



Ernst & Young Global
Limited
6 More London Place
London
SE1 2DA

Tel: + 44 20 7980 0000
Fax: + 44 20 7980 0275
ey.com

11 September 2019

Mr. Willie Botha
IAASB Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th floor
New York, New York 10017

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

Dear Mr. Botha

Ernst & Young Global Limited, the central coordinating entity of the Ernst & Young organization welcomes the opportunity to offer its views on the Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*, issued by the International Auditing and Assurance Standard Board (IAASB). We support the IAASB's efforts to bring focus to the challenges in applying the International Standards on Auditing (ISAs) to less complex entities (LCEs) and possible options to address the challenges. Of utmost importance is for the ISAs to form the robust foundation that drives the consistent performance of quality audits for entities of all sizes. We appreciate the IAASB's outreach on this project to obtain input from a variety of stakeholders.

General comments

We strongly believe that a single set of ISAs that contain clear and explicit principles-based requirements, and that can be applied to the audit of any entity, is the direction that is in the public interest. We believe it is equally important that the requirements of the ISAs can be 'scaled-up' or 'scaled-down' by auditors depending on the nature and circumstances of the entity, including its complexity and risks of material misstatement. Supporting guidance on scalability, in our view, is absolutely necessary to achieving appropriate application of the ISAs to all audits.

We believe the intent of the clarity project in 2009 was to achieve the goal of principles-based standards capable of application to an audit of any entity, but over time the revisions to the ISAs have made them lengthier and have been designed with audits of larger entities front of mind. This Discussion Paper and project of the IAASB provide an important opportunity for stakeholders to challenge the current direction of the ISAs and provide critical input into the IAASB's development of a go-forward strategy for standards development that achieves the needs of stakeholders of all entities, as well as serves the public interest.

We strongly support the focus on LCEs for the purposes of the IAASB's project. We acknowledge that certain jurisdictions have developed separate standards to address scalability concerns, but we believe that the majority of these initiatives have been focused on very small entities (i.e., less than a certain

number of employees, below a defined revenue threshold, and in some cases, below statutory audit thresholds). We believe the IAASB is rightly focused on LCEs, which should be inclusive of entities subject to statutory audits and private entities for which audits may be required. Many of these entities likely would not meet the criteria of 'small' but are certainly less complex, and scalability challenges in applying the ISAs to audits of these entities exist.

We believe that if the decision is made to develop a separate standard for audits of LCEs, this could have significant implications to the profession and its stakeholders. This decision should not be taken lightly by the IAASB. We believe that the existence of a separate LCE standard could negatively affect the competency of auditors in the profession should certain auditors only obtain or retain experience in performing audits under the 'scaled-back' standard. These circumstances could create 'two tiers' of auditors and limit the mobility of auditors (i.e., moving between smaller firms and larger firms and vice versa will be more difficult) within the profession, and even within the same firm. Additionally, given the pace of change in the current environment with respect to accounting standards, tax laws and other regulations, as well as in terms of technology, the knowledge and training needs for auditors, including auditors of LCEs, are already extensive and complex. Introducing separate auditing requirements for audits of LCEs would increase the time and complexity of continued education requirements for auditors to maintain competency in performing audits under both sets of standards.

Of greater concern, stakeholder perceptions may also evolve that 'two tiers' of audits exist, regardless of whether reasonable assurance is required to be obtained under both sets of standards. These perceptions could have the effect of further widening the expectations gap, which would not be in the public interest. Overall, we strongly encourage the IAASB to take the time to fully understand both shorter-term and longer-term possible consequences for the profession and its stakeholders related to the options under consideration, including through the input received through this consultation. Our specific feedback on the different proposed approaches is described in our response to question 4 below.

We support the IAASB's effort to create a definition for LCEs. We agree with the IAASB's starting point of adapting the current definition in the ISAs of a smaller entity to become the definition of an LCE. However, how LCEs are described in the Discussion Paper can be enhanced. We believe that it would be critical for the definition of LCEs to be clear and capable of consistent application should the IAASB take an approach involving differential auditing requirements for LCEs versus other entities. For approaches involving guidance or supplemental implementation materials, the definition also will remain important to guide appropriate use of that guidance or materials. Our specific feedback on how LCEs are described in the Discussion Paper is included in our response to Question 1 below.

Responses to the specific questions in the Discussion Paper for which the IAASB is seeking feedback are set out below.

Q1. 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?

