

25 October 2019

The Chair  
International Auditing and Assurance Board  
C/- The International Federation of Accountants  
529 5<sup>th</sup> Avenue  
New York, New York  
United States of America

Dear Sir

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

On behalf of the Institute of Public Accountants (IPA), I submit our comments on the Consultation Paper (CP) – *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*.

While the IPA acknowledges there are challenges in applying the ISAs in their current format to the audit Less Complex Entities (LCEs) the IPA is wary of any response that would be perceived as a “watering-down” of audit requirements. Given the high profile audit failures and the general mistrust of business the IASB needs to be cautious as to the impact and perception of any changes to auditing standards that could be perceived as reducing responsibility and accountability.

As noted in our response to Question 3 of the CP, the IPA supports the revision of ISAs to enable an outcomes orientated approach with additional processes and procedures that scale with complexity and risk. The IPA believes that many of the issues in applying ISAs to LCE audits relate to the planning related ISAs and these should be the focus of any revision. The IPA does not support a separate standard for the audit of LCEs.

Our comments and responses to the questions in the CP are set-out in Appendix A to this letter.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen La Greca ([stephenlagreca@aol.com](mailto:stephenlagreca@aol.com)) or Mr Colin Parker ([colin@gaap.com.au](mailto:colin@gaap.com.au)) GAAP Consulting.

Yours sincerely

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### **About the IPA**

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

## **Appendix A**

### **Question 1**

*We are looking for views how LCEs could be described (see page 4). In your view, is the description appropriate to the types of entities that should be the focus of our work in relation to audits of LCEs, and are there any other characteristics that should be included?*

### **IPA response**

The IPA broadly agrees with the description of LCEs in the CP. However, the IPA believes that restricting the description to an entity with a small number or single owner would result in the omission of entities that many practitioners consider as LCEs. Practitioners would often consider member organisations, unions, charities, and sporting and other community bodies as LCEs.

### **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 LCEs. In relation to the challenges we are looking to address:*

- a. What are the particular aspects of the ISA that are difficult to apply? It would be most helpful if your answer includes references to specific ISAs and the particular requirements in the ISAs that are more problematic in the audit of an LCE.*
- 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?*

### **IPA response**

The IPA believes the following aspects of ISA are problematic particularly in the context of the audit of LCEs.

1. Too many mandatory procedures – the IPA believes the ISAs need to be streamlined and more principled based with more emphasis on principles. The IPA is of the view that the large number of mandatory procedures lead to a checklist approach to audit which is neither efficient or effective and costly in an LCE environment. The IPA would like to see the auditing standards based on principles with defined and clear outcomes.
2. Guidance is often not useful – many ISA do not have definitive guidance best characterised by a variation on of “...consider the impact on the nature and extent of audit procedures” or “... consider the impact on the audit report/the auditor’s opinion”. Such guidance should be replaced by equivocal guidance which clearly articulates the recommended response.

3. The standards covering the planning of the audit ISA 300 “Planning an Audit of a Financial Report”, ISA 315 “Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment” and ISA 330 “The Auditor’s Response to Assessed Risks” are not well integrated and while they purport to have the objective of producing an overall audit plan the actual output is never well enunciated. This results in a checklist approach to the planning of the audit which is inappropriate in the best circumstances and time consuming and inefficient in the context of an LCE audit. This is exacerbated by the auditor’s assumption that they will be undertaking a substantive based audit and the planning requirements of the ISAs have little value add.

The IPA believes that planning should be output based with the objective of producing an overall planning document which sets out: industry and company background, key information systems subject to audit; the governance structure; internal control if any; fraud risks; materiality; regulatory requirements and risks; and financial statement risk by assertion with audit response.

