

International Auditing and Assurance Standards Board
529 Fifth Avenue
New York, NY
10017

12 September 2019

Dear Sirs

**Discussion Paper: Audits of Less Complex entities -
Exploring Possible Options to Address the Challenges in Applying the ISAs**

PKF International Limited ("PKFI"), administers the PKF network of legally independent member firms. The PKF International network consists of member firms and correspondents with over 400 offices operating in over 150 countries providing assurance, accounting and business advisory services. PKF International Limited is a member of the Forum of Firms and is dedicated to consistent and high-quality standards of financial reporting and auditing practices worldwide. This letter represents the observations of PKF International Limited, but not necessarily the views of any specific member firm or individual.

We welcome the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB's) Discussion Paper: Audits of Less Complex entities - Exploring Possible Options to Address the Challenges in Applying the ISAs.

We would like to thank the Chairman and the IAASB for the efforts and consultations in recognizing the challenges faced by practitioners in applying the ISAs.

Echoing the need for maintaining the robustness of the extant ISAs, the challenges not within the control of the IAASB and the potential possible actions identified, we take this opportunity to share our thoughts, perspectives and interpretations in the form of responding to the specific questions raised within the discussion paper. Where relevant, we also take this opportunity to include additional thoughts, perspectives and interpretations that we believe are relevant. These are all contained in [Appendix 1](#) of our submission.

If you would like to discuss any of our comments, do not hesitate to contact me.



Yours sincerely

Jamie Drummond

Director of Assurance
PKF International Limited

Appendix 1

Questions for respondents

Question 1

We are looking for views about how LCEs could be described. In your view, is the description appropriate for the types of entities that would be the focus of our work in relation to audits of LCEs, and are there any other characteristics that should be included?

Response

In our view, the current definition of a “smaller entity” does set out the typical qualitative characteristics that could be attributable to a less complex entity. However, the word “often” in point (a) relating to ownership and management in the definition of a smaller entity, could be interpreted as must, thereby scoping out smaller entities who do not have a single individual as the owner or manager. We would prefer that the ownership and management characteristic read as follows:

“concentration of ownership and/or management in a small number of individuals (either by natural persons, owner-managed configurations, trust structures or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and”

The definition also does not cater for ownership and management structures for not-for-profit, co-op’s or mutual organizations where most of the decision making comes mainly from a single authority within the organization.

The term “relevant qualitative characteristics” would also need to be defined from the perspective of a parent-subsidiary/joint venture situation.

It is important to also consider that some jurisdictions have size classifications for entities based on certain quantitative criteria, such as number of employees, revenues and average assets. Although the size classification impacts the magnitude and extent of many of the qualitative characteristics, it does not have a direct relationship to complexity. The qualitative characteristics should address this misunderstanding.

Question 2

Section II describes challenges related to audits of LCEs, including those challenges that are within the scope of our work in relation to audits of LCEs. In relation to the challenges that we are looking to address:

- a. What are the particular aspects of the ISAs that are difficult to apply? It would be most helpful if your answer includes references to the specific ISAs and the particular requirements in these ISAs that are most problematic in an audit of an LCE.*
- b. In relation to 2(a) above, what, in your view, is the underlying cause(s) of these challenges and how have you managed or addressed these challenges? Are there any other broad challenges that have not been identified that should be considered as we progress our work on audits of LCEs?*

Response

The audit of “smaller entities” have their own challenges reflecting circumstances more often apparent at a smaller entity rather than in a larger entity. Such circumstances include limited or non-existent formalized policies and procedures (thereby creating a perceived weak internal control), an amplified risk of management override, higher frequency in the occurrence of errors within the financial reporting environment and an overall weak audit trail.

Collectively, these circumstances can create inefficiencies for the audit engagement, with little opportunity for the provision of perceived value-add benefits to the client as an output of the audit process. As audit fees tend to be lower for smaller entities, all of these circumstances can collectively make it extremely difficult for practitioners to achieve an acceptable level of profitability when conducting an ISA-compliant audit on a smaller entity.

