

12 September 2019

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submitted electronically through the IAASB website

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

Dear Willie,

We would like to thank you for the opportunity to provide the IAASB with our comments on the IAASB Discussion Paper “Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs”, hereinafter generally referred to as “the paper”.

We have provided our responses to the questions posed in the Discussion Paper in the Appendix to this comment letter.

However, we would like to make the following overall observations about the status of auditing standard setting at the IAASB.

We welcome that the IAASB has undertaken a project to seriously consider how to address the issues that have arisen with the audits of financial statements of LCEs (hereinafter referred to as “LCE audits” in this letter and its Appendix). However, we have concluded that the question arises as to how the “problem” with respect to LCE audits has become so acute that increasingly national standard setters are seeking their own solutions for these audits outside of the ISAs. We believe that the IAASB may need to diagnose how it ended up where it is, and why, as part of seeking a solution.

We have concluded that the current malaise in auditing standard setting for the ISAs in the context of smaller entities results from fundamental changes in how ISAs are being written due to changes in the composition of the IAASB and its due process that began to have a real impact on the IAASB about five years

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ago. We believe that the delicate balance among IAASB stakeholders was upset over time when – primarily as a result of the various financial and concomitant audit crises (the bursting of the dot.com bubble in the early 2000's and the crisis in the financial industry in 2008) – the capital markets, prudential and audit regulators represented in the Monitoring Group began to exercise increasing influence on the composition of the IAASB, its due process, and (through various mechanisms within the due process) the content of auditing standards. This was accompanied by what we perceive to be a fundamental change in the political attitudes of the international networks of accounting firms to regulatory pressure on the content of auditing standards, a political attitude which appeared to us to move from active engagement to ensuring that auditing standards remain fit for purpose for all kinds of engagements to a policy of acquiescence to regulatory pressure as long as the auditing standards were capable of being implemented in firm methodologies.

The result of these changed pressures on auditing standard setting can be seen most clearly in the revisions of ISA 720 (which has less impact on LCE audits), and ISA 540 and the draft revision of ISA 315 (which do have a major impact on LCE audits). In all three cases, the standards are pushing the envelope of what an audit *is* (for ISA 720, extending assurance-type procedures to documents far beyond the financial statements being opined upon; for ISA 540, clearly extending the applicability of the standard to almost all monetary items in the financial statements and significantly increasing the work effort on accounting estimates; and for draft ISA 315, among other matters, using a PCAOB audit approach and thresholds that change the meaning of reasonable assurance). In particular, the extent to which ISA 540 (Revised) appeared to us to be driven by the influence of prudential and audit regulators is noteworthy. Furthermore, the nature of much of the voluminous guidance in ISA 540 (Revised) suggests the guidance is directed towards alleviating weaknesses in accounting standard setting through auditing standards.

It seems to us that capital markets and prudential regulators, and audit regulators interested primarily in the audits of entities subject to these regulators, are engaged in an exercise to fundamentally change what an audit means in terms of scope and depth to serve their purposes (hereinafter we refer in this letter and its Appendix to audits meeting these regulatory purposes as “regulatory audits”). In no way are we suggesting that these regulatory purposes are not legitimate. However, through the noted regulatory influence on the ISAs, the “product” or “brand” signified by the word “audit” is being fundamentally changed not only for these audits within the noted regulatory space, but also for both statutorily required and voluntary audits of financial statements of other

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entities. The impact is greatest on the LCE community and their auditors. In many jurisdictions, audits of LCEs were required by legislators and contractual parties a long time ago based upon a common understanding of what an audit entailed at the time the legislation was written or the contracts signed. Stakeholders of these other entities, including legislators, management, auditors, and financial statement users have a legitimate concern that the nature and extent of work effort needed to perform an audit is being changed in a fundamental way to serve other (regulatory) purposes because it appears the IAASB is increasingly focused on servicing the concerns of the noted regulators in the Monitoring Group rather than other stakeholder groups. The result of this tension naturally leads to these stakeholders exercising pressure on national standard setters to cease adopting the ISAs and to create another set of standards for those audits not in the noted regulatory space.