4. Internal Controls – both the existing and proposed ISA 315 place significant emphasis on obtaining and understanding of internal controls. For most auditors of LCEs this is considered a waste of time as such entities usually have poor segregation of duties and high degrees of management/owner override and the auditor from the outset intends to adopt a substantive audit approach and not undertake tests of controls (TOCs). The IPA is sympathetic to this view; however, the IPA is concerned this underplays the risk of misstatement through error or fraud. In addition, the IPA is concerned that by overlooking controls auditors are not obtaining sufficient knowledge of the information systems that have input into the financial reporting process.
5. IT General Controls – ISA 315 guidance on consideration of IT general controls is significantly lacking and does not consider the impacts of cloud based IT solutions and the poor segregation of duties. The IPA is also concerned the undue reliance on management/owner involvement as a mitigating factor is reinforced by the existing guidance (IAS 315.A112). It is the IPA’s view that this assumes a level of IT knowledge that is often absent as well as an understanding of financial outcomes that are not always evident in owner-mangers.
6. Fraud – The CP appropriately recognises that ISA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of a Financial Report” as an area of difficulty for the audit of LCEs. The IPA is of the view that ISA 240 does not address the specific issues relating to LCEs including the poor segregation of duties and management override. ISA 240 is focused on a rigorous fraud risk assessment process by the client which is often not present. As noted above the IPA is uncomfortable with auditors placing undue reliance on manager/owner oversight as in practice the manager/owner may not necessarily have the skills required to exercise effective oversight. Finally, the IPA believes ISA 240 needs to address the issue of manager/owner fraud such as wage theft (i.e. underpayment of employees and non payment of entitlements such as superannuation) and non disclosure of revenue for LCEs.

### Question 3

*With regard to the factors driving challenges that are not within our control, or have been scoped out of our explanatory 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?*

#### IPA response

The IPA believes there are two related issues not within scope that need to be considered:

1. Fee Pressure – the IPA believes that fee pressure on LCE segment of the audit spectrum is a major issue driving the pressure for a simplified or two tier audit approach. This has been exacerbated by new accounting standards such as IFRS 15 “Revenue from Customer Contracts” and IFRS 16 “Leases”. An increasing complicated financial reporting framework put pressure on fees particularly for LCE which generally have less sophisticated financial reporting resources and rely on the auditor to address compliance with these requirements. In many cases the auditor is unable to recover costs incurred in providing what amounts to financial reporting assistance.

Furthermore, the audit requirement is seen as a purely compliance requirement. While this is often the case for audit other than LCEs this factor is aggravated by the owners/managers and/or Those Charged with Governance (TCWG) not recognising the existence of other stakeholders in relation to financial reports required to be lodged by LCEs.

Finally, while the IPA believes there is a certain intrinsic scalability to the audit process there is an amount of “overhead” related to undertaking a financial statement audit that is perceived to not be directly related to the work performed but rather relates to the planning of the audit and documentation of conclusions supporting the audit opinion. Where fees are tight these portions of the audit process are considered onerous by auditors and LCE clients are perceived to receive no benefit from these activities.

While this is a significant issue the IPA recognises there is little the IASB can do to effect market pricing other than educating auditors as to the real cost of undertaking audits and the importance of the planning process particular to ensuring an appropriate audit report is issued. That said the IPA does believe the IASB could adjust the structure and output of the planning process to mitigate the associated costs.

2. The Audit Requirement – the IPA believes some of the pressure arises from the requirement for LCEs to be subject to audit. While there are often non-regulatory requirement arising from banks and other financiers many LCEs are subject to audit as a result of a regulatory requirement. There are a number of considerations on which the IASB could engage policy maker and regulators:
  - a. The policy considerations underlying the audit requirement of LCEs and whether such requirements are set at an appropriate size of entity;

- b. Whether the policy considerations requiring the audit of LCEs could be achieved by other regulatory methods and/or assurance service. For example if an audit requirement is driven by the receipt of government funds an “acquittal” audit may be appropriate; similarly if there are concerns as to employee entitlements the requirement of payment of such amounts into a trust account with associated audit requirements may be appropriate;
- c. Whether the financial reporting framework is appropriate i.e. is compliance with “full” IFRS necessary or would a reduced disclosure regime be appropriate for LCEs. The IPA is generally not in favour of different measurement and recognition criteria being applied in reduced disclosure regimes.

