

Agenda Item E.2

Please note this paper represents the IAASB LCE Issues paper that was presented to the Board at its June 2020 meeting. Specific questions for CAG Representatives are included in Agenda Item E (LCE Presentation)

Audits of Less Complex Entities (LCEs)–Issues and Recommendations

Objective of this Agenda Item:

The objective of this Agenda Item is to obtain the Board's agreement on the LCE Working Group's recommendations for developing a separate standard for audits of LCEs on the basis of the overarching principles set out in **Section III**.

Board Discussion:

The **focus** of this Board discussion will be on **Section III** in relation to the **development of the separate standard**, including the basis for the development of the standard.

Section I (Background) and **Section II** (Description of LCE) are provided for context for this discussion and it is not intended that the matters noted within these sections will be specifically discussed.

In order to progress both workstreams discussed with the IAASB in April 2020 (i.e., an ISA Focused Workstream and the Separate Standard Workstream), the LCE Working Group agreed to rather focus on matters related to the development of the separate standard at the June IAASB meeting.

Matters related to the workstream focusing on the ISAs more broadly (the ISA Focused Workstream) will continue to be progressed based on the feedback received from the Board in April 2020, and will be presented for discussion at the December 2020 IAASB meeting.

The description of an LCE needs to be further considered by the LCE Working Group and will also be presented for more specific discussion at the December 2020 IAASB meeting.

Matters for IAASB Consideration:

The following matters will be discussed at the June IAASB meeting:

1. The Board is asked for its views on each of the overarching principles set out in **Section III** (paragraphs 51–72), and whether there are other principles that should be included.
2. The Board is asked whether there are any other matters that the LCE Working Group should consider in its work to develop a separate standard for audits of LCE's and preparation of a related project proposal?
3. Do Board members agree that the LCE Working Group commence development of the separate standard using the overarching principles as set out in **Section III** of this Agenda Item (subject to Board comments about these matters), and prepare a project proposal on this basis for the December 2020 IAASB meeting? If not, why not? *[Each Board member will be asked during the Board meeting for their views on these matters].*

I. Background—How the LCE Working Group has Developed Its Recommendations

1. The IAASB currently develops and maintains one set of auditing standards. 130 jurisdictions¹ use, or are committed to using, the International Standards on Auditing (ISAs) globally, demonstrating the importance the global community attaches to the ISAs.
2. The ISAs are applied to a wide variety of entities with differing circumstances and sizes, ranging from those whose nature and circumstances are simpler and more straightforward (i.e., LCEs), to those entities whose nature and circumstances are more complex (for example, more complex structures, more complex information systems or controls, or more complex transactions and other financial statement items).
3. Although listed entities are clearly in the public interest, the number of LCEs having their financial statements audited using the ISAs far outweigh the number of listed entities, and therefore challenges related to LCEs are also of public interest. For example, although it is difficult to obtain precise numbers it is estimated that more than 95% of entities across the world are small- and medium-sized (SME) entities (with some regions estimating that the percentage could be higher,² such as in the European Union where it is estimated that over 99% of entities are SMEs).³
4. The IAASB has always been mindful of the need for the ISAs to be able to be used for audits of all entities. It also recognizes that the operating and reporting environment is becoming more complex and is continually evolving. In addition, the quality of audits has been spotlighted through the results of audit inspections and recent corporate failures. This has contributed to the recent revision of ISAs such as ISA 540 (Revised)⁴ and ISA 315 (Revised 2019),⁵ as well as revisions to quality management standards,⁶ to make sure that the ISAs remain fit for purpose. One of the consequences of these revisions has been widespread, growing concern about the length and understandability of the ISAs, and their application to audits of LCEs, including whether they can be applied in a cost-effective manner to these audits.
5. In response to these concerns, and similar concerns that have been mounting over a period of time, various jurisdictions or regions have undertaken initiatives targeted at audits of less complex (or smaller) entities.⁷ Furthermore, other jurisdictions have also announced the intention to develop

¹ Refer to the [IFAC 2019 Global Status Report](#)

² Reference: <http://www.edinburgh-group.org/activities/papers.aspx>

³ Reference: https://ec.europa.eu/eurostat/statistics-explained/index.php/Statistics_on_small_and_medium-sized_enterprises#General_overview

⁴ ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

⁵ ISA 315 (Revised 2019), *Identifying and Assessing the Risk of Material Misstatement*

⁶ The quality management standards series includes three exposure drafts, International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*; ISQM 2, *Engagement Quality Reviews*, and International Standard on Auditing (ISA) 220 (Revised), *Quality Management for an Audit of Financial Statements*

⁷ These include: the draft [Nordic Standard for Audits of Small Entities](#) “SASE” (an exposure draft consultation for a proposed standard) developed by the Nordic Federation of Public Accountants, the Sri Lanka Auditing Standard for the Audits of Non-Specified Business Enterprises (“SLAuS”) developed at the Institute of Chartered Accountants of Sri Lanka, the Belgium statutory standard for contractual auditing of SMEs and small not-for-profit entities, two [new standards in France](#) for audits that fall below the statutory threshold and an audit standard for small and medium entities, developed based on the IFAC SMP Guide translated into French by the Ordre des Experts Comptables of Morocco.

standard(s) or solutions for audits of LCE's within their jurisdictions.⁸ Different standards for the same type of engagement (i.e., an audit of an LCE) is not in the public interest and may have unintended consequences. The IAASB has been urged to give “careful consideration of the potential options, [which] should be balanced with the need to move forward and manage the risks and potential severe long-term implications for the IAASB's remit as the global standard setter for all types of entities.”⁹

6. Formal IAASB activities related to audits of LCE's have been ongoing since 2017 (including 5 Board discussions (one in an Executive Session) and 5 IAASB Consultative Advisory Group (CAG) discussions and updates. The Working Group for this project comprises 8 members, including a number of practitioners auditing small- and medium-sized (SMEs) or representing SME / small- and medium-practices (SMP) stakeholders (see **Appendix 1**).
7. The Board has also consulted extensively on the issues and challenges related to audits of LCEs:
 - Regular updates to, and input from, the International Federation of Accountants (IFAC) Small and Medium Practices Committee (SMPC).
 - Specific outreach targeted at stakeholder groups representing the interests of SMP's, such as the Nordic Federation, Accountancy Europe, the Edinburgh Group and other relevant professional accountancy organizations.
 - Ongoing outreach to and discussions with national standard setters, regulators and audit oversight bodies.
 - Two working roundtables in Paris (in 2017 and 2019), each attended by over 75 people from over 24 jurisdictions representing the interests of SMPs.
 - Issuance of a Discussion Paper (DP), [*Audits of Less Complex Entities \(LCEs\): Exploring Possible Options to Address the Challenges in Applying the ISAs*](#). Substantial feedback was received from a broad range of stakeholders and from various regions, including 93 written responses to the DP (including one Monitoring Group (MG) Member),¹⁰ and over 1,700 responses from a related survey undertaken by IFAC.¹¹

All of the feedback from this extensive outreach has been used to develop the recommendations within this Agenda Item. The more recent feedback received has not highlighted any new significant matters in the challenges and issues that have not been raised previously, but does continue to provide a rich basis of evidence to inform the IAASB on the most appropriate way forward.