Unless the IAASB addresses these fundamental concerns, the result will be an increasing use of solutions other than the ISAs for auditing standard setting at a national level and hence disuse of the ISAs for other than regulatory audits. More guidance alone will not resolve this issue: we believe that the IAASB may need to either fundamentally change its standard setting processes to rewrite the standards so that they are truly scalable for all entities by “thinking small first”, or the IAASB will need to distinguish between “regulatory audits” and other audits and develop a separate set of standards or standard for the latter. We prefer the former approach (rewriting the standards by “thinking small first” so that scalability works “bottom-up” rather than “top-down”), but are not optimistic that the IAASB will actually be able to implement this in practice quickly due to resource constraints, or at all, due to regulatory pressure. Our experience has been that the current composition of the IAASB and its due process will likely not allow for a “think small first” approach to auditing standard setting. The latter approach (a separate set of standards or a standard based upon the current ISAs for other than regulatory audits) is likely to be much quicker and more practicable and therefore has greater chances of success. However, a prerequisite for such a set of separate standards or a standard is that these are stand-alone so that auditors need not to refer to the set of standards designed for regulatory audits.

Over the longer term, we believe that the IAASB and its stakeholders need to engage in some “soul searching” to consider whether permitting one set of stakeholders (regulators) to have more influence on the content of standards than others is a model that has a future for other than regulatory audits.

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We would be pleased to provide you with further information if you have any additional questions about our response and would be pleased to be able to discuss our views with you.

Yours truly,



Melanie Sack  
Executive Director



Wolfgang Böhm  
Technical Director Assurance Standards,  
Director International Affairs

**Appendix:**  
**Responses to Questions Posed in the Discussion Paper**

- 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?**

A more fundamental question that needs to be asked, and answered, is what the purpose of the concept of an LCE is in an auditing standard setting context. There is no doubt that the characteristics currently used to describe a “small entity” in ISA 200.A66 and the IAASB’s Glossary of Terms<sup>1</sup> have provided a useful basis for developing application material for the ISAs that provides guidance on the special considerations of the audits of financial statements of small entities. However, we note that the possible actions being explored by the IAASB in the paper go far beyond just developing additional or revised application material to provide such guidance in the ISAs: the paper also considers revising the ISAs (which implies also revising the definitions and requirements) or developing a separate auditing standard for LCE audits. Such a list of “typical” characteristics that is neither exhaustive nor exclusive to smaller entities, nor provides a definitive set of criteria for identifying such entities, cannot form a basis for a revision of the ISAs or for a separate set of auditing standards.

As we note in the body of our letter, the standard setting issues relating to LCE audits appear to result from regulatory pressure that results in auditing standards that meet regulatory purposes (“regulatory audits”), and that the incorporation of these regulatory purposes in the ISAs then extends these requirements to other audits with the resulting “LCE audit problem”. Consequently, we have become convinced that the distinction between LCEs and non-LCEs is not really useful. Rather, a distinction needs to be made between entities whose financial statement audits are

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<sup>1</sup> We note that the description of an LCE in ISA 200.A66 is authoritative, as this description is within the application material of a standard, whereas the description in the IAASB Glossary of Terms is non-authoritative on its own. We were therefore surprised to the reference in this paper to the Glossary, rather than to ISA 200.A66.

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subject to certain regulators (capital markets regulators and prudential regulators) – that is, entities subject to “regulatory audits” – and those entities that are not. We recognize that this might mean that in certain jurisdictions the audits of the financial statements of very small and simple publicly listed entities would be subject to more onerous auditing requirements or standards, but that would be the price they would need to pay for seeking or maintaining their status as listed entities.

**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.**

The main issue in addition to those addressed in Section II of the paper is the fact that the ISAs are not written in a “think small first” format, which forces auditors to apply scalability in a “top-down” approach (consider the relevance of every requirement) rather than a “bottom-up” approach (apply the requirements applicable to all entities plus consider whether the circumstances causing a condition requirement to become relevant exist). Auditors of financial statements of LCEs are confronted by the entire suite of ISAs with all of their requirements and must then decide which requirements are not relevant pursuant to paragraph 22 (b) by then “scaling down” what they need to do. Furthermore, auditors are often then asked to justify to their audit regulators as to why the auditors considered a particular requirement not to be relevant, which can be an onerous exercise fraught with regulatory risk for the auditor.

In a “think small first” approach, only those requirements that apply to “all” audits (that is – including tiny dormant companies) ought to be required for all audits in the first instance. Requirements in addition to those that apply to all audits ought to be written as conditional requirements so that these only apply when the condition exists. It may be helpful to actually physically separate those requirements that apply to all audits from those that are conditional to further aid scalability. This would allow auditors to engage in “bottom-up” scalability by adding requirements to those that need to be fulfilled as conditions are identified as existing that cause them

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to be relevant. It would also ease the burden of auditors versus audit regulators because the onus would be on the regulator to demonstrate that the requirement is relevant by asserting that the condition leading to the relevance of the requirement exists, as opposed to having the onus on the auditor to demonstrate that a requirement is not relevant because the condition does not exist.