#### **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 consequence be if the possible action(s) is undertaken? This may include if, in your opinion, 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 as noted in response to 4b above.*

#### **IPA response**

The IPA supports a revision of the existing ISA to streamline the audit process and the adoption of a “building-block” approach to guidance reflecting appropriate responses to increasing complexity and risk. In particular the IPA would like to see the revision of the ISAs addressing the following matters:

- A movement to more outcomes based requirements were the result of the standard(s) is represented by a clearly articulated result including the appropriate documentation;
- An emphasis on the planning standards (ISA 300, ISA 315 and ISA 330 plus ISA 240 and ISA 250 “Consideration of Laws and Regulations in an Audit of a Financial Report”). As noted above the IPA believes the current format of the standards is cumbersome and not outcome based and as such is seen as burdensome to auditors of LCEs. The IPA would like to see the emphasis of the planning standards on the production of document summaries the key aspects of the engagement (i.e. industry, regulations, financial reporting related system, risk areas [including risk of fraud] and audit response to identified risks).

- More equivocal guidance that addresses increasing complexity and risk with incremental processes and procedures.

The IPA does not support a separate auditing standard for LCEs. The IPA is concerned such an approach would in effect institute a two-tier audit approach which it believes is problematical. Such an approach may be considered as a “watered-down” audit and cause confusion for users. The IPA is concerned as to the impact on the audit report of the application of standalone ISA for LCEs. The IPA believes many users are already unclear as to the distinction between reasonable assurance and limited assurance engagement, the introduction of another reasonable assurance engagement conduction under a different standard would only aggravate user confusion.

While the development of guidance for auditors of LCEs, the IPA sees such an approach as interim approach and does not address the inherent issues with the applying ISAs to the audit of LCEs. Any proposed guidance should be an intrinsic part of a revised suite of ISAs.

### **Question 5**

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

### **IPA response**

The IPA has a number of concerns in relation to proposals for the audits of LCEs:

1. Less Complex does not equal Low Risk – the IPA is concerned that the CP gives the impression that LCEs are low risk because they are less complex. The IPA believes such a conclusion is inappropriate for a number of reasons:
  - a. There is often poor segregation of duties and a high degree of management overrides which increase the risk of misstatement due to error or fraud;
  - b. There is lack of financial reporting expertise increasing the risk of misapplication of accounting standards and the consequent risk of material misstatement;
  - c. Poor Governance – TCWG often lack the skills in risk and finance to provide adequate oversight;
  - d. The systems are often rudimentary without adequate exception reporting and/or those capable of addressing the matters raised by such reporting;
  - e. The LCE has limited sources of funding and may have significant debt funding with limited recourse to alternative sources of finance; and
  - f. The LCE may be dependent on a small number of customers or a government entity for its cash flow with the resultant risk of financial disruption in the event of loss of a customer or government funds.

The IPA is of view that the impacts of such risk are often understated by auditors when planning the audit including determining the nature and extent of audit

procedures. The IPA believes that the current guidance in the ISA does not adequately address these issues and their impact on the audit process.

2. Undue Reliance on Owner/TCWG oversight – The IPA believes that auditors tend to place undue reliance on Owner or TCWG oversight to offset poor segregation of duties and unsophisticated systems. The IPA believes such reliance is often unwarranted due to:
  - a. Lack of financial and risk knowledge of the Owner/TCWG;
  - b. Inappropriate assumption that the Owner/TCWG are close to the operations
  - c. The lack of appropriate reporting Owner/TCWG to enable them to exercise effective oversight

The IPA is concerned that the current guidance in the ISAs reinforces this misconception and that this should be addressed in any revision of the ISAs.

3. Risk of Fraud – the IPA believes the risk of fraud is often poorly addressed by auditors. There appears to be disconnect between the poor segregation of duties, management override and lack of effective oversight by Owners/TCWG and the risk of fraud. As such the IPA believes the risk of fraud in LCEs is often underestimated. Furthermore the IPA believes there insufficient consideration that the owner could be the source of fraud and the auditors responsibilities under laws and regulations. This issue should be addressed in any revision of the ISAs