Implementation of International Auditing Standards for all Statutory Audits in the European Union

Briefing Note from FEE, the European Federation of Accountants

Executive Summary

FEE welcomes Article 26 of the Statutory Audit Directive. This provides for statutory audits of all companies to be carried out in accordance with international standards. FEE considers this approach to be in the public interest.

The Directive aims to ensure consistent high quality statutory audits in Europe. This requirement supports the belief that there should be one benchmark audit and this concept is referred to as “as audit is an audit”.

An alternative model would create first and second-class audits, which could lead to the following difficulties:

- It could create confusion and misunderstanding on the significance of an audit
- It would be problematic to establish the necessary distinction between business entities in order to allow for the application of specific standards.

As small and medium sized entities (SMEs) activities expand across national borders, taking advantage of the internal market, uniform standards arguably become just as relevant for them and the users of their financial statements as they do for large companies, particularly in accessing finance.

FEE favours using professional judgement to apply principles-based standards. This ensures that auditing remains a thoughtful activity and does not merely require compliance with prescriptive checklists.

The International Auditing and Assurance Standards Board (IAASB) aims to ensure that its International Standards on Auditing (ISAs) remain principles-based and equally applicable to all audits of all entities. Specifically, ISAs are intended to meet the needs of SMEs without the need for separate standards.

Members of the European Parliament should therefore support IAASB and not to call for another set of “light” standards. They should encourage regulators to enforce the application of auditing standards in a principles-based environment that enhances a thoughtful approach to audits requiring the exercise of judgment.

Issue

In this briefing note FEE considers why the public interest is best served if the same auditing standards apply equally to all audits of financial statements, irrespective of whether the entities audited are large or small, public interest or private.

The adoption of IFRSs for accounting purposes and of ISAs for auditing purposes are appropriate European measures to reinforce confidence in the financial markets.

Therefore FEE welcomes Article 26 of the Statutory Audit Directive that provides for statutory audits of all companies to be carried out in accordance with International Standards on Auditing (ISAs) adopted by the European Commission. The IAS Regulation 2002 already requires publicly traded companies to prepare their consolidated (group) accounts in conformity with International Financial Reporting Standards (IFRSs) adopted by the European Union.

The IAS Regulation requires that the IFRSs are applied to publicly traded companies but leaves it to Member States to opt whether or not to apply IFRSs to other companies, or to financial statements of individual companies, as it is widely accepted that IFRSs are too complex for many small businesses. Some might conclude that two sets of auditing standards, one for publicly traded companies and one for SMEs, would be an appropriate parallel response. However, IFRSs and ISAs fulfil very different purposes:

- IFRSs set out measurement, recognition and disclosure standards in order to ensure a high degree of transparency and comparability of financial statements for publicly traded companies. Provided financial statements explain the standards that have been followed, large and small entities can apply different standards without misleading those using their financial information. It is primarily the degree of complexity in accounting practices and in disclosures made to financial statement users that will differ with the size of the reporting entity.

- ISAs, in contrast, set out the framework within which the professional external auditor undertakes the procedures, and makes the judgements, necessary to enable the auditor to express an opinion on the financial statements. How the standards are applied is necessarily not publicly disclosable in view of the confidential nature of the auditor’s work. Users expect a consistent, reasonable level of assurance from an unqualified audit opinion but different levels of audit assurance, arising from different sets of auditing standards, could not easily be quantified or explained in a transparent way. It would seem therefore that an audit must be performed to the same standards for any size of entity.

Discussion

The Statutory Audit Directive requires “statutory auditors and audit firms to carry out statutory audits in accordance with international auditing standards” to ensure consistent high quality statutory audits in Europe. This requirement supports the long standing belief that there is only one benchmark audit, whereby the level of assurance obtainable from an audit exceeds the level obtainable from other types of assurance engagements. If an auditor intends to issue a report under International Standards on Auditing, then compliance with all ISAs is necessary. This concept is generally referred to as “an audit is an audit”. Any conceivable alternative model would create first and second class audits.

ISAs require that the auditor obtain ”reasonable assurance” as to whether the financial statements are free from material misstatement. ISAs are indeed designed to enable the auditor to obtain that reasonable assurance. An opinion, however, is not expressed in terms of the assurance provided. The opinion is expressed in the same overall terms whatever the nature, complexity and risks attaching to the audited entity and the work performed by the auditor. Users of an ISA audit report have an expectation that they will receive consistent audit assurance based on consistent audit quality.

ISAs are prepared so as to be applicable to all audits of all entities. This is achieved following the objectives or “principles” based structure. The objectives of each audit are the same, the requirements to achieve the objectives are the same, but the specific audit procedures to be undertaken to comply with the requirements may vary considerably in the audit of a small and simple entity compared to that of a large or complex one. ISAs are therefore intended to meet the needs of the smaller entity without the need for separate standards.

