

## **IFAC Small and Medium Practices Committee Response to the IAASB's Discussion Paper *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs***

### **INTRODUCTION**

The SMP Committee (SMPC) is pleased to respond to the IAASB (the Board) Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs* (the DP). The SMPC is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMPC are small- and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members and Technical Advisers serving the SMPC are drawn from IFAC member bodies representing 22 countries from all regions of the world.

### **GENERAL COMMENTS**

The SMPC strongly welcomes the DP. In our [response](#) to the IAASB Proposed Strategy for 2020-2023 and Work Plan for 2020-2021, we stated that this is an extremely important initiative that should be a high priority for the Board.

Representatives from the SMPC attended the second Paris conference in May 2019 and observed a great sense of urgency for an international solution, especially when compared to the first conference in January 2017. As the global standard setter, there is a rising pressure and expectation for the IAASB to be seen to take meaningful action to address the challenges identified and minimize both the risk of the development of further disparate national standards, as well as concerns over audits attaining audit quality objectives.

We acknowledge the necessity for the IAASB to balance the needs of all stakeholders, but there are strong concerns that the IAASB has in recent years had an increasing tendency to move away from developing truly principles-based auditing standards, to longer, more rules-based, complex and detailed standards that may not prove inherently suitable for application in the SME audit market. The international nature of business means that many SMEs/ LCEs will continue to need a widely accepted international auditing solution. The Board needs to be very cognizant that the use of the ISAs remains predominately in audit engagements of less complex entities (LCEs) and the value of audit to SMEs, which are highly significant to economies worldwide.

### **DETAILED COMMENTS**

The SMPC held a session on the DP during its June meeting and would like to thank Isabelle Tracq-Sengeissen, IAASB Board Member for presenting and helping facilitate the break-out sessions.

There were a range of different views on the questions and options outlined in the DP. Therefore, as the Board considers the way forward, we provide a summary of the comments raised:

#### **Challenges Applying the ISAs In Audits of LCEs**

- The ISAs have been developed primarily with large/ listed/ public interest entities in mind and from a “top down” rather than “bottom up”/ simple approach.
- The scalability in the requirements (e.g. what exactly is not applicable in an LCE audit) is not made clear enough. This could be remedied, for example, through conditionality (e.g. applicable to listed entities) or

signposting in the standard (e.g. considerations specific to LCEs). This has led to some firms wanting a clearer 'prescriptive/ check list approach'.

- The ISAs are considered too long and complex and the size continues to increase in the IAASB's recent proposals to revise the standards. The most recently revised or proposed revisions to standards (e.g., ISA 540 (Revised)<sup>1</sup>, ISA 315 (Revised)<sup>2</sup>, ISQM 1<sup>3</sup>) are not yet applicable but are expected to be challenging in LCE/ SME audit market.
- Audit fee pressure and competition are key factors – some of the costs of undertaking an audit can be viewed as in the public interest and for stakeholders, but certain procedures are not seen to be adding value to audit clients or enhancing audit quality.
- The documentation for LCE audits is a significant challenge, including interpretation/ judgement by inspectors and regulators on the requirements and work undertaken. For example, there is a fear that inspectors will report that the standard is not being followed if a requirement is merely documented as not done because it is not applicable to an LCE audit. If the inspectors' driving force for auditors results in undue focus on compliance and documentation, the quality of audit will not be enhanced.
- Knowledge, training, education and a lack of understanding all contribute to the challenges in applying the ISAs in LCE audits and may be associated with a lack of resources in SMPs. Thus, the increasing length and complexity of standards coupled with an increasing pace of change is even more challenging to such firms.
- Risk assessment and identification is always a challenge and needs clarity in the standards e.g. where to spend the right amount of time. Some SMPs may be cautious and adopt a substantive approach to an audit rather than fully relying on applying a risk-based approach.
- The skills and experience of the employees at the company being audited and their knowledge of financial reporting are very important.
- The availability and affordability of audit software is a factor for many SMPs.
- An acknowledgment that each jurisdictions laws and requirements for which entities require an audit is not within the control of the IAASB.

### **Revising the ISAs**

- Revising the ISAs would be the "ideal" solution from a theoretical/ consistency perspective, maintaining the concept of "an audit is an audit" and less potential confusion or misplaced incentives in the marketplace. For example, it should be avoided that audit clients might seek to choose whether they should be classified as LCE or not, which may be driven from a cost perspective and may ensue if the market were to perceive a difference in quality between the ISAs and whatever alternative a separate standard might offer.