⁸ See [Comment Letter](#) of the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India (ICAI) and see [Comment Letter](#) of the Institut der Wirtschaftsprüfer in Deutschland e.V. (IDW)

⁹ The IAASB has recently received letters from the Nordic Federation and the International Federation of Accountants (IFAC) advocating for quicker progress in relation to audits of LCE's, and highlights the consequences if the IAASB does not progress in a timely way.

¹⁰ The International Forum of Independent Audit Regulators (IFIAR)

¹¹ A detailed summary of the input received can be found in the December 2019 IAASB Board papers ([Agenda Item 6](#)) and a summary and overview was provided in the IAASB's [Feedback Statement](#) published in December 2019.

What Stakeholders Have Told Us

8. The following summarizes the more substantial, overarching matters that have been identified *related to audits of LCEs* through the outreach and consultation noted above:
 - There is an **urgent need** to have an international solution to address issues related to audits of LCEs, in particular as jurisdictions develop standards and commence other initiatives in this area.
 - The IAASB should **prioritize its efforts** on developing a solution to address the challenges and issues related to audits of LCE's (in particular it was noted that it is not in the public interest to delay further because more and more jurisdictions are commencing activities on their own solutions, which may have long-term implications on the adoption and use of ISAs).
 - The solution is not only one action, and likely involves all of the actions set out on the DP.
9. The responses to the DP also highlighted that many of the issues and challenges being experienced in audits of LCEs was not unique to LCEs, but could also apply more broadly for many other audits. In particular, issues in applying the ISAs related to complexity, understandability, scalability and proportionality for all audits was highlighted.

Proposed Actions for Two Workstreams

10. Based on discussions with the IAASB in December 2019 and April 2020, the Board was generally supportive of progressing two workstreams to address the comments to the DP (including those issues specific to LCE's but also that affect the ISAs more broadly). However, there were concerns about **how** the work would be undertaken in each of the workstreams, as well as how the two workstreams would interact given the different projected timing. **Appendix 2** to this Agenda Item sets out the draft minutes from the April 2020 IAASB videoconference.
11. **Appendix 3** sets out a high-level illustration of the two workstreams. Each of the workstreams, and how they interact, is described further below.

ISA Focused Workstream

12. The objective of this workstream is to enable more consistent and effective use of the ISAs through a focus on how the ISAs are written and presented.
13. The focus of this workstream would be to address issues related to complexity, understandability, scalability and proportionality more broadly (than only LCEs). The LCE Working Group envisions the following:
 - *Step 1:* Develop drafting principles and guidelines.
 - *Step 2:* Consult on these drafting principles and guidelines, and finalize in light of stakeholder input.
 - *Step 3:* Determine the appropriate way forward for using the drafting principles and guidelines within the ISAs (i.e., a decision will be made at that later stage about the nature and extent of any project to revise the ISAs, for example making changes on a rolling basis, as projects are opened up, or in a substantial project to revise all of the ISAs or in a phased manner focusing on groups or clusters of ISAs at a time).

14. Initial activities to develop the “drafting principles and guidelines” will likely include:
- Assembling the ‘Clarity drafting conventions’ in an organized and comprehensive manner so that they can be applied consistently as new standards are developed or extant standards are revised.
 - Considering how the new presentation principles used in the revision of ISA 315 (Revised 2019), and other recently revised ISAs, would be helpful to the ISAs more broadly, in particular with a focus on what was done regarding scalability and proportionality.
 - Considering how drafting of the ISAs can be undertaken using clear, plain language, avoiding duplication, repetition of requirements and cross-referencing where unnecessary.
15. As part of the work undertaken in relation to the ISA focused workstream, consideration is needed as to what specific (possibly separate) actions are needed with regard to the documentation requirements within the ISAs, both within ISA 230¹² and within individual ISAs. This may also involve the development of non-authoritative materials.
16. In addition, although not forming part of the activities of this workstream, IAASB Staff have commenced activities to convert the IAASB’s paper handbook to a digital format. This initiative will deliver a solution with enhanced functionality and will address some of the usability concerns related to the ISAs. It is expected that the digital version of the handbook will be available for use early in 2021.
17. In developing the drafting principles and guidelines as described above, there would be specific, clear actions to address complexity and understandability. However, it may not be as clear with regard to the actions relating to scalability and proportionality. A significant part of the issues relating to scalability and proportionality will be addressed by the ‘separate standard workstream.’ There may also be some aspects addressed when developing the drafting principles and guidelines (for example it may be decided to present examples illustrating complex circumstances as well as non-complex circumstances to illustrate how a certain requirement can be applied in different ways). At this stage, until the work in the two workstreams has been sufficiently progressed, it is difficult to assess whether more is needed with regard to scalability and proportionality. Accordingly, it is proposed that in the consultation on the drafting principles and guidelines that this be specifically addressed, for example through a specific question about whether more is needed with regard to scalability and proportionality.

Separate Standard Workstream

18. The objective of this workstream would be to address issues and challenges specific to audits of LCEs through the development of a separate standard for audits of LCEs. The focus of this workstream would be to address issues related to complexity, understandability, scalability and proportionality **specifically for LCEs**.
19. **Section III** below sets out the LCE Working Group’s recommendations for the development of the separate standard.

¹² ISA 230, *Audit Documentation*

Interaction of the Two Workstreams

20. As many of the same issues and challenges may be addressed in both workstreams (notwithstanding that the separate standard workstream is more focused on LCE's), it is essential that the two workstreams run in parallel to inform each other as work is progressed. For example, the separate standard would be developed using the drafting principles and guidelines (where relevant), and as the separate standard is developed and more thought is given to scalability and proportionality, the learnings could be incorporated into the drafting principles and guidelines as appropriate.
21. It is envisioned that the drafting principles and guidelines will be developed (i.e., Step 1 in paragraph 13 above) during the same period as the exposure draft of the separate standard is developed. Consultation on the drafting principles and guidelines (i.e., Step 2 in paragraph 13 above) is targeted for the same period that the exposure draft of the separate standard is targeted to be consulted on. It is also intended that the drafting principles and guidelines are finalized before completion of the separate standard so that these can be used when finalizing the separate standard (where appropriate).

How the Issues and Challenges Identified Relating to Audits of LCEs Will be Addressed by the Two Workstreams

22. The DP explored issues and challenges when applying the ISAs in auditing LCEs. The following sets out the 'root causes' identified by respondents to the DP (as set out in the IAASB's Feedback Statement) relating specifically to audits of LCEs,¹³ and how the work proposed above will address these issues or challenges:

Significant Issues or Challenges Identified in relation to the ISAs	LCE Working Group's and Other Proposed Responses
<ul style="list-style-type: none"> Overall length and volume of the standards 	<ul style="list-style-type: none"> Development of a separate standard¹⁴ that focuses on the principal procedures appropriate for the audit of an LCE Converting the IAASB's handbook to an electronic format
<ul style="list-style-type: none"> Complexity is an issue, as well as an increasing level of prescriptiveness 	<ul style="list-style-type: none"> Development of drafting principles and guidelines to sustain consistent, principles- based standards Development of a separate standard with straightforward procedures to reduce the complexity of using the full set of ISAs¹⁵

¹³ The DP was focused on audits of LCEs.