We are supportive of the overall direction of the use of overarching principles in the definition of LCEs. This would allow auditors to use their professional judgment, taking into account an entity's nature and circumstances, to determine whether an entity meets the criteria of an LCE. However, we believe the definition of an LCE that is proposed in the Discussion Paper needs enhancement to make it capable of consistent application. The definition, as currently drafted, is open to great interpretation as to which entities would meet the definition of an LCE. We recommend that the IAASB develop a framework to support the application of the definition and that includes factors for consideration to help determine whether the entity is less complex, along with examples on how to apply the framework. Examples of high-level factors to consider in determining an entity's complexity could include the following:

- ▶ Lack of complexity of the entity's business model, which means that it has few sources of income or activities (e.g., a limited range of products, services and locations)
- ▶ Simplicity of the entity's business processes, financial reporting processes and IT processes
- ▶ Few regulatory considerations

For the high-level factors, detailed considerations could also be provided. For example, in considering an entity's IT environment and whether it is less complex, detailed considerations could consist of the following:

- ▶ Low reliance on IT at the entity.
- ▶ The IT application used by the entity is a purchased and unmodified IT system from a reputable vendor, or otherwise of low complexity.

Another example for determining complexity could be around the use of experts. If the entity is making extensive use of specialized skills involving tax, or extensive use of management experts (e.g., for valuation of complex derivative instruments, actuarial valuations or internally generated estimates), then the entity's business and financial reporting processes are probably complex and would not qualify as an LCE.

Finally, we believe that it would be helpful to highlight in the definition or in application guidance to the definition whether an entity that has multiple subsidiaries (i.e., an audit subject to ISA 600) could be considered an LCE or whether a component of a group audit could be considered an LCE.

Q2. 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 the audit of an LCE.

ISA 315 has been a standard with specific challenges for audits of LCEs and we acknowledge the IAASB efforts to address those challenges, especially around the IT environments of LCEs in the current draft of ISA 315 (Revised)¹. We also believe that the new drafting conventions and scalability considerations sections in ISA 315 (Revised) will help address the challenges for audits of LCEs. We view these efforts by the IAASB as a step forward in making the ISAs more “user-friendly” for LCE audits.

We have identified areas of the ISAs where scalability challenges exist in applying them to the audits where their nature and circumstances are less complex. Areas identified are as follows:

Sampling - ISA 530² indicates that when the circumstances are similar, the effect on sample size of identified factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen. We believe this statement in ISA 530 may imply that the auditor needs to reconcile between the two approaches. Additional application guidance on how to develop judgmental sample sizes would be beneficial for audits of LCEs, for which judgmental sampling may be a more efficient approach in many cases. We believe that when using judgmental sampling, professional judgment should be able to be applied, along with consideration of such factors as our understanding of the entity’s business, risk assessments, and the characteristics of the population tested to determine an appropriate sample size to understand the population and conclude that a material misstatement does not exist.

Level of Documentation - ISA 230³ requires that audit documentation shall be sufficient to enable an experienced auditor to understand the audit procedures performed, the audit evidence obtained, and any significant judgment applied. Individual ISAs then require specific documentation. We believe that the documentation requirements within the ISAs are more geared towards audits of larger entities and are not tailored to audits of LCEs. Additionally, the extent of documentation for an LCE is an issue as the documentation requirements throughout the ISAs are very extensive. As a result, we believe that auditors spend a significant amount of time documenting why certain audit procedures have not been

¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement*

² ISA 530, *Audit Sampling*

³ ISA 230, *Audit Documentation*

performed when auditing an LCE. We also believe that auditors struggle with regulators' expectations related to documentation.

Areas where documentation is particularly challenging include: documentation around understanding the entity and its environment, entity-level controls (i.e., control environment, the entity's risk assessment process, and the entity's process to monitor the system of internal control), and estimates. Specifically, we believe that ISA 540 (Revised)⁴ has moved away from a principles-based approach and as a result it is introducing new challenges to documenting the procedures performed around estimates at an LCE.

Estimates - The length and volume of the requirements for estimates in ISA 540 (Revised) may be difficult to scale to audits of LCEs. For example, the details around understanding and testing management's process for making accounting estimates may be very straightforward in LCEs and the requirements do not reflect this. Additionally, we believe that the references in the application material that relate to the scalability of the revised ISA lack detail as to how a scalable approach for ISA 540 (Revised) may be applied in the audit of an LCE. We believe more guidance is needed to implement ISA 540 (Revised) when auditing LCEs.

(b) In relation to 2a 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 LCE?