- a. On that prelude, we have noted a few ISA requirements that present challenges when performing an engagement for these types of entities:
 - *ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* – para 15 and 16 require the auditor to exercise and document both the application of professional skepticism and professional judgement. For smaller entities, obtaining corroborative evidence can be very challenging. Poor audit trails and a lack of re-performable evidence limits the reliance on management’s representation. Based on current ISA requirements in this area, in applying professional judgement in order to rely on a non-formalized policy or procedure, requires a greater extent of audit justification when compared to a formalized policy or procedure, which in turn is more likely to require more experienced (and therefore more expensive) members of the engagement to have a direct involvement.
 - *ISA 315 (Revised) - Identifying and assessing the risks of material misstatement through understanding the entity and its environment* – para 14 requires the auditor to understand the control environment and whether management has created and maintained a culture of honesty and ethical behavior and whether the control environment elements provide an appropriate foundation for the other components of internal control. For owner managed entities, obtaining evidence of how a culture of honesty and ethical behavior can be significantly more challenging compared to a larger entity which maintains a stronger audit trail of verifiable evidence in this regard. For smaller entities it is usually based on management’s representation that a culture of honesty and ethical behavior is promoted and maintained. This feature of a smaller entity audit can often lead the engagement team to an assessment of the control environment as “weak” and often done so at the frustration of the client. In these minimal control environments in smaller entities and LCEs, there can be compromised controls (such as the bookkeeper who prepares bank reconciliations, writes cheques and posts journal entries), the auditor is aware control deficiencies before an overall assessment of the system of internal control and control activities are performed. To execute the entire risk assessment process is onerous. Revising the extent and scope of several of these extant ISA requirements for a smaller and/or LCE audit would help mitigate the existing and realistic risk that documentation is included in the audit file purely for compliance with the audit requirements as opposed to it providing meaningful insight and value into the engagement team’s risk assessment process.
 - *ISA 330 The auditor’s responses to assessed risks* – because of the control environment classification and limited control activities identified and tested, the

auditor ultimately concludes that a fully substantive approach is taken to complete the audit. This means a testing strategy which uses larger sample sizes for test of details, as opposed to other alternative testing strategies which may, in theory, be more efficient.

- *ISA 402 Audit Considerations Relating to an Entity Using a Service Organisation* – many smaller entities use outsourced service providers for their payroll and secretarial functions. Para 16 addresses the expectation that controls at the service organisation are operating effectively. The requirements then set out are often burdensome and very onerous, especially when a type 2 report is not available. As the use of external providers of IT solutions including cloud based services will undoubtedly increase for smaller entities, we believe that this is a specific area where the onerous requirements of ISA 402 will become even more extensive with respect to the relative impact they have on the audit of a smaller entity.

- b. At a network wide level, it is difficult to identify the systemic cause for the challenges noted above. Tailored training programs and methodology guidance have proved to have some success in assisting engagement teams in managing the extent of audit work for smaller entities. Reinforcing the need to direction, supervision and review by the engagement partner has added some benefit. We use the management letter as a means of informing the client of weaknesses and gaps in the control environment with the expectation that it has a positive impact on the subsequent audits. From a commercial perspective, we have encouraged our practitioners to deliver quality audits that add value.

Another broad challenge includes the demotivational effect on audit practitioners who struggle to comply with the specific requirements of ISAs (particularly those relating to planning and risk assessment activities) on smaller entity and LCE engagements for which the client does not have a sophisticated control environment. It is our view that practitioners can feel undervalued, frustrated and disillusioned with their career because their efforts may ultimately seem pointless in those situations where the client clearly does not have the type of formalized and strong financial control environment which the ISAs can be perceived as assuming all audit clients should have.

While we acknowledge the ISAs do feature some concessions and some related application guidance in this regard, in our view they do not go far enough in scaling the requirements to smaller, LCE engagements. We believe that our view on the demotivational impact of overly complex ISAs on smaller, LCE engagements is a real problem to the profession as a whole which, in part, contributes to the high staff attrition rates of many firms. Consequently we see the LCE discussion paper as an opportunity to promote a more relevant set of audit requirements, which are more appropriately aligned to the circumstances of a smaller, LCE entity and which will, in turn, promote a better and more satisfying work experience for those practitioners involved in audits of this nature, while still focusing on achieving a high level of audit quality.

Question 3

With regard to the factors driving challenges that are not within our control, or have been scoped out of our exploratory information gathering activities (as set out in Section II), if the IAASB were to focus on encouraging others to act, where should this focus be, and why?

Response

Although the list of exclusions is reasonable and expected, the IAASB must not ignore the commercial considerations relating to an audit and we believe that more can be done to emphasize to the wider global market of end-users that an ISA-compliant audit has value. As correctly alluded to in the discussion paper, fees are driven by market forces and other environmental influences, which may not reflect the necessary and inherent cost for performing the required audit procedures.

The IAASB should not ignore that reality. If this gap between cost and perceived benefit continues to widen, it may drive down average audit fees to a level which is not sustainable in context of the related audit risk and with respect to achieving audit quality. Consequently, we may see a flight from the provision of audit services with increasing numbers of practitioners instead choosing to specialize in non-audit services, as well as a reduction in the numbers of new recruits into the profession.