¹⁴ Refer to **Sections II** and **Section III** of this paper that provide relevant context in terms of the LCE Working Group's recommendations for exploring the development of a separate standard.

¹⁵ Presently, the ISAs in the 200 to 700 series apply to an audit of financial statements, with ISA 800 (Revised), *Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* and ISA 805 (Revised), *Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, dealing with special considerations for audits other than an audit of a complete set of general purpose financial statements.

<ul style="list-style-type: none"> Some prescribed procedures in some cases do not have a benefit or add little value 	<ul style="list-style-type: none"> Development of a separate standard with focused, straightforward procedures Aspects of this may be addressed in changes to the ISAs for the drafting principles and guidelines (although that workstream is not intended to address the principles and the underlying work effort related to specific requirements)
<ul style="list-style-type: none"> Lack of support tools and guidance 	<ul style="list-style-type: none"> The IAASB's Strategy for 2020–2023 has a greater focus on the implementation of the IAASB's standards, including activities and the development of support materials where appropriate. The Strategy also sets out that the IAASB will coordinate / encourage others with regard to broader support tools and guidance As both workstreams progress, further consideration will be given to activities to support implementation of the IAASB's standards, including the development of support tools and materials as appropriate
<ul style="list-style-type: none"> The DP asked a question as to which specific ISAs, and parts of ISAs, were challenging. This provided a rich dataset of feedback on the ISAs. Specific ISAs highlighted include ISA 230 (documentation), ISA 240¹⁶ (fraud), ISA 315 (Revised 2019) (identifying and assessing risks) and ISA 540 (Revised) (accounting estimates) 	<ul style="list-style-type: none"> Work has commenced in relation to the topic of fraud, including ISA 240 (and all comments raised with respect to audits of LCE's will form part of the considerations for what needs to be addressed in that project) in addition to focused consideration on fraud specific to LCE's in the separate standard workstream ISA 315 (Revised 2019) has recently been revised. Implementation support materials to help with the implementation of the revised standard are currently being developed ISA 540 (Revised) has recently been revised and a post-implementation review is planned to commence in 2021 to identify any specific issues related to the revised standard It has been recommended that as part of the work in the ISA focused workstream that ISA 230 is focused on, in addition to addressing documentation specific to LCE's in the separate standard workstream (see paragraph 70)

23. **Section I** of this Agenda Item is intended to provide context for the two workstreams together. There is still much work to be undertaken with respect to the ISA focused workstream, including the specific planned activities to develop the drafting principles and guidelines. Further progress on this will be made in the second half of 2020, and it is intended that recommendations with regard to this

¹⁶ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

workstream are discussed with the Board at the December 2020 IAASB meeting. The remainder of this paper focuses on the recommendations for developing a separate standard.

II. Description of LCEs and Its Possible Applicability in Audits of Financial Statements

24. A consideration in the development of a separate standard is the types of entities for which the standard could appropriately be used (i.e., the content of the standard would be reflective of a typical audit for these types of entities).
25. This section sets out initial views of the LCE Working Group in this regard, but further consideration of these matters will be needed as the development of a separate standard is progressed.

Description of LCEs

26. The use of the term “LCE,” and whether this is a ‘defined’ term within the standards depends on what the term will be used for. The LCE Working Group has the view that this term would be used for two purposes:
 - For use in the ISAs for specific LCE considerations within the application material.
 - To describe the types of entities that the separate standard has been developed for.
27. Within the current standards the IAASB’s Glossary contains a description of “smaller entity” to explain the types of entities to which the term applies when it is used within the IAASB’s standards. The present definition of “*smaller entity*” as set out in the IAASB’s Glossary is provided in **Appendix 4**.
28. The DP asked for views from respondents about how an LCE could be described. This included whether the present definition of “*smaller entity*” within the ISAs, which sets out some qualitative characteristics, would be appropriate for the IAASB’s work in relation to audits of LCEs, and if there are any other characteristics that respondents believed would be relevant for determining an LCE. Respondents to the DP were broadly supportive of a description using qualitative characteristics, and offered views about both the types of entities that should be included as well as about appropriate qualitative characteristics that could be used.¹⁷
29. In respect of the definition of an LCE, it is the LCE Working Group’s view that it would be more appropriate to characterize the term ‘less complex entity’ as a “description” rather than a “definition.” Developing a detailed and prescriptive definition would not be beneficial or a preferred approach, because it would not be possible to prescriptively determine applicability in all individual jurisdictions (considering the variety of legal or regulatory requirements and other relevant circumstances of each jurisdiction).
30. Also, having a broad description of an LCE based on qualitative characteristics about a type of entity, or type of audit, for which it would be suitable for the auditor to plan and perform an audit using the separate standard, would help the IAASB’s stakeholders understand the intended applicability (or scope) of the standard.

¹⁷ A detailed summary of the input received can be found in the December 2019 IAASB Board papers ([Agenda Item 6](#))

Types of Entities that Should Not be Considered LCEs

31. Although respondents to the DP had the view that determining whether an entity be designated as an LCE for the purpose of using a separate standard should be a judgmental decision based on the nature and circumstances of the entity, there were strong views from some that a separate standard should not apply to certain kinds of entities. Feedback on the LCE ‘definition’ included:
- (a) Given that both large and small entities can be complex, it is important that the LCE definition avoids any ambiguity as to what is, and what is not, included. It was noted that there is an expectation gap as to the auditor’s procedures for certain types of entities because of their public interest nature, regardless of size or complexity of the entity itself;
 - (b) That the description should provide adequate consideration for entities classified as Public Interest Entities (PIEs) as defined by the International Ethics Board for Accountants’ (IESBA) Code of Ethics¹⁸, and national regulations, including unlisted banks and insurers, entities receiving a significant portion of its income from public sources, charities, or entities raising crowdfunding, given that such entities tend to have greater public accountability and carry a higher overall risk; and
 - (c) Mixed views on excluding ‘listed’ or ‘public interest entities’ from the description (i.e., excluding from the scope entities listed in regulated markets or those who have issued public debt), with the one MG respondent strongly noting that any standard(s) for LCEs, and any specific guidance or application material developed, should not be applicable to listed entities, irrespective of their size or complexity.
32. Further, in respect of group audits, the MG respondent expressed the view that while they agree with the concept of “less complex entity” and that this concept is better aligned with the risk-based approach of the ISAs, a distinction may be particularly relevant in the context of groups and consolidated financial statements, for example when a number of LCEs may be included in a complex consolidation and that specific procedures may need to be performed in relation to those entities to address the requirements for the group audit.
33. The LCE Working Group believes it is necessary to be clear about the types of entities for which the separate standard for audit of LCEs may not be suitable, but acknowledges that more work is needed on the description.
34. It is envisioned that the separate standard for audits of LCEs will be developed taking into account the specific characteristics of LCEs (i.e., to distinguish the audits of LCEs from the many circumstances that could lead to complexity either in the audit or because of the nature of the entity, which would not be addressed by procedures within the separate standard).
35. The separate standard would therefore not be considered suitable for certain types of entities, for example:¹⁹
- Listed entities (or those entities in the process of being listed) that would likely have complexity around laws and regulations (e.g., compliance with listing rules, etc.) which would not be addressed by the separate standard.

