Dear Sirs

AUDITS OF LESS COMPLEX ENTITIES: EXPLORING POSSIBLE OPTIONS TO ADDRESS THE CHALLENGES IN APPLYING THE ISAS

We strongly support the ideas put forward in this Discussion Paper.

The majority of the entities which we audit would be classed as less complex entities. Our general experience of applying the ISAs (in our case the UK versions developed by the FRC) is that many of their requirements are difficult to apply in the context of such entities because the standards assume a level of record keeping that such entities have no reason to apply.

In addition to this, we agree with the suggestion in the second bullet point at the top of page 6 of the Discussion Paper that the ISAs as currently presented can result in “a ‘checklist approach’, with a greater focus on compliance rather than using professional judgement”. In the UK, there has been much criticism of auditors recently. We believe that a significant cause of audit failure is that auditing is increasingly seen as the application of a process rather than the exercise of professional judgement. Auditors, and also audit regulators and oversight bodies, place too much emphasis on the completion of the process. Both auditors and regulators should focus on whether the judgements made are/were reasonable at the time they were made (crucially this will include determining whether sufficient evidence has been obtained to support judgements made in circumstances where there may be limitations on the level of evidence available).

Both issues would be addressed by recasting the ISAs as a smaller number of key principles, supplemented by guidance on how these could be applied in the different contexts of complex and less complex entities.

The guidance should set out possible approaches in a number of circumstances, there would not only be the two (i.e. complex and less complex) basic scenarios.

Although the effectiveness of the audit should be judged primarily with reference to the quality of the judgements made, compliance with the ISAs would be determined with reference to whether the auditor had:

a) applied appropriate procedures to meet each relevant principle; and
b) justified a conclusion that other particular issues were not relevant in the particular circumstance.

Such an approach would remove the need to establish a threshold for the application of a simpler standard, and would avoid any suggestion that in such cases a lesser standard of auditing is being applied. We do not think that voluntary audits should be carried out to a lower standard than statutory audits. All audits should be completed to the same standard, but the circumstances of the particular audit would determine the level of work involved in each case.
The Discussion Paper sets out various options for change, we believe that the approach outlined above would give the best solution to the issues raised. A revision of the ISAs to enable them to be more readily applied to entities of different types, and with different circumstances, would, as well as facilitating the audit of less complex entities, also address the separate issue that in the audit of more complex entities the application of an audit process has diminished the role of judgement. While additional guidance will always be welcome, we do not think that guidance alone will address the issues raised.

Our detailed comments in response to the points raised in the consultation are set out as an Appendix to this letter.

We would be interested to supply more detailed comments on how the proposals could be further developed. We believe that this is an important project which should be given priority.

Yours faithfully

MICHAEL COMEAU
TECHNICAL PRINCIPAL
RESPONSES TO CONSULTATION QUESTIONS

1. We are looking for views about how LCEs could be described (see page 4). 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?

The existing definition of a small entity does cover the main characteristics which are relevant to the current project (and does not make specific reference to measures of size). Many of the factors are interrelated but we would highlight “few internal controls” as the key factor. We do not think that auditing standards should assume a level of internal control which less complex entities see no need for, while in circumstances where such controls are relied upon by the client a more efficient approach will often be to test them.

However, we do not support the development of a separate set of requirements for smaller or less complex entities so that we do not believe that this definition, or a separate definition of less complex entities, is necessary to progress the project.

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.

There are numerous cases where the ISAs assume a level of internal control which less complex entities are unlikely to apply. While we accept that all businesses are likely to apply some level of internal control, such controls are often not susceptible to testing and cannot therefore be relied on in the work undertaken.

The requirements in relation to accounting estimates place too much emphasis on the auditing of a process to establish the estimates. In practice in many audits a review of what actually happened post-balance sheet and simply the reasonableness of the estimates will be the most effective approach.

One very specific example of an assumption made by an ISA which is not in practice correct is the assumption in section 13 of ISA 550 that management will have identified the entity’s related parties, their relationships with the entity, and the transactions with them. The further assumption in s14 of ISA 550 is that they will have established controls to ensure that this information is complete. Section A11 of ISA 550 says that in the context of the requirements of many financial reporting frameworks: “Management is therefore likely to have a comprehensive list of related parties …”, in our experience this is seldom true. Management will be able to identify disclosable transactions and balances, but the starting point would not be the establishment of a full list of related parties.

While the ISA does accept that such information will not always be readily available the assumption of the ISA is still that obtaining a complete list of related parties will be the starting point of the relevant audit work. In practice a more efficient approach would be to focus on transactions which may not have been concluded under normal commercial terms and then consider whether such transactions may have been with related parties.

Other standards whose requirements cause particular difficulties for less complex entities and for which a more proportionate approach should be considered include:

i) ISA230 audit documentation – documenting the audit work;

ii) ISA300 Planning – documenting the audit plan; and
iii) ISA530 audit sampling – justifying sample sizes and sampling techniques.

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 LCEs?

Our general approach has been to interpret how the requirements of the standards can best be met in the context of the majority of our audits, but our resulting procedures still include requirements (derived from the ISAs) which do not seem entirely necessary in many cases.

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?

The most significant area would be to encourage audit regulators and oversight bodies to focus more on the judgements made in the audit, and the question of whether the conclusions reached were justified by the level of evidence obtained, rather than on how well a particular audit process has been followed. We accept that this will make the reviews harder to do, but we do not think that confirming that a process has been followed is a reliable indication that the correct judgements have been made.

While we accept that managing public expectations is outside IAASB’s current remit, it would be useful if in public pronouncements the IAASB could describe audit as relying on judgements about the future and on judgements regarding the sufficiency of the evidence that can realistically be obtained in a cost-effective manner. The expectation that an audit would ever be able to give a conclusive clean bill of health is not realistic.

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.

As set out in our covering letter, we believe that the best approach is a rewrite of the ISAs in a more principles-based format. The existing detail can be retained, but with clear indications of where this can usefully be applied and with an indication of simpler alternatives which may be an appropriate way of meeting the principles in different circumstances. This would result in longer standards, but with appropriate headings and structure they could be made much more usable.

We do not think that a completely separate set of less complex entity standards would be helpful. Apart from issues around the suggestion that this might result in a lesser kind of audit, we do not think that in every area there is a clear distinction between the needs of different kinds of entity. An approach that offers a series of different ways of meeting the overall objectives depending on the circumstances of the particular client in each area would give a more effective approach and result in higher quality audits at all levels.

Additional guidance, while welcome, will not alone resolve the issues raised.

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?

We have no additional suggestions at this stage.
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.

Although we are calling for a substantial review of all of the ISAs there would be no reason for all the changes to be made at a single time. While there will be issues with maintaining consistency within the standards, an approach whereby batches of standards are updated in a rolling programme would bring the benefits of these changes into effect sooner. It would also mean that experience of implementing the first few standards in the new format could be used in developing further standards as the project continues.

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?

We have no further comment at this stage.