

**Meeting:** IAASB Consultative Advisory Group (CAG)

## Agenda Item

**Meeting Location:** New York, United States of America

**Meeting Date:** September 11–12, 2018

### Exploring Possible Actions for Dealing with the Perceived Challenges of Conducting Audits of Less Complex Entities

#### Objectives of Agenda Item

The objectives of this agenda item are to:

- (a) Obtain Representatives views on the draft project proposal for the development of a Discussion Paper (DP) for public consultation setting out the perceived challenges and difficulties when undertaking an audit of less complex entities, as well as exploring respondents' views about possible solutions to address these perceived challenges and issues (**Agenda Item I.1** sets out the draft project proposal).
- (b) Obtain Representatives' views about additional matters which could be explored for inclusion in the DP.

#### Introduction

1. Paragraphs 2 to 9 of **Agenda Item I.1** (the project proposal) set out the background for this initiative, including discussions to date, as well as environmental developments.
2. The International Standards on Auditing (ISAs) continue to be revised in response to calls from certain stakeholders on a wide range of issues in the evolving environment. Some of these changes (or proposed changes) are being seen by some stakeholders, in particular in the small and medium entities (SME) environment, to be overly detailed and complex when applied to the audits of less complex entities.
3. Notwithstanding that national or regional jurisdictions have attempted to address the perceived challenges and issues, it is of strategic importance that the IAASB consider how it may respond to calls from auditors and other stakeholders to address the relevance of the increasing volume and complexity of the ISAs in the context of the audits of less complex entities. There is a risk that jurisdictional developments may lack consistency, and have the potential to undermine the trust and confidence of both audit as a service, and the international standards, within the SME and less complex audit environment.
4. The IAASB has recently received comments to its survey on its Future Strategy for 2020–2023 (see **Agenda Item 3-A**). A number of stakeholders responding to this survey have highlighted that issues related to audits of less complex entities and the related scalability of the ISAs as a current trend that will continue into the period covered by the next strategic plan. They also noted that the proportion of small and medium practices (SMPs) undertaking audits of SMEs in many jurisdictions has reduced in recent years, partly as a result of the introduction of, or increase to, audit thresholds, and therefore there has been a consequential demand for review, other assurance and related services engagements.

5. With respect to the scalability of the standards, various respondents to the Strategy Survey noted that:
  - They agree with the principle of a single set of high-quality standards applicable to all entities and understand that, as the world becomes more complex, there is pressure to revise standards to address the complexity.
  - The desire to accommodate the most sophisticated/ complex audits has resulted in highly complex ISAs and that the IAASB should seek to write standards that are more principles-based, using a “think small first” approach. Under this approach it is suggested to design requirements for small and less complex entities first and add requirements for larger, more complex entities on top of that.
  - Scalability is a critical prerequisite for standards to be suitable for SMEs and to perform a cost efficient audit on smaller engagements.
  - The IAASB should give high priority to its current work on audits of SME’s, noting that recent attempts to build scalability into standards often do not go far enough. The view was expressed that simply asserting that a standard is scalable will not make it scalable and that the IAASB needs to provide examples of how requirements are scalable for SMEs.
6. In order to determine how to move forward, it has been agreed that further consultation is necessary. The project proposal set out in **Agenda Item I.1** details the proposed work to be done in relation to this consultation, including developing recommendations for IAASB action.

#### Smaller and Less Complex Entities

7. It is not intended that this project deal with audits of listed entities and Public Interest Entities (PIEs). Rather this initiative is focused on the audits of less complex entities, in particular in relation to the application of IAASB standards in a SME environment.
8. Traditionally, matters related to scalability and proportionality have been primarily focused on audits of SME’s. The extant ISAs have specific considerations for audits of SME’s within the text of the application material to assist with the implementation of the standards in an SME environment.
9. It is proposed that this consultation will address less complex entities, which may be broader than just small entities, and may also include some medium-sized entities. These types of entities may constitute a different group of entities to what has traditionally been known as SME’s, and the Working Group intends to further explore this in the DP for stakeholder comment.
10. As part of the current ISA and International Standards on Quality Control (ISQC) projects underway, the IAASB continues to develop ways of addressing scalability and has therefore explored different ways of embedding considerations into the text of the standards to address scalability. As part of these discussions, it has become clearer that it is not necessarily only about SME’s, but rather about the complexity of the entity. The IAASB’s Glossary describes a small entity (see box below), with many of the characteristics being qualitative in nature rather than relating to size (i.e., about complexity of the entity and its transactions).