Overall, we believe that the limited guidance available within the ISAs, or in the form of supporting non-authoritative guidance, that specifically addresses the application of the requirements to audits of LCEs is an underlying cause of the challenges noted. Auditors are meant to apply professional judgment in determining how to apply the principles in the ISAs. However, a lack of guidance can result in inconsistency in how the principles are applied and coupled with the documentation challenges noted in (a) above, we believe many auditors tend to perform more extensive procedures, as well as prepare more extensive documentation, than may be required. In some cases, this is driven by the fact that regulators continue to challenge the use of professional judgment and documentation.

Some specific areas to highlight where we have tried to address these challenges consist of the following:

Development of guidance for auditors to understand the extent of management oversight of financial reporting and the effects on the audit- We have created guidance specific to understanding entity-level controls in an LCE that is an approach to achieving the requirements of the ISAs for an entity that has the following criteria level:

- ▶ Has frequent interaction with and oversight of staff, including knowledge of employee compensation

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

- ▶ Has direct contact with principal customers and major vendors
- ▶ Performs periodic reviews of key financial measures or financial performance
- ▶ Reviews documentation prepared by others (e.g., monthly financial statements, reconciliations, payroll registers)
- ▶ Communicates roles and responsibilities clearly
- ▶ Authorizes significant transactions

Under our approach, when audit hours are below a certain threshold, we have streamlined the documentation and explained how management involvement in an LCE affects our identification and assessment of risks of material misstatement at the assertion level.

Level of Documentation - Based on our experience we have found it necessary to develop specific enablement (e.g., forms and documentation guidance) to help auditors of LCEs properly scale the ISAs. As a result, we recommend that guidance on how to scale the documentation requirements in the ISAs be a specific focus of the IAASB.

Q3. *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?*

We believe that one set of principles-based auditing standards is the direction that is in the public interest. Nevertheless, we fully expect that there will be different views as to the approach that should be taken and the IAASB will need to determine the appropriate way forward. Whatever approach is taken, it will be important that the IAASB's stakeholders are on board and understand both how the approach addresses the challenges and how it is meant to be implemented. We encourage the IAASB to develop a stakeholder communication and collaboration strategy in conjunction with its project strategy. It will be critically important that auditors, regulators, national standard setters, investors, preparers and those charged with governance all have a common understanding about the approach taken and how it serves the public interest. In particular, auditors and regulators must have a common understanding of execution and documentation requirements.

As a result, we believe that the IAASB could collaborate with regulators to provide directional advice on the expectations for documentation for audits of LCEs. For example, the fear of inspection risk has led to 'over documenting' by many practitioners for audits of LCEs in our experience. The IAASB could engage in a dialogue with regulators to see what could be done to ease the practitioner's concerns about inspection risk at LCEs and to jointly discuss the requirements around documentation for audits of LCEs.

Regardless of the approach taken by the IAASB, we believe that supporting implementation guidance and materials related to performing audits of LCEs is likely to be an important component. We view the IAASB to have a primary role in the development of such guidance to promote international consistency, but we acknowledge the resource constraints of the IAASB. For the IAASB to commit to

robust implementation support, we believe formal collaboration protocols with others (e.g., IFAC, member bodies, National Standard Setters) need to be established. National Standard Setters and member bodies are also more familiar with the nature and circumstances of entities in their jurisdictions, as well as the needs of their auditors.

Q4. To be able to develop an appropriate way forward, it is important that we understand our stakeholder's 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.**

Revising the ISAs

If revising the ISAs is deemed to be the way forward, we recommend that the ISAs be revised in order of priority (as opposed to undertaking a project to revise all ISAs at once). We believe this would result in more timely and effective relief for audits of LCEs. If the IAASB prioritizes revising all its standards in a new format, we believe there is merit to the “building blocks” approach that would set out the base audit requirements for all audits, then expanding as needed to address audits of complex entities. This approach would be grounded in principles-based requirements and result in the same ISAs being applied to all audits, supplemented with conditional requirements for audits of complex entities, as applicable.

If this approach is adopted, we are of the view that it should be done on a phased basis (i.e., focusing on ISAs specifically identified to require scalability enhancements such as ISA 540 (Revised)). Additionally, we believe that, as a short-term solution until all the ISAs can be revised, the IAASB should create an ‘LCE perspective’ publication (i.e., implementation guidance on how to approach certain ISAs from an LCE perspective) for those standards that are intended to be revised for audits of LCEs at a future point in time. This short-term solution could create a blueprint as to how the standards would look once they are revised.

