are embedded in the financial reporting framework;
- No setting of performance materiality required, considered not necessary (and too complicated as regard the size of the entity) to plan the audit;
- Substantive analytical procedures presented as the primary audit procedures;
- No "useless" audit documentation (professional judgment);
- As it is supposed that audit is operated later after closing date, external confirmations may not be necessary;
- Overall an audit which values professional competence, judgment and partner's involvement.

The audit reports will refer to the audit having been conducted according with the specific standard.

– **Developing guidance for auditors of LCEs or other related actions**

Even if, on its own, it is not the answer to the problem because the audit oversights will not recognize any authoritative value to the guidance, we believe that guidance and other support material developed specifically for audits of LCEs would be useful.

Among the options developed in the discussion paper, we support the issuance of an international auditing practice note (IAPNs) for audits of LCEs as a support to a separate and standalone standard on the audit of LCEs, since it will provide a practical assistance to auditors on specific areas where additional guidance is needed.

We suggest building the guidance step by step, chapter by chapter to become exhaustive at the end. This should be implemented into a support tool easy to use, including many illustrations with practical examples.

Concerning the **actions to be pursued by the IAASB as a priority**, we have identified the following ones:

- First, as a matter of urgent priority, develop a separate and standalone standard for the LCE audits and work on a IAPN for audit of LCEs;
- Then, on a longer term, revise the ISAs following the “think small first” principle with clear and unambiguous language.

The proposed separate standard should be based on the existing ISAs and provide the same level of assurance and have the same objectives as the ISAs. We consider that this project should be coordinated with national standard setters and regulators.

Knowledge and experience of countries which are already using a separate standard at national level could serve as a starting point for the IAASB’s work. Considering that several European countries have come up with their own national solutions, Accountancy Europe as a body representing these countries at European level could serve as a platform for this exchange and potential collaboration.

As a second step, we believe that the IAASB should start working on revising the ISAs based on a “think small first approach”, beginning by the most fundamental ones, such as. ISA 240, 315, 330 and 540. This means that the core of the ISAs would consist of the most fundamental requirements applicable in all audits. Complexity added in each ISA should be systematically conditional on the size and complexity of the audited entity as well as on the circumstances. The newly developed separate standard for the LCE audits could serve as a starting point for this work. It would be the fundamental building block.

We are convinced that using a “think small first” approach to revise the IASs should be a appropriate way to revert to standards that are largely principles-based and so applicable to audits of all entities. This would also allow convergence of a separate standard for LCEs with revised ISAs in a longer term.

Question 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?

No