In summary, we believe that unless there is some form of intervention on the issue of audit fee pressures, this will compromise the audit profession's ability to support global markets in accessing high quality external audit services.

Question 4

To be able to develop an appropriate way forward, it is important that we understand our stakeholders' views about each of the possible actions. In relation to the potential possible actions that may be undertaken as set out in Section III:

- a. *For each of the possible actions (either individually or in combination):*
 - i. *Would the possible action appropriately address the challenges that have been identified?*
 - ii. *What could the implications or consequences be if the possible action(s) is undertaken? This may include if, in your view, it would not be appropriate to pursue a particular possible action, and why.*
- b. *Are there any other possible actions that have not been identified that should be considered as we progress our work on audits of LCEs?*
- c. *In your view, what possible actions should be pursued by us as a priority, and why? This may include one or more of the possible actions, or aspects of those actions, set out in Section III, or noted in response to 4b above.*

Response

- a. Our views regarding each of the proposed possible actions are as follows:

Possible action	Do the possible action address the challenges	Implications or consequences
Revising the ISAs	Partly	In revising the ISAs, this approach could address the language used in the ISAs but will not address the

			<p>length and documentation requirements of the ISAs.</p> <p>Although this approach may involve a greater focus on clearly setting out what the auditor needs to do, the additional application material to support the requirements increases the length of the standard and the auditor's understanding of the ISAs.</p> <p>The "building block approach" does not support the concepts of scalability and a risk-based approach to performing an audit.</p> <p>Providing more examples contrasting the application for scalability and proportionality considerations would be very beneficial.</p> <p>If this possible action was used, we would recommend either revising all of the ISAs as one substantial project or revising the ISAs on a rolling or phased basis.</p>
	<p><i>Developing a separate auditing standard for audits of LCEs</i></p>	<p>Yes</p>	<p>We favor the development of a separate auditing standard based on the existing ISAs. A separate stand-alone standard would allow for simpler and less complex requirements without diluting the robustness of the standard.</p> <p>This approach would allow the current ISAs to remain principle-based, without cluttering the application guidance with voluminous small entity guidance.</p> <p>A separate standard allows for the practitioner to justify the application of professional judgement once in determining the ISAs relevant to the engagement.</p> <p>In most cases, internal controls are not relevant for smaller entities. A</p>

			<p>stand-alone will address the realities of the engagement, i.e. a more substantive approach. Attempting to address this approach through guidance in the extant ISAs would add to the complexity already experienced by the auditor.</p> <p>The comment that the “ISA does not prescribe how auditor are trained” is true to a point, however there is an expectation that auditors have the necessary education and background, proper supervision and review. This is an on-the-job training that is experienced by most new auditors while working with experienced auditors. We do believe the ISA can require one to have specialized training in the “building block approach” or the “separate ISAs” for LCEs.</p>
	<p><i>Developing guidance for auditors of LCEs or other related actions</i></p>	<p>Partly</p>	<p>The IFAC guide, although very useful, is non-authoritative in nature. If there are efforts in developing guidance and support materials, it must be authoritative. If practitioners cannot defend the use of the guidance as substitutes for the application guidance already within the ISAs, then this option would not provide the intended relief for the onerous documentation requirements of the ISAs.</p>

b. We have not identified any further possible actions.

c. We recommend developing a separate Auditing Standard for Audits of LCEs.

Question 5

Are there any other matters that should be considered by us as we deliberate on the way forward in relation to audits of LCEs?

Response

Although we envisage that revisions to existing standards will expound the elements of scalability and proportionality, the inherent complexity of standards like ISA315, ISA402 and ISA 540, will continue to make the application of these standards to the audit of a LCE very onerous, especially if the auditor is required to justify the relevancy of the audit procedures required or not for a LCE for the purposes of meeting the documentation requirements. From the perspective of our U.S. practitioners that do not apply the ISAs, the IAASB is reminded to consider whether the possible action taken will have flexibility to accommodate other auditing standards frameworks.

The overall priority would be to reduce the complexity of the audit process and the burden on the auditor. In the current economic environment, the auditor has to provide reasonable assurances on areas that are critically important to stakeholders, but more importantly, to provide these assurances in a timeous manner. With technology advancing exponentially, the "old way" of performing an audit will soon be outdated and antiquated. For an LCE engagement, the auditor ultimately relies of the samples selected, inquiries with management and professional judgement.

Glossary of terms

IAASB	International Audit and Assurance Standards Board
ISA	International Standards on Auditing
LCE	Less Complex Entity
U.S.	United States of America