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<sup>1</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>2</sup> Proposed ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*

<sup>3</sup> Proposed International Standard on Quality Management 1 (previously International Standard on Quality Control 1) – *Quality Management for Firms that Perform Audits or Reviews or Financial Statements, or Other Assurance or Related Services Engagements*

- It would need a “building blocks” approach to start simple to be effective – the new approach to ISA 315 (Revised) could be an option for other ISAs being revised on a rolling basis, but an acceptance that this would take too long and there is an urgent need to deliver results.
- Despite the Board's best intentions, it could be unrealistic to believe that the current standard setting model and approach will lead to the development of shorter, more scalable and less complex standards, so the problems might remain unresolved. The expected timeframe to revise the ISAs would also not bring a solution fast enough.

### **Description of LCEs**

- The definition of an LCE will be critical. It needs to be simple and easy to use to be applied consistently. There is concern about how the definition would be applied in practice and the clarity that will be needed by regulators, firms and audit clients. For example, how it would be applied for subsidiary companies that may classify as an LCE but are part of a group that does not.
- There is a risk of a lack of consistency if it is left to individual jurisdictions. Consideration of how many of the descriptions need to be met to qualify as an LCE e.g. more than one as clients may put pressure on which standard to apply due to the need to apply professional judgement.
- Possible changes to elements of the existing definition of “smaller entities” included removing “few internal controls” as LCEs can have more than “few” internal controls, that some LCEs will have wide ownership (i.e. not concentrated in a small number of individuals) and an addition could be “no complex accounting estimates”.
- Potential disqualifying characteristics could be listed entities and/ or PIEs, or subsidiary entities of these and linked to higher risk. For instance, if the LCE is involved in public funds or has an impact on society it may not be considered an LCE. A stakeholder matrix may assist the consideration.

### **Developing a Separate Auditing Standard for Audits of LCEs**

- A global separate standard could reduce the risk of further fragmenting the profession and contribute to harmonization.
- A separate standard could be developed in a timelier manner than revising all the ISAs.
- Challenges with the length, complexity, documentation requirements and the top-down approach of the ISAs could be reduced by having a truly principles-based separate standard.
- There is support for the approach of developing a separate standard based on the existing ISAs.
- There is a lack of understanding/ clarity on what the approach to develop a separate auditing standard based on a different framework means as there is limited detail in the DP.
- IFRS for SMEs is seen as successful, so an assumption this could be the same in International Standards on Auditing. The IAASB could connect with the IFRS Foundation.
- The legal environment is a key consideration and whether a separate LCE standard will be adopted/ accepted by legislators. There will be different implications in different jurisdictions and that other financial

statement service engagements (e.g. review, compilation, agreed-upon procedures) may be appropriate alternatives where an audit is not required or needed.

- One of the risks is the perception of audit quality under a separate LCE standard compared to the audit of financial statements under the “full ISAs” and the potential impact of a two-tier audit marketplace. For example, where firms may promote their “higher quality” through applying the full ISAs. However, some consider that overall audit quality could improve by having a separate standard as the auditor would be able to spend more time on important audit matters rather than requirements to perform certain procedures solely to comply with ISA requirements with no additional assurance and there could be potential cost savings.
- A concern it could lead to multiple definitions of what is considered as reasonable assurance and may result in an increased expectation gap between what the auditor is required to do and what some stakeholders expect the auditor to do.
- Time will be needed to maintain the separate standard as ISAs change, although this would likely need less amendments.

#### **Developing Guidance for Auditors of LCEs or Other Related Actions**

- More non-authoritative guidance could be useful. However, it may need to be considered in combination with another option, because on its own it may not actually help all the implementation challenges and solve the issues trying to be addressed.
- It would require SMPs to have recourse to even more material and so exacerbates one part of the problem.
- The communication needs to be clear whether any material is authoritative or not. In some jurisdictions regulators already interpret application material as quasi-authoritative.
- The maintenance of guidance needs to be considered as the ISAs change. Achieving timely alignment could be challenging.
- The timeliness of guidance is critical to help support implementation.
- A concern that the IAASB may stop considering complexity/ scalability because guidance for LCE audits exists.

#### **CONCLUDING COMMENTS**

We hope that the IAASB finds this letter useful. We are committed to helping the Board in whatever way we can to build upon the results of the DP.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,



Monica Foerster

Chair, SMP Committee