*Small entity:* 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.

11. In its discussions on ISA 315 (Revised),<sup>1</sup> the IAASB extensively debated how to describe the smaller / less complex entities. On balance it was agreed that it was likely mainly around complexity, but it was also recognized that it was likely that size in most cases may also influence complexity. At the same time, accepted use of terms such as SMP and SME also allude to size and are well known and well understood, and accordingly the IAASB, for the purpose of the exposure draft of ISA 315 (Revised) agreed to articulate this as “smaller and less complex entities.” The intention was that using the term ‘smaller’ did not limit the proposals to ‘small’ entities only. The IAASB also made clear in the exposure draft of ISA 315 (Revised) that it was smaller entities that were also less complex, as concern had been raised that some small entities may be more complex. However, the IAASB also acknowledged this initiative and agreed that the matter could be further explored as part of the IAASB’s deliberations on SMP/SME matters.
12. The Working Group further discussed this issue, and is of the view that it is broadly about the complexity or lack thereof, of the entity that would drive the need for simpler standards or more guidance. Accordingly, the Working Group intends to call the project “Audits of less complex entities” but will explore the issue further in the DP.
13. Furthermore, the Working Group will:
  - (a) Make clear in the DP that any proposals that are presented have been developed with a specific type of entity in mind, and would therefore only be appropriate in certain circumstances. Because of the different laws and regulations globally it would be left to each jurisdiction if, and how, any pronouncement or guidance would be adopted and implemented. Accordingly, the Working Group agreed not to explore size limits etc., to describe the applicable entity, but rather describe it using qualitative characteristics, similar to how a small entity is described in the International Standards today (the Working Group has agreed that this description may also need to be revisited in light of its work in this area).
  - (b) Explore how to describe the types of entities that are applicable, in particular whether omitting the term ‘small’ from this work will impact the perceptions about whether it is applicable or not.

#### Further Matters for Consideration

14. The project proposal in **Agenda Item I.1** sets out the objective and scope of the project. It is intended that this project proposal cover the period to where the IAASB considers

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<sup>1</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

recommendations for further specific possible actions, at which time a new project proposal covering these recommended possible actions will be developed.

15. In order to be able to provide an appropriate and balanced solution to address the issues surrounding the audit of less complex audits, the Working Group is of the view that it is necessary to obtain a greater understanding of the calls for change. This includes exploring:
  - Why it has been suggested that the ISAs are not fit for purpose, and can be perceived by some to inhibit or not promote audit quality in the context of the audits of SMEs and less complex audits.
  - What is currently happening that impacts the environment in which SME's are operating. This includes understanding what related initiatives are underway (or completed), and why they were undertaken, and whether this may have an implication for the adoption of the ISAs in that jurisdiction.
  - If, and how, audit exemption is impacting audit and other engagements performed for SME's (for example, what role does social policy play in determining the applicability of the audit framework).
  - To what extent can, and is, technology addressing the issues, taking into account that the application of technology to methodologies can streamline both volume and complexity.
  - To what extent are the issues driven by commercial considerations and, although not impacting the standard-setting process, determining if and how this should be considered in the IAASB's standard-setting process.
  - Whether more is needed in relation to other non-audit engagements to address some of the perceived challenges and issues identified.
16. As noted in the project proposal, in order to further explore these matters the Working Group is going to:
  - (a) Undertake an in-depth environmental scan to catalogue global developments and the impact of the changing environment through:
    - (i) Working with academics to understand relevant academic literature relating to the perceived challenges and issues that have been identified (commenced August 2018).
    - (ii) Further outreach with national standard setters (through a survey) to understand developments in different jurisdictions to respond to perceived challenges and issues for engagements relating to smaller and less complex entities (September / October 2018).
    - (iii) Outreach with INTOSAI representatives to further understand the perceived challenges and issues in relation to the public sector with respect to the implementation of the ISAs, and any responses that have been developed to address these challenges and issues. (September / October 2018)
  - (b) Possibly undertake a survey of SMPs to understand specific areas within the ISAs that are challenging, to provide factual information and evidence to support the perceived challenges and issues identified about the specific issues that will form a robust basis for the options to address the perceived challenges and issues that are presented to the IAASB.