Exemptions or carve-outs of auditing standards, or even alternative “small company standards”, would result in an auditor obtaining a lower level of assurance. As users of financial statements already have difficulty understanding the concept of "reasonable assurance" envisaged in ISAs, to introduce another version of audit assurance would only increase the scope for misunderstanding. In general, the user wants reasonable assurance that the financial statements have been properly prepared and are free from material misstatements, and should not be expected to consider what the auditor has done differently that impacted the auditor’s conclusion.

A world in which two levels of audit assurance coexist would have a number of other potential difficulties:

- The confusion and misunderstanding which could result from the introduction of another version of audit assurance would raise a number of questions: How much less assurance could a user gain from financial statements audited to "light" standards? Which aspects of the financial statements should the user rely on to a lesser extent? How would the user view such reduced assurance in the context of potential fraud? These are impossible questions to expect a user to judge without a detailed knowledge of auditing.

- The size and nature of entities to which the "light" standards would apply needs to be defined. As entities near the threshold grow or shrink, their audit requirements would vary in a complex way from year to year. Special treatment would be needed for small entities (for example not-for-profit organisations) which are nevertheless of public interest.

- As SMEs activities expand across national borders, in many cases uniform standards arguably become just as relevant for them, the users of their financial statements and their auditors as they do for publicly traded entities.

Potential solutions

Standard setting

While concluding that two sets of auditing standards would not be appropriate, FEE recognises that increasingly prescriptive auditing standards introduce an additional burden for auditors of SMEs. The solution to this problem lies in the hands of the International Auditing and Assurance Standards Board (IAASB), and in their dialogue with the regulators, companies and others who press for more prescriptive auditing standards.

It is critically important for the future health of the auditing profession that auditing standards continue to be based on principles and objectives with only limited required procedures that are applicable in virtually all circumstances, often called the "think small first" approach. Auditing standards that achieve this goal will also be capable of application to SMEs because they will not impose an unnecessary burden of prescriptive required procedures.

This approach leaves it to the professional auditor to determine the best way to achieve the objectives. It ensures that auditing continues to be a thoughtful activity exercising judgment and not one driven by extensive "box ticking" through mere compliance with prescriptive checklists. It allows for future development and innovation in what should be a healthy, competitive, professional environment.

Work is under way within the standard setting community to address the special considerations in the audits of small entities. Those projects are designed to maintain the benchmark of an audit, but recognise that there are certain characteristics commonly found in SMEs that will impact the application of the ISAs. A project commenced by the International Federation of Accountants (IFAC) aims at developing guidance for auditors applying ISAs to smaller audits. SME considerations are also being addressed directly in the IAASB Clarity Project with SME considerations being incorporated directly into the redrafted ISAs.

Audit exemption

Amendments to the Fourth Company Law Directive passed by the European Parliament in December 2005 increased the thresholds defining SMEs by 20%. National legislators may use the Member State option to exempt small entities from the statutory audit requirement, as considered appropriate in the national public interest and where it is considered that an audit may impose unnecessary additional costs on small and medium sized companies. However, if Member States fix the thresholds for the exemption from audit as a lower level than that provided for by the Directive, it has to be clear that the "audit is an audit" principle will also apply to those SMEs that, even if potentially exempted according to the Directive, have not actually been exempted by national legislators.

Only in case of exemptions from audit provided for by national legislators in the framework of the Directive, there may be demand for some alternative form of assurance on the exempted small entities, although experience in some Member States suggests that such demand may be limited. If it exists, standard setters may be asked to prepare appropriate standards and procedures. However, for the reasons set out in the discussion above, the assurance given should not be described as an "audit" and the scope of the work performed would have to be clearly described in the assurance report.

Conclusion

Central to this topic is the future development of ISAs. FEE calls upon the IAASB to ensure that its standards continue to emphasise objectives, with limited prescription, leaving professional auditors with responsibility to design the necessary procedures that are appropriate to the size, risk and complexity of the audited entity. Members of the European Parliament should support IAASB in the development of such ISAs and not to call for another set of "light" standards, and should also encourage regulators to enforce the application of such auditing standards in a principles-based environment that enhances a thoughtful approach to audits exercising judgment.

FEE also calls upon regulators and other commentators to recognise the importance of this approach and to reflect it in their interactions with IAASB.

The public and users of financial statements expect the same level of assurance from the audit of an SME and of a publicly traded company. FEE supports IAASB in its determination to develop and maintain one set of international standards for both large and small entities as it is in the public interest to do so.