¹⁸ The International Code of Ethics for Professional Accountants (including International Independence Standards) (IESBA Code)

¹⁹ These examples are shown for illustrative purposes – no firm decisions have yet been made with regard to the content of the standard. The examples are meant to provide illustrations of what is likely not to be addressed within the standard.

- Complex groups. Although further consideration is needed as to how group audits are addressed within the separate standard, it is unlikely that it would include procedures in respect of large, complex group structures involving the use of many component auditors.
- Entities using internal auditors, as procedures relating to internal auditors would likely not be included in the separate standard.

Accordingly, it would likely be unsuitable to use the separate standard for such entities.

36. However, to prevent any inappropriate use of the standard, the LCE Working Group believes a more explicit statement regarding the use of the standard by entities that are listed (or in the process of being listed) is needed (i.e., such entities should not be using the standard).²⁰ Such approach would align with the analysis of the jurisdictional initiatives who have developed separate standards for audits of less complex entities and in which listed entities have been specifically excluded from the scope of the jurisdictional LCE standards.²¹
37. Further, the LCE Working Group recognizes that the decision for which audits are permitted to use the separate standard will rest with legislative and regulatory authorities, or national standard-setters or others as appropriate, in individual jurisdictions. Such authorities would need to prescribe more closely the suitability of the standard considering their specific circumstances.
38. Also, some auditing firms may choose to not use the standard for audits of LCEs within their firms or networks (as they may already have developed audit methodologies tailored for applying the full ISAs to audits of LCEs).

Characteristics of an LCE

39. As noted above, respondents to the DP supported a principles-based approach using qualitative characteristics, and indicated that the current definition of a “*smaller entity*” in extant ISAs has broadly proven to be appropriate and relevant (although certain specific concerns were highlighted – see below).
40. The qualitative characteristics of ‘smaller entity’ were considered by respondents to be a good starting point for developing the LCE description. Further, respondents broadly agreed that the qualitative characteristics should not be used as a checklist, but rather all factors should be considered together. It was also highlighted that judgement should be applied when determining the LCE designation. Respondents also noted that the LCE designation for a specific entity should be a continual assessment that could change over time.
41. Respondents expressed concern that the characteristics of a “*smaller entity*” continue to emphasize size and volume, and noted in some cases it was not clear what was meant by certain descriptors, for example ‘simple’ record keeping or ‘few’ lines of business. There was a call for clarity in the qualitative characteristics used.
42. Respondents also called for further guidance and examples on how to weigh the importance of the various qualitative characteristics which would be necessary to avoid ambiguity, ensure consistent application of

²⁰ The LCE Working Group will also continue to monitor the IESBA’s PIE project and its outcomes, and may revisit its recommendations and expand this limitation as development of the separate standard progresses.

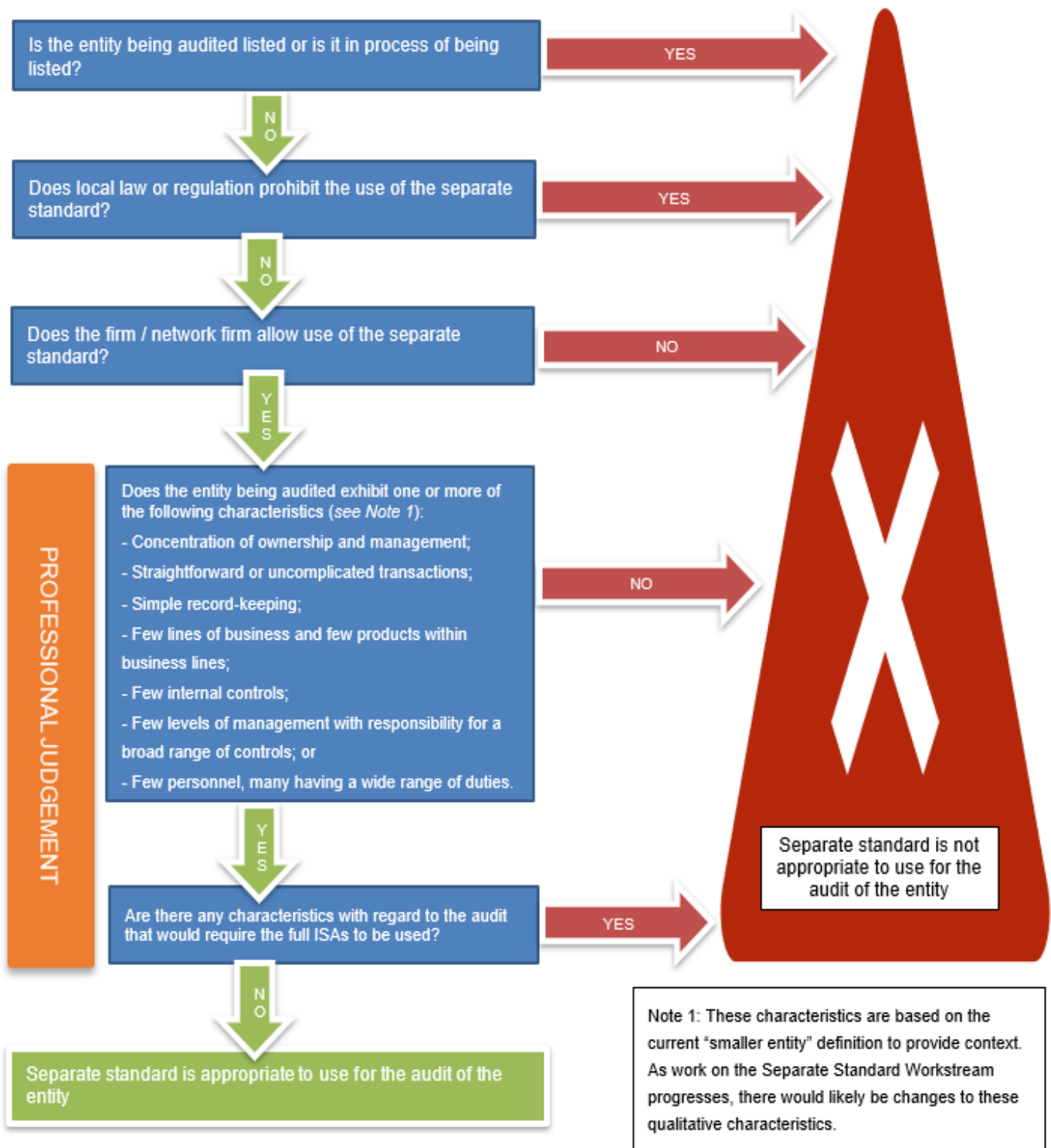
²¹ An analysis of the jurisdictional initiatives who developed standards for audits of LCEs was provided in [Agenda Item 9](#), presented at the IAASB 14 April 2020 videoconference.

the LCE designation across jurisdictions, and reduce the risk of improper classifications, which otherwise may result in an adverse effect to audit quality.