- 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?**

We refer to the body of our letter, which explains how regulatory considerations have caused the challenges mentioned in Section II. In the past, as a national standard setter and body of professional accountants, the IDW had sought to address these issues by means of implementation guidance, such as our quality control handbook. However, our practitioners are still faced with the challenges identified in Section II of the paper and in 2 a) above. For this reason, the IDW has approved, and will soon commence, a project to seek to design auditing standards that are based on the ISAs, but that are customized to the nature of the entity whose financial statements are being audited, so that auditors can use a bottom-up approach to determining the relevance of requirements. However, the issuance of ISA 540 (Revised) and the looming issuance of ISA 315 (Revised) show the limits on scalability that can be achieved through our project without fundamentally changing the ISAs to reflect a “think small first” approach or setting a separate standard or standards for other than regulatory audits.

- 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?**

We are not convinced that legal or other (e.g., contractual) requirements for audits are going to be changed any time soon, nor will the IAASB be able change the overall commercial considerations involved for audits of smaller entities. While technology may assist auditors in performing more

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efficient audits, we are not convinced that the IAASB has a direct role to play in this case.

For these reasons, we believe that the IAASB should not focus at all on seeking to influence others, but rather focus on what it needs to do to resolve the situation we identify in the body of our letter: either rewrite the standards applying a “think small first” approach, or failing that, setting a separate auditing standard or set of auditing standards for other than regulatory audits.

**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?**

*1. Revising the ISAs*

Revising the ISAs so that they apply a “think small approach” as we describe in our response to 2 a) so that auditors are able to apply a “bottom-up” rather than “top-down” approach to scalability would help address the challenges that have been identified. However, this would require an immense project similar to the Clarity Project and would likely take more than four years, like that project did. Doing this piecemeal ISA by ISA is not likely to work because of the many connections between the ISAs. However, given the experience of the IAASB with regulatory influence on its auditing standard setting in the last four years, we are not convinced that this option is likely to be practicable.

*2. Developing a Separate Auditing Standard for Audits of LCEs*

We believe that developing a separate auditing standard or standards for other than regulatory audits where that auditing standard is based on the ISAs would help address the challenges that have been identified.

We do not believe that developing a separate auditing standard based on a different framework would meet the challenges identified or be



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politically acceptable: using a completely different framework would call into question whether the type of engagement represented in this standard really ought to be branded as an “audit” and would lack political support from users of audit reports.

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

The main problem for auditors of LCEs is too much material – not too little. For these reasons we do not believe that creating a comprehensive guide on the audit of LCEs, an IAPN, guidance within the ISAs or outside of the ISAs, or implementation packs would actually meet the challenges 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.**

### *1. Revising the ISAs*

In principle we are in favor of revising the ISAs so that they apply a “think small approach” as we describe in our response to 2 a) so that auditors are able to apply a “bottom-up” rather than “top-down” approach to scalability. However, the immense nature of the work, the long time period it would involve, and the low likelihood that the regulatory community will accept a re-orientation of the IAASB’s work program and of the content of the ISAs means that this option is not likely to be practicable.

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

Although, in principle, we favor revising the ISAs so that they apply a “think small approach” in the first instance, as a practical matter, given the experience of the IAASB with regulatory influence on its auditing standard setting in the last four years and the work effort and time that would be needed, developing a separate auditing standard or set of auditing standards based on the ISAs for audits other than regulatory audits may be the only practicable option that addresses the challenges identified. We note that one implication of this approach is to recognize that what reasonable assurance means in the circumstances varies by context.

We do not believe that developing a separate auditing standard based on a different framework would meet the challenges identified or be politically acceptable.

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*3. Developing Guidance for Auditors of LCEs or Other Related Actions*

We do not believe that creating a comprehensive guide on the audit of LCEs, an IAPN, guidance within the ISAs or outside of the ISAs, or implementation packs would actually meet the challenges identified and therefore believe that these options should not be pursued further.

**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?**

In our view, other than the possible actions noted, there are no other actions that need to be considered as the IAASB progresses its work on LCE audits.

**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.**

In our view, if a realistic opportunity to revise the standards as we describe in our response to 2 a) does not present itself, we believe that the IAASB should seek to commence and quickly complete a project on the development of a separate standard or standards for other than regulatory audits as a matter of priority. The other actions noted in Section III will not meet the challenges identified and therefore the IAASB should not use its resources to engage in these other actions.

**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?**

In our view, there are no other matters that would need to be considered by the IAASB when it deliberates on the way forward in relation to LCE audits.