17. Although as noted in the project proposal, the Working Group is of the view that there has been substantial discussion to date on perceived issues, there has not been a concerted effort to confirm such perceptions. Furthermore, obtaining stakeholder views on these matters will also help the Working Group in making its recommendations to the IAASB regarding future possible actions. Accordingly, the Working Group is of the view that the DP could include a description of the possible solutions (including examples where appropriate) and ask for stakeholder views on these matters. This may include, but is not limited to:
- (a) Exploring whether there are alternative ways of obtaining a reasonable assurance audit opinion that is not an audit using the IAASB's ISAs, as currently written.
  - (b) Exploring what more can be done within the ISAs to address complexity in the standards.
  - (c) Exploring possible content and presentation of a separate ISA for audits of smaller and less complex entities.
  - (d) Guidance for applying the ISAs to smaller and less complex entities.

The Working Group may also solicit respondent views about the IAASB's current efforts to address scalability and proportionality, such as the changes made in the recently revised ISA 540 (Revised)<sup>2</sup> or the changes proposed in the exposure draft for ISA 315 (Revised).

#### *Guidance in the ISAs*

18. Generally, the guidance that forms part of the standards (i.e., the application and other explanatory material), should not in itself pose a challenge for the audits of less complex entities. In practice, however, there are growing concerns that the application material in the ISAs, particularly in relation to documentation, is becoming more detailed and complex, and therefore more onerous to implement. Practitioners have indicated that they have difficulties in navigating the ISAs because of the structure and length of the standards. In addition, it has been suggested that the application material is being interpreted by some regulators as having the same standing as requirements.
19. In addition to the requirements and guidance in the ISAs, a separate guide on how to apply ISAs when auditing SME's<sup>3</sup> has been developed by the International Federation of Accountants (IFAC) SMP Committee. There are two volumes and it has been suggested by users of this guidance that the volume may make it difficult to use. Thus, in the case of audits of entities that are less complex, the sheer quantity of material a practitioner has to consider when performing an audit is quite onerous in comparison to the nature of the audit being undertaken.
20. At the same time, additional guidance is also being developed and used by national institutes to support their members in implementing the ISAs for audits of SME's. The result of these initiatives have been different, but what most of them have in common is that they have not solved the issue relating to audits of SME's and less complex entities using the ISA's. One of the reasons for this is not being able to get the same acceptance and authority by the regulators and inspectors as the standards and guidance developed internationally.
21. As part of its environmental scan, the Working Group will further explore the guidance being developed, and why this guidance is necessary. In doing so, further consideration may be given to including a description of jurisdictional guidance in the DP, if it is deemed that the guidance may be useful, and able to be applied globally. However, notwithstanding that additional guidance may help practitioners in applying the ISAs, this may add to the burden and may not be enough

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<sup>2</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>3</sup> [Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities](#)

to respond to practitioners' challenges (as it may be viewed as even more material being added to the ISAs).

#### *Development of Alternative Auditing Standards for Audits of Less Complex Entities*

22. As part of its efforts, the Working Group will also explore whether there is another way of providing a reasonable assurance audit opinion that does not use the ISAs as currently written. Matters such as reasonable assurance and how this is obtained will need to be considered, but the Working Group will further explore if there are any other possible solutions that can be presented for stakeholder comment. The Working Group plans to work with the academic community to further explore this option.
23. The development of a separate standard specifically for audits of SME's has been the subject of discussion internationally following the publication of the exposure draft "[Standard for the Audit of Smaller Entities](#)" by the Nordic Federation (and others following this example, such as Sri Lanka). At the IAASB/ Compagnie Nationale des Commissaires aux Comptes (CNCC) / Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) Working Conference held in Paris in early 2017,<sup>4</sup> (the 'Paris conference') the Nordic Federation indicated that it had progressed the development of its standard as far as it could, and that if it is to be progressed further it would have to be done at an international level by the IAASB. Accordingly, based on this as well as other developments in the environment, the IAASB believes it is in the public interest to explore whether the development of such a standard would be feasible, capable of providing the assurance needed, and will address the issue of scalability.
24. Therefore the Working Group will further consider what such a standard could look like, and present this in the DP for stakeholder views. The respondents' views will assist the IAASB in its deliberations whether to move forward in developing such a standard.