43. The LCE Working Group believes that the present characteristics of a “*smaller entity*” within the ISAs provide an appropriate starting point. These characteristics are principally indicative of the types of characteristics that could be used for the description, while recognizing that further consideration needs to be given to the specific qualitative characteristics to be included, including how they are described.
44. The current qualitative characteristics of a “smaller entity” are a mix of those about the entity itself, while others could be seen to be about the audit. Further exploration is needed about:
 - What drives ‘complexity’ and how the description of an LCE would be influenced by this (for example, does the need for the use of an expert in an audit exclude that audit from being able to be undertaken using the separate standard);
 - The most appropriate qualitative characteristics to be included in the description of an LCE; and
 - Whether the characteristics are about the entity, or the audit, or both.
45. The LCE Working Group also notes that the qualitative characteristics are not intended to be used as a checklist. They will need to be considered individually and in aggregate, and judgement will need to be applied in making the determination.

Using the Separate Standard

46. As discussed above, there are a number of variables that will influence whether the separate standard could be used or not. As the separate standard will be developed with a specific type of entity in mind, there will be some entities where it is inappropriate to use.
47. A series of decisions, depicted in the diagram below, could help in determining whether the separate standard could be used (note, the qualitative characteristics presented in the diagram are based on the current description of ‘smaller entity’ and are shown for context only – these would be updated as the LCE Working Group develops the appropriate description to be used). This decision tree is for illustrative purposes only and there is no intention (at this stage) for this to form part of the separate standard:



III. Principles for Developing the Separate Standard for Audits of LCEs

Approach to Developing the Separate Standard

48. At the April 2020 IAASB videoconference, the LCE Working Group presented proposed actions (in [Agenda Item 9](#)) for exploring the development of a separate standard. Although generally supportive of exploring the development of a separate standard, the Board had concerns about how this would be undertaken. The concerns raised were broadly related to:
- Needing more clarity about what the standard would encompass (i.e., the principles that would be used to develop the standard), and
 - The process for making sure that the separate standard would meet the needs of stakeholders in relation to a separate standard.
49. To help understand *how* the separate standard could be developed, the LCE Working Group has established overarching principles for the development of the separate standard (as outlined below). Proposed actions to obtain input from relevant stakeholders over the course of the development of the standard (i.e., regular check-ins with targeted stakeholders to confirm the principles being used, and about the feasibility and usability of the separate standard as it is being developed) are also set out below.

Objective of a Project to Develop a Separate Standard

50. The objective of the project is to develop a separate standard for conducting an audit to obtain reasonable assurance about whether the financial statements are prepared in accordance with an applicable financial reporting framework and as a whole are free from material misstatement, whether due to fraud or error. The standard will be tailored for LCEs and address the issues and challenges identified in relation to such audits, using the overarching principles set out below.

Overarching Principles for the Development of the Separate Standard

51. In order to meet the objective above, the overarching principles set out below provide the parameters and intended outcomes, and will guide the development of the standard:
- (a) Methodology for Developing the Separate Standard (see paragraphs 53 – 59 below):
- **Based on the ISAs**, with similar underlining concepts as the ISAs.
 - Approach to the audit is a **risk-based approach** so that it can be applied to entities with a wide range of circumstances (with the common feature of the audit being less complex).
 - **Principle-based requirements** setting out the **auditor's obligations** to help determine what needs to be done.
 - Including **objectives** for each section to help the auditor understand the extent of work needed to achieve the relevant objective.
 - Focusing the auditor on the use of **professional skepticism** and **professional judgment** in undertaking their work.
 - Premising the standard on the auditor complying with **relevant ethical requirements**, and the firm (which includes sole practitioner) being subject to the underlying **quality management standards**.

- (b) Intended Outcomes from the Audit Work Using the Separate Standard (see paragraphs 60 – 63 below):
- **High-quality audit** that would enhance the credibility of the financial statements for the users thereof.
 - A **reasonable assurance** opinion.
- (c) Other Development Principles (see paragraphs 64 – 72 below):
- Drafting the standard using **concise, direct, simple language**, following **predefined drafting principles and guideline**, and in an order that **follows the flow of the process of an audit**.
 - **Basis for opinion** based on **compliance with the separate standard** (not the ISAs).
 - Establishing **clear, consistent documentation requirements** that would apply to the LCE audit.
 - **No (or very limited) application material**; ability to refer to applicable material within the ISAs where relevant.
 - Intention to be able to use “full” ISAs where a matter is not addressed by the separate standard.

There will also be other focus areas, for example the auditor’s considerations of fraud unique to an LCE audit, but these will not be addressed as overarching principles and will be focused on as the separate standard is developed.

52. These principles for the development of the separate standard are described further below. **Supplement to Agenda Item 4** sets an example of a standard for auditing SMEs using similar principles (the designation LCE had not been used at the time of development of the example standard, but as LCE and SME would encompass many similar characteristics the example can be used to illustrate some of the principles below). It is not intended that the Supplement be discussed, it is presented for illustrative purposes only.

Methodology for Developing the Separate Standard

Principles, Risk-Based Approach

53. Drafting a standard using a principles, risk-based approach could be achieved by using the ISAs as a guideline. This would entail identifying those core procedures within the ISAs that need to be undertaken in an audit (where they would be relevant in an audit of an LCE) and ‘repackaging’ them in a separate standard.
54. It is intended that many of the basic concepts used in the ISAs to support the risk-based approach would also be incorporated, including:
- The use of materiality;
 - Obtaining sufficient appropriate audit evidence to support the audit opinion; and
 - Using the audit risk model, i.e., applying the concepts of inherent risk, control risk and detection risk.

Objectives of the Auditor for Each Section

55. Within each section of the standard, the objective of the auditor will be presented to provide a link between the requirements and the overall objectives of the auditor. Where applicable, the objectives will be similar to the individual objectives within the ISAs.
56. The objectives serve to focus the auditor on the desired outcome of the audit work while assisting the auditor in:
- Understanding what needs to be accomplished; and
 - Deciding whether more needs to be done in the particular circumstances of the audit.

The objectives can also be used by the auditor in determining whether sufficient appropriate audit evidence has been obtained.

Professional Skepticism and Professional Judgment

57. The same underlying concept of professional skepticism would apply as it would in an ISA audit. In drafting the separate standard, further consideration will be needed about how to encourage the exercise of professional skepticism when designing and performing audit procedures, evaluating the results and concluding.
58. Using a risk-based approach also necessitates the exercise of professional judgment in planning and performing the audit, and would be applied in the same way that it would in an ISA audit.

Relevant Ethical Requirements and Quality Management Standards

59. The standard will be developed on the premise that the relevant requirements of the IESBA Code of Ethics (or other requirements that are at least as demanding) apply and that the practitioner who is performing the engagement is a member of a firm that is subject to quality management standards at least as demanding as ISQC 1.²² In this respect, a similar approach as with ISAE 3000 (Revised)²³ that deals with assurance engagements other than audits or reviews of historical financial information can be applied.

