



**The Japanese Institute of
Certified Public Accountants**

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Mr. Willie Botha
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
529 5th Avenue, 6th Floor
New York, NY 10017, USA

Dear Mr. Botha,

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

The Japanese Institute of Certified Public Accountants (JICPA) is grateful for the opportunity to comment on the Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs* (DP).

The attached are our comments on “Questions for Respondents.” We hope that our views will be of assistance to the IAASB.

Sincerely yours,

Sayaka Shimura
Executive Board Member - Auditing Standards
The Japanese Institute of Certified Public Accountants

Questions for Respondents

- 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?**

(Our Comment)

We believe that the qualitative characteristics described on page 4 are generally appropriate for the description of the types of entities that would be the focus of the IAASB's work in relation to audits of LCEs. We also believe that the definition of LCEs should be principle-based as described on page 4, so that each jurisdiction can decide how to apply the definition in light of its circumstances.

However, we believe that it is necessary to have a common understanding across the globe of what types of entities fall under the definition. From these perspectives, we have the following comments.

- In our view, it should be understood that listed entities are excluded from the definition of LCEs because of the characteristic *a*. (i.e., "concentration of ownership and management in a small number of individuals"). We believe that non-listed entities that have significant public interest (e.g., unlisted banks) should also be excluded from the definition of LCEs; however, it is not clear from the definition on page 4. We suggest "no significant public interest as it does not have a large number of stakeholders" be included as an essential qualitative characteristic similar to *a*.
- We believe some non-profit organizations may fall under the category of LCEs. However, non-profit organizations do not have the concept of "ownership" described in *a*. and it is therefore unclear whether a non-profit organization may fall under the definition of LCEs. We believe that the definition should clarify that non-profit organizations may fall under the category of LCEs.
- We agree that it is difficult to establish a threshold for the size of entities that can be applied globally, and we also agree that the size is not the only issue in today's environment. However, whether the entity is less complex is a relative concept, which is determined based on a subjective judgment. Therefore, in order to ensure an appropriate degree of consistency, we suggest that the IAASB provide typical examples of entities that the IAASB considers to be LCEs. We also believe that inclusion of a description that indicates the size (such as annual sales and number of employees) in the examples would be beneficial for fostering a common understanding about what are envisaged as LCEs. Without a common assumption about the size, it would be difficult to reach a consensus on what should be required for audits of LCEs. For example, the extent of understanding of the entity's system of internal control that the auditor is required to obtain depends not only on complexity, but also largely depends on the size of the entity. Therefore, an indication about the size of the entities for LCEs will be beneficial to make a discussion fruitful.

- 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 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 Comment to a.)

We believe that obtaining an understanding of the system of internal control in the proposed ISA 315 (Revised) "Identifying and Assessing the Risks of Material Misstatement" ("ED-315") is most problematic in an audit of an LCE. The audits of LCEs are conducted within tight time constraints, and there are calls for more scalability in the standards so that the auditor can allocate more audit time to risk response (especially to substantive procedures) than to risk assessment. In LCEs, it is expected that only one or a few management grasp the entire business and that they also conduct ongoing monitoring activities. Therefore, an inquiry of management should be emphasized among the auditor's risk assessment procedures. In combination with inquiry of management, analytical procedures and inspection of related materials, we believe that the auditor can identify and evaluate risks of material misstatement as a basis for further audit procedures.

On the other hand, it should be noted, that the extent to which process-level internal control (i.e., control activities) needs to be understood largely depends on the size of the entities being defined as LCEs. In the audits of micro-sized entities, for example, the auditors may be able to perform substantive procedures for all transactions without evaluating the design of controls and determining whether they have been implemented. However, if the entity has a certain volume of transactions, we believe that it is necessary for the auditor to evaluate the design of controls and determine whether they have been implemented even though the entity's transactions are simple.

In addition to ED-315, DP also noted ISA 540 (Revised) "Auditing Accounting Estimate and Related Disclosures" and ISA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" as ISAs that are particularly problematic. The following are our observations on these standards.

- ISA 540 (Revised): Given the definition of LCEs, the application of ISA 540 (Revised) in an audit of LCE is less problematic because complex accounting estimates are not normally included in the financial statements of the LCE.
- ISA 240: Compared to ED-315, we believe there are fewer challenges in the application of ISA 240.

However, we believe there are some aspects in the current ISA 240 in which scenarios for risk responses are required to be determined not by the degree of the risk of fraud, but by whether or not such a risk exists. For example, it is assumed that a risk of management override of controls is presented in all entities, and testing of the appropriateness of journal entries and other adjustments is required regardless of the degree of the risk (paragraphs 32 to 34 of ISA 240). It is not clear from the requirements how the auditor can determine the nature, timing and scope of the required procedures for this testing in a scalable manner in response to the degree of risk. Therefore, some application issues may arise in an audit of LCE in designing procedures that meet the requirements of ISA 240.

(Our Comment to b.)

We believe that the underlying cause of these challenges is that standards are getting very long and complex, resulting in difficulties in understanding the purpose of requirements, and in understanding which parts are relevant in each audit engagement.

However, this is not a problem specific to audits of LCEs. For all auditors, it becomes difficult to apply ISAs to varying degrees. Over the years, requirements have accumulated in the ISAs and supporting application materials also become voluminous. Many auditors seem to literally follow these requirements and application materials. There is a risk that the achievement of "thinking audits" advocated in the Clarity Project will be hindered, and that the audits will become a compliance-oriented task that follows the standards only superficially. In order to facilitate the appropriate exercise of professional skepticism, we believe that ISAs should clarify the principles underlying the risk-based approach in auditing and leave room for professional judgment; it does not make sense to merely explain in the ISAs the importance of exercising professional judgment during the audit. To foster appropriate audit behavior such as "thinking audits" and the appropriate exercise of professional skepticism, it is time for the IAASB to consider the restructuring of ISAs. We believe that the challenges faced in audits of LCEs provide a good opportunity for such a consideration (see our Comment on questions 4).

- 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?**

(Our Comment)

We recommend that the IAASB encourage the regulators of LCEs to emphasize that it is the responsibility of management to properly prepare financial statements in accordance with the applicable financial reporting framework. In LCEs, management often has significant influence on the entity. Therefore, we believe that in order to ensure proper financial reporting in LCEs, it is essential to ensure that management acknowledge its responsibility for the preparation of financial statements, including prevention and detection of fraud.

We also recommend that the IAASB raise the awareness of LCE stakeholders about the nature and value of engagements other than the audit, in particular, the review engagement and the agreed-upon procedures engagement. If an audit is not mandated for the entity, a review engagement or an agreed-upon procedures engagement may be more appropriate than an audit in light of intended users' needs and costs. However, the review engagement and the agreed-upon procedures engagement are currently used only in limited circumstances as there is a lack of understanding of the nature and value of these engagements.

- 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.**

(Our Comments)

We believe that the building-blocks approach in *A. Revising the ISAs* (“adopting an approach of revising the standard by setting out the basic requirements for all audits, then expanding as needed to address more complex circumstances”) is the