#### *Non-Audit Standards*

25. The provision of non-audit services may represent a credible alternative in respect of some audit engagements being undertaken for SMEs and less complex entities. The Paris conference identified a number of initiatives in different jurisdictions that have been successful as an alternative to audit. Although not the focus of this project, further work as proposed may present viable solutions, which may also need to be further considered.
26. For example, consideration of how to innovate with non-audit standards, such as hybrid engagements and direct engagements, could be explored to establish if the development of an international response is appropriate, to include:
  - (a) Reviews or other services that could offer a lower level of assurance than audit.
  - (b) Hybrid engagements, direct engagements or other engagements that do not offer *assurance* but are better aligned with the needs of stakeholders.
27. In order to understand what type of possible solutions can be provided at an international level, a better understanding of the market requirements is needed. It is recognized that the market for the audit of SME's is very different globally, as is the responses that have emerged to date in various jurisdictions. This is partly due to the different statutory requirements and the requirements of National Standard Setters and national laws and regulations. A greater

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<sup>4</sup> The working conference was held over two days which focused on understanding the needs of SMPs and explored applying audit and non-audit IAASB standards

understanding of market requirements and market responses will assist in formulating any possible response by the IAASB.

#### *The Use of Technology*

28. The role of technology in addressing the application of the ISAs to the audits of less complex audits may be significant. The Working Group intends to liaise and coordinate with the Data Analytics Working Group and its Project Advisory Panel, as appropriate, in developing the relevant parts of the DP related to technology. Some of the areas that have been identified, which will be further explored in the DP are:

#### The Role of Audit Software

29. Audit software can very effectively address some of the issues around the volume and complexity in the standards. The methodologies utilized in audit software are mapped to the ISAs and updated on a regular basis. It is therefore necessary to explore the role, if any, of the IAASB in this process, or whether anything can be done on a global level, including licensing arrangements for vendors. In addition, it may be appropriate to identify how practitioners can be encouraged to use such software.

#### The IAASB Handbook

30. The IAASB handbook is still produced in paper and PDF format. This has been identified as both cumbersome, has a long lead time in relation to updates and lacks integration. Enhancing the handbook to a fully digitized, live and integrated offering would substantially improve its functionality for SMP's and others. The Working Group will further consider the feasibility of a digitized handbook.

#### **Matters for CAG Consideration**

1. CAG Representatives are asked for views for views on the project proposal as set out in **Agenda Item I.1.**
2. CAG Representatives are asked whether there are any other matters that the Working Group should explore in its development of the DP.

#### **Material Presented – IAASB CAG Papers**

- Agenda Item I.1**                      Project Proposal– Exploring Possible Actions for Dealing with the Perceived Challenges of Conducting Audits of Less Complex Entities

**Appendix**

**Project Details and History**

An informal group was established to consider the issues raised with a view to advising the IAASB on an appropriate way forward in response to the views expressed by stakeholders at both the Paris conference and the NSS meeting. This group has developed these agenda papers and comprises:

- Chuck Landes – IAASB Member
- Ron Salole – IAASB Member
- Brendan Murtagh – Past IAASB Member
- Kai Morten Hagen – Technical Manager Audit, The Norwegian Institute of Public Accountants
- Gordon Cummings – CPA Canada, past member of the Canadian Standards Board.

**Summary**

	<b>IAASB CAG Meeting</b>	<b>IAASB Meeting</b>
Feedback from Working Conference on matters relating to SMEs and SMPs	March 2017	March 2017
Update from IAASB Chairman on matters related to SMEs and SMPs	September 2017	
Executive session discussion on way forward relating to matters related to SMEs and SMPs		March 2018 (Executive session)