Intended Outcomes from the Audit Work Using the Separate Standard

High-Quality Audit

60. Similar to the ISAs, the separate standard would set out the requirements, that taken together, would fulfill the overall objective of the auditor (i.e., express an opinion based on the audit evidence obtained).²⁴ These requirements would be tailored to suit the circumstances of less complex entities, and if complied with would support how the auditor obtains sufficient appropriate audit evidence as the basis for the reasonable assurance opinion.
61. The development of the separate standard for auditing LCEs is intended to make such audits more effective and efficient, taking into account the characteristics and circumstances of the entity and the

²² International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

²³ International Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements other than Audits or Reviews of Historical Financial Information*

²⁴ Similar to the overall objectives of the auditor in ISA 200, paragraph 11

audit engagement. It is envisioned that this will be possible through making the auditing standard being used easier to understand and apply. For example, auditors of LCEs will not need to spend time working out what is applicable and what is not, as it should be clearer what the required procedures²⁵ are when the circumstances of the entity and the audit are less complex. The auditor would therefore be able to invest more time tailoring the audit and executing the procedures that more effectively targets the identified risks of material misstatement, thereby improving the overall quality of the audit.

62. However, it is not envisioned that the development of the separate standard will necessarily reduce the core procedures the auditor is required to perform to support a high-quality audit. There has been a strong message that the separate standard should be based on the ISAs, and retain the robustness of an audit using the ISAs. Accordingly, the separate standard would present the requirements for an audit of an LCE based on the core requirements of the ISAs but drafted and presented in a more understandable and straightforward way.

Reasonable Assurance

63. The LCE Working Group has the view, at this stage of the project, that based on the principles as set out in paragraph 51 above, an audit of an LCE that is planned and performed in accordance with the separate standard would support a reasonable assurance opinion. Key contributing principles to achieve a reasonable assurance opinion (in a similar way to the ISAs) include:

- A **risk-based audit** encompassing the audit risk model (i.e., designing and performing audit procedures to reduce audit risk to an acceptably low level to enable the auditor to draw conclusions on which to base the auditor's opinion).
- **Establishing** specific **objectives** for the work to be performed to ensure that sufficient appropriate audit evidence is obtained to be able to conclude.
- **Using the core ISA procedures and concepts** (such as professional judgment) as a base for establishing the work effort of the auditor when performing an audit of an LCE assist in obtaining sufficient appropriate evidence to reduce audit risk to an acceptably low level in the same way as the ISAs, and therefore forming the basis for a reasonable assurance opinion.

Other Development Principles

Drafting Principles and Guidelines

64. One of the most fundamental principles in drafting the separate standard will be “to keep it straightforward.” This is in terms of the structure, the flow, the way that the procedures are described and how the standard is presented.
65. As the drafting principles and guidelines are developed in the ISA focused workstream (see **Section I**), these principles and guidelines will be used for drafting the separate standard where appropriate. For example, keeping the requirements within the standard focused, keeping the description of the requirements understandable, reducing any cross referencing and avoiding repetition.
66. Furthermore, it is envisaged that the separate standard would be presented to follow the flow of an audit more closely. This would help with the practical understanding of how the requirements in the standard should be implemented.

²⁵ Work still needs to be undertaken to determine what the ‘core procedures’ are to support a high-quality risk-based audit.

Basis for the Auditor's Opinion

67. The separate standard will set out the auditor's overall responsibilities when conducting an audit in accordance with that standard. It will set out the overall objectives of the audit and explain, through requirements, the nature and scope of the audit to enable the auditor to meet those objectives. Accordingly, in the auditor's report, consistent with the reporting requirements in ISA 700 (Revised),²⁶ the auditor would need to explain the standard used in obtaining sufficient appropriate audit evidence as a basis for the audit opinion being reported.
68. Notwithstanding that the broader content of the auditor's report has not yet been considered in detail (nor modifications thereof), the LCE Working Group is of the view that a statement asserting that the separate standard was used would also need to be incorporated into the auditor's report for an audit of an LCE using the separate standard.
69. Such a statement would be consistent with the Board's view (in April 2020) that the opinion paragraph of the separate standard for audits of LCEs should clearly indicate that the audit had been performed in accordance with the LCE standard, so as to avoid confusion of users about which standard(s) had been applied in the audit, thereby ensuring international comparability. The proposed approach outlined would also be consistent with other IAASB pronouncements outside of the ISA suite (for example, ISAE 3000 (Revised)).

Clear, Consistent Documentation Requirements that Would Apply to LCE audits

70. The separate standard would establish clear and consistent documentation requirements relevant and appropriate to an audit of an LCE. In doing so, the documentation requirements would include the overriding principle that the documentation needs to be sufficient to enable an experienced auditor, having no previous experience with the audit, to understand the nature, timing and extent of the audit procedures undertaken, the results of the audit procedures and the audit evidence obtained, significant matters arising during the audit, and professional judgements made in reaching conclusions.

Application Material

71. Since the entities audited under the separate standard are less complex, the intention is to develop requirements that are more direct and straightforward. As such, it is anticipated that no or very limited application material would be necessary to explain what a requirement means or is intended to cover. As the separate standard would be 'based on' similar concepts and core procedures as the ISAs, where they are relevant in an audit of an LCE, there would be a presumption that the auditor using the separate standard would have a good working knowledge of the ISAs. Therefore, if the auditor needed additional guidance about how to implement a certain requirement they could revert to the ISAs.

Fit of the Separate Standard Within the ISA Structure

72. The relationship between the separate standard and the ISAs, and its placement in terms of the IAASB's standards, should allow for being able to use the "full" ISAs where a matter is not addressed by the separate standard (either requirements or relevant application material). However, the LCE Working Group still needs to fully consider how this standard interacts with the ISAs (where needed).

²⁶ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 28

Development of the Separate Standard

73. In considering the options for a possible basis for development of the separate standard, the LCE Working Group believes that the Example Draft SME Standard developed by the IAASB informal working group²⁷ is a good starting point for further work to develop a separate standard. In the view of the LCE Working Group this would expedite the process for the development of a separate new standard and would leverage the extensive thinking that has already been done. However, the working group also acknowledges that there is substantial work required to convert this to an IAASB proposed standard (including, but not limited to, making changes for recently finalized standards not yet reflected in the example, and to address any areas that may still be required to be added (and where no discussions have yet taken place or decisions made) such as group audits).
74. It is intended that as part of the development process, all the requirements within the to-be-developed separate standard will also be mapped back to the relevant ISAs to ensure completeness, to help ensure the separate standard maintains the same robustness as the ISAs.
75. Furthermore, consideration will also need to be given to:
- Whether more specific guidance materials may be needed to support the effective implementation of such a separate standard (not necessarily for the IAASB to develop but working or coordinating with others to ensure that there is adequate implementation support when implementing and using the separate standard), and
 - How the standard will be updated when underlying ISAs are revised, i.e., whether an approach is taken to maintain a 'stable platform' by say revising the separate standard only every 3 years, or another approach.