The benefits we see to this approach are as follows:

- ▶ The use of simpler language and structure in the ISAs would improve the overall flow of the standards for all audits and would allow requirements for audits non-LCEs to be separated, as applicable.
- ▶ Auditors would need to be knowledgeable about only one set of auditing standards within which the flexibility to apply those standards to audits of varying complexity would be provided, mitigating the risk of fragmenting the standards and the profession.
- ▶ Retain consistency in the audit opinion between LCEs and non-LCEs (i.e., both are in

accordance with the ISAs versus an opinion for an LCE audit that is in accordance with a separate standard, which may be viewed to be a “lesser” opinion).

The drawbacks we see to this approach are as follows:

- ▶ A full project to revise the ISAs would take a long time when action is needed quickly. To address this drawback, development of implementation guidance for particular standards that have been identified as challenging for audits of LCEs would need to be a prioritized effort by the IAASB.

Developing a Separate Standard for Audits of LCEs

We believe that developing a separate standard for audits of LCEs would pose quite a challenge for the profession, resulting in risks of fragmentation of the profession and potentially causing the firms that perform audits for complex entities and LCEs to develop two separate audit methodologies. As previously stated in the general comments in the introduction to our letter, we believe a separate auditing standard would create many challenges for both audit firms and stakeholders of the audit, including the users of the financial statements, and do not believe this option should be pursued.

If the IAASB were to pursue this option, the drawbacks to this approach are as follows:

- ▶ A separate standard for LCEs could widen the audit “expectations” gap between audits of complex entities and LCEs as the public may perceive that an LCE audit would be an inferior product to an audit in accordance with the full ISAs.
- ▶ It may be challenging for practitioners and regulators to understand the differences between the two sets of standards.
- ▶ If the audit opinion were to change for LCEs, an assessment would be needed to determine whether it would be an acceptable opinion for stakeholders such as investors, banks, or regulators.
- ▶ Practitioners could have difficulty in determining when such a standalone standard would apply (versus application of the full ISAs) creating a risk of inappropriate application of the standalone standard.

If the IAASB were to pursue this option, the benefits we see to this approach are as follows:

- ▶ It would be a speedier response to address the issues faced when auditing LCEs than revising the ISAs.
- ▶ A standalone standard could make more use of professional judgment, moving away from an approach that is too focused on compliance and documentation of non-applicable requirements.

Developing Guidance for Auditors of LCEs or Other Related Actions

We believe that the standards alone cannot provide enough guidance for auditing LCEs through application material or appendices. As indicated in our response to Question 3, we believe that supporting implementation guidance and materials related to performing audits of LCEs is an important component of any approach. Some auditors may benefit from a full Guide such as the existing *IFAC Guide to Using International Standards on Auditing in the Audits of Small-and Medium-Sized Entities*. However, for our purposes, we would find guidance and other support materials to apply the ISAs to LCEs to be more useful when targeted to specific problematic areas in the ISAs. For example, developing guidance which enables auditors of LCEs to reduce the burden of documentation or providing guidance on the potential positive effects on the audit for LCEs with good management oversight of the financial statements would be beneficial to auditing an LCE.

(b) Are there any other possible actions that have not been 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.

None noted.

(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.

We believe that the IAASB should take an approach that involves:

- ▶ Identifying ISAs that are particularly challenging for audits of LCEs, which require priority action, and the key issues to address.
- ▶ Setting forth plans for revising those ISAs to simplify and clarify them.
- ▶ Until such time the ISAs can be revised, pursuing as an immediate priority the development of 'LCE perspective' publications that assist auditors of LCEs in applying the standards; such publications would also provide a blueprint for future revisions. We encourage collaboration with others in this effort.

The reasons for this being the preferred approach and considerations for how this process would occur are detailed in our response to (a) above.

We acknowledge that the IAASB is in the process of finalizing ISA 315 (Revised) and has plans to develop implementation materials, including materials to address scalability. We encourage the IAASB to specifically focus on audits of LCEs as part of the development of these materials. It is important that the implementation materials are available shortly after the release of the final standard to allow them to be taken into account appropriately in firms' transition planning to adopt the revised ISA.

Q5. *Are there any other matters that should be considered by us as we deliberate on the way forward in relation to audits of LCEs?*

As indicated in our overall comments, we believe that if the decision is made to develop a separate standard for audits of LCEs, this could have significant negative implications to the profession and its stakeholders. This decision needs to be carefully deliberated by the IAASB and should not be taken lightly.

We would be pleased to discuss our comments with members of the International Auditing and Assurance Standards Board or its staff. If you wish to do so, please contact Don Zimmerman, Global Vice Chair, Professional Practice (donald.zimmerman@eyg.ey.com) or Kurt Hohl, Global Deputy Vice Chair, Professional Practice (kurt.hohl@eyg.ey.com).

Yours sincerely,

Ernst + Young Global Limited