Outreach

76. The Board encouraged that further, more specific, outreach and consultations are undertaken with stakeholders as the separate standard is developed. Broadly, this would be to ensure that the separate standard will actually address the issues that have been raised, and would therefore be used. In this regard, views were expressed that as the work is undertaken and when significant proposals are made (or milestones reached), these be "checked" along the way to ensure that the final output will meet stakeholder needs or expectations.
77. The LCE Working Group has further considered how this could be achieved without the perception of further outreach looking like a further delay (there has been significant information gathering on this topic to date). Accordingly, it is proposed that, during the development of the standard:
- A group of targeted, relevant stakeholders is used to 'test' the proposals at strategic times during the development of the standard, for example the 'basic fundamental principles' (as set out in this Agenda Item) that are agreed on could be the initial matters tested with such a group. This could be done via a videoconference roundtable. Further consideration will be needed as to the composition and status of such a group.
 - The IAASB ask national standard setters (NSS) (and possibly other professional accountancy organizations through IFAC) to obtain views from policymakers who are responsible for laws or regulations on who has to apply auditing standards (which will vary in each jurisdiction—for example in some jurisdictions this may be government, in others it may be the professional

²⁷ Further context is provided in the Supplement to Agenda Item 4

accountancy organization), whether the standard being developed would meet their needs and be considered for adoption. This could only be done, however, when the project is further advanced (for example later in 2020) as these discussions would need a basis (i.e., even if indicative that the standard would be adopted there would need to be enough information provided for an informed view to be able to be provided).

- The LCE Working Group also believes it is important to obtain the views of regulators and audit oversight bodies about the separate standard (such as International Forum of Independent Audit Regulators (IFIAR) and the International Organization of Securities Commissions (IOSCO)) once a draft has been sufficiently progressed.
78. The LCE Working Group will also continue with normal outreach activities related to this project. In addition, it is still the intention of the IAASB to convene the “3rd Paris Conference” once the separate standard has been finalized for consultation.

Appendix 1

LCE Working Group

LCE Working Group Members

1. The LCE Working Group brings together a diverse group of international professionals including representatives from academia, the auditing and accounting profession and practitioners working with LCEs, each bringing together unique insights and perspectives in relation to audits of LCEs. The LCE Working Group consists of the following members:
 - Roger Simnett (Chair), current chair and CEO of the Australian Auditing and Assurance Standards Board, a member of the New Zealand Auditing and Assurance Standards Board and a Scientia Professor of Accounting at UNSW Sydney Business School, Australia. In both Australia and New Zealand over 95% of the audits undertaken in accordance with the ISAs are classified as SMEs.
 - Isabelle Tracq-Sengeissen (assisted by Fabien Cerutti), audit partner at EY in France and deputy chair of the auditing standard board of Compagnie Nationale des Commissaires aux Comptes (CNCC). Mrs. Tracq-Sengeissen is involved in the development of auditing and accounting profession in foreign countries, especially in French speaking African countries. Mrs. Tracq-Sengeissen is also IAASB Liaison to the IFAC SMPC.
 - Kai Morten Hagen, Technical Director at the Norwegian Institute of public accountants (DnR) and Vice chair of the Audit & Assurance policy group in Accountancy Europe responsible for SME audit. In this role, he supports the auditing standard setting board in Norway and is responsible for DnR's work relating to audit and assurance matters. Mr. Hagen is also Vice Chair of the Accountancy Europe's Audit & Assurance Policy Group (responsible for SME audits). Mr. Hagen was also integrally involved in the DnR's work to develop an auditing standard for SME's and formed part of the IAASB's informal working group.
 - Chun Wee Chiew, regional head of policy for ACCA, supporting its advocacy and policy work across Asia Pacific, including Australia, China, Hong Kong, Malaysia, Mekong region, and Singapore. Mr. Chiew is also IAASB Liaison to IFAC's SMPC.
 - Rich Sharko, partner in the PwC Audit and Assurance practice in Amsterdam, with extensive experience focusing on providing accounting advice to the financial institution industry. He is also a member of the PwC network's global board.
 - Brendan Murtagh, previous IAASB member representing SME/SMPs. Mr. Murtagh is a practicing auditor providing audit and related services with a focus on owner managed and other SMEs. Mr. Murtagh is a Technical Panel Member of the Irish Auditing and Accounting Supervisory Authority and is a previous Global President and Council Member of ACCA. Mr. Murtagh also formed part of the IAASB's informal working group.
 - Gordon Cummings, a practicing auditor providing audit, review engagement, and related services to owner-managed small businesses, startup and growth-stage public companies, not-for-profits, and charities. Mr. Cummings is a former member of the Canadian Auditing and Assurance Standards Board and also formed part of the IAASB's informal working group.
 - Christopher Arnold is a Director at IFAC and Head of SME/SMP and Research. Mr. Arnold started his career as a Small Business Policy Adviser at the Association of Chartered Certified

Accountants (ACCA), before qualifying as an accountant in a mid-tier accountancy practice in London, moving to Deloitte and then IFAC where he has worked with a SMP/SME focus for the last 7 years.

Further information about the project can be found [here](#).

Working Group Activities since the April 2020 IAASB Discussion

2. The LCE Working Group had four videoconference (May 2020) since the last IAASB discussion in April 2020.

Appendix 2

Draft Minutes²⁸ from the April 2020 IAASB Videoconference Audits of Less Complex Entities (LCEs)

Prof. Simnett, Chair of the Less Complex Entities (LCE) Working Group introduced the session, explaining the LCE Working Group's further work to explore an appropriate way forward in relation to Audits of LCEs, as included in **Agenda Item 9**. The Board was generally supportive of progressing two separate workstreams, one focused on exploring a separate standard specifically and how it can address issues relating to audits of LCE's, and another workstream to explore how to address issues relating to the ISAs more broadly.

The following sets out the more substantive comments, suggestions and concerns from the Board.

ISA FOCUSED WORKSTREAM

The Board generally supported the development of "drafting principles and guidelines for a revised presentation of the standards," which would underpin the drafting of the ISAs and help promote clarity and consistency for audits of all entities (including audits of LCEs). The Board asked the LCE Working Group to further consider:

- The proposed timeline to develop these, in light of the work that has been undertaken previously with developing the Clarity conventions and the 'drafting approach' applied when revising ISA 315 (Revised 2019)²⁹; and
- How the consistent use of such drafting principles and guidelines for a revised presentation of the ISAs would continue to be used over time.

In respect of the timing and manner in which the ISAs could be revised, various views were expressed about how the drafting principles and guidelines for a revised presentation of the standards could be applied to the ISAs once they had been developed, but it was acknowledged that they needed to first be developed, with a decision thereafter on the appropriate way to apply them.

The Board also encouraged the LCE Working Group to:

- Provide further clarity to the Board about how the issues that have been identified and outlined at earlier meetings are being addressed, and whether what was being proposed would address these issues. It was suggested that in this regard further outreach with the International Federation of Accountants Small and Medium Practices Committee and other targeted stakeholders may be needed;
- Clarify how the two workstreams interacted with one another;
- Further consider whether the concerns in respect of scalability and proportionality are being addressed adequately with the work that was being proposed in both workstreams; and
- Reconsider how the "pain points" that had been specifically identified were being dealt with.

Board members also supported the conversion of the handbook to a digital format for enhanced accessibility and searchability.

²⁸ These draft minutes are still subject to review by the IAASB and therefore further changes may be made.

²⁹ ISA 315 (Revised 2019), *Identifying and Assessing the Risk of Material Misstatement*

SEPARATE STANDARD WORKSTREAM

Notwithstanding that the Board broadly supported a workstream to explore the development of a separate standard, some concerns were expressed about how this would be done and whether it would achieve the objectives for undertaking the work. The Board encouraged the LCE Working Group to focus on how the separate standard could be developed so that the Board could better understand the implications of the LCE's Working Group's proposals in this regard.

With regard to this workstream, the Board encouraged that:

- Significant proposals be tested and checked along the way to ensure that the final output will meet stakeholder needs and expectations, i.e., that the significant proposals are checked on an ongoing basis during the development process for early feedback to make sure that the proposals will actually address the issues that have been raised and that the separate standard would be used;
- The LCE Working Group perform further outreach with policy-makers to understand whether, in principle, the new standard would be adopted (and used); and
- Further clarity be provided about how the standard would be developed, including explaining the objectives for the work and the principles used to develop the separate standard. In particular that it was noted that there would need to be clarity about how this standard would relate or interact with the ISAs.

The LCE Working Group was also cautioned about moving too quickly without having the underlying principles properly developed. However, it was also highlighted that the Board needed to consider the consequences or risks of not acting in a timely manner in this regard.

In respect of the matters for further consideration by the LCE Working Group while determining the applicability of the separate standard for audits of LCEs, the Board encouraged the LCE Working Group to further consider:

- Which types of entities would be able to use the standard. In particular, there was support from the Board for excluding listed entities. In this regard, the Board also encouraged that the LCE Working group continue to monitor the IESBA's project on the definition of Listed Entity and Public Interest Entity (PIE); and
- The relationship between the applicability of the separate standard for LCEs and the extant ISAs in relation to the membership obligations for Forum of Firms.

The LCE Working Group was also asked to further consider the basic principles in light of excluding specific entities, for example listed entities, and how that would interact with some of the basic proposed principles such as reasonable assurance.

PIOB OBSERVER REMARKS

Mr. Matsumoto expressed concern for the development of a separate standard for audits of LCEs outside the extant ISAs, noting a preference that the applicability of such standard should exclude listed entities and those with public accountability. Further, in order to avoid confusion among users as to which standard has been applied in the audit, the auditor's report should clearly indicate whether an audit is performed based on the separate standard.

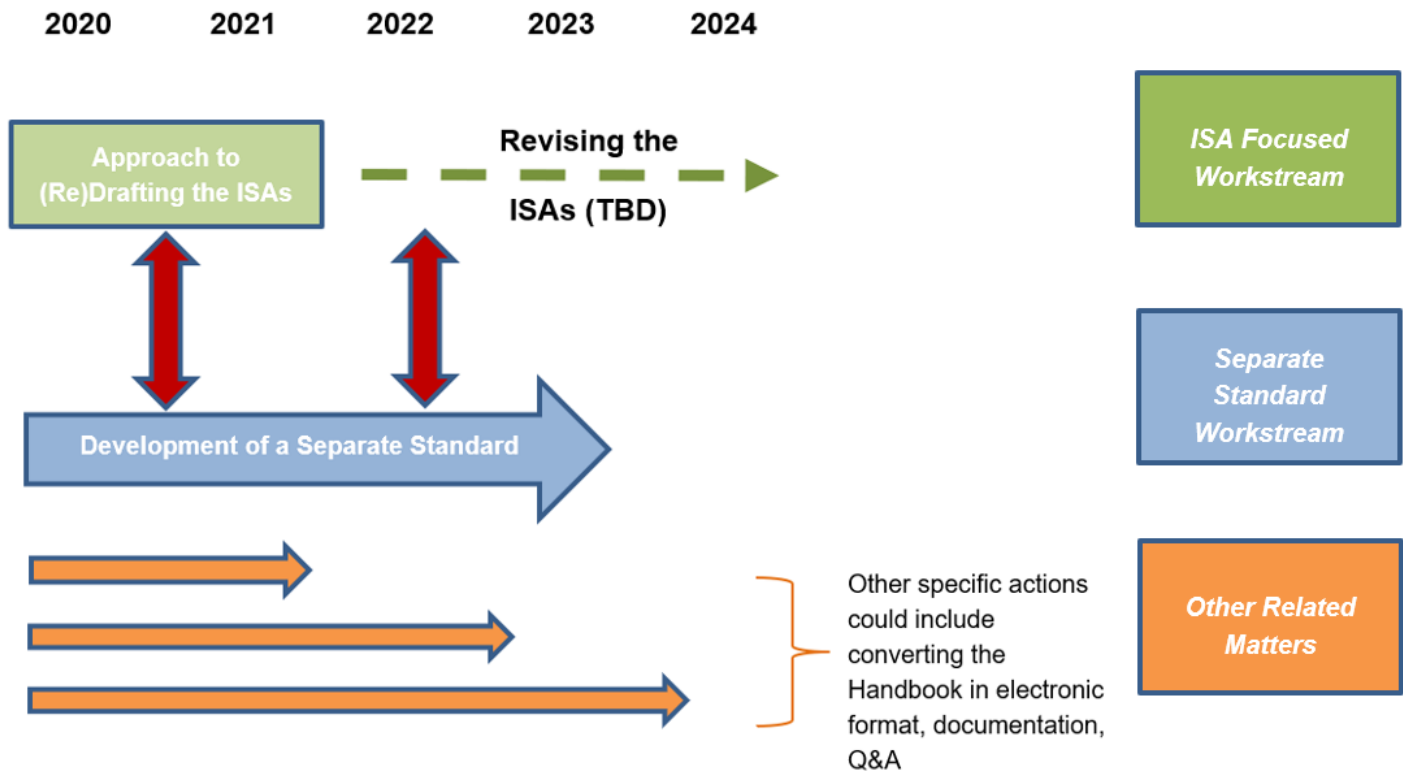
WAY FORWARD

The LCE Working Group will bring recommendations for the way forward relating to the separate standard workstream to the June 2020 IAASB meeting for a Board decision about the way forward.

Appendix 3

High Level Illustration of the Proposed Workstreams

The graph below provides an illustration of the proposed activities by the LCE Working Group and the possible timing of each, including illustrating their synergies:



Appendix 4

Current Definition of “*smaller entities*”

“An entity which typically possesses qualitative characteristics such as:

- (a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
- (b) One or more of the following:
 - (i) Straightforward or uncomplicated transactions;
 - (ii) Simple record-keeping;
 - (iii) Few lines of business and few products within business lines;
 - (iv) Few internal controls;
 - (v) Few levels of management with responsibility for a broad range of controls; or
 - (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.”³⁰

³⁰ IAASB's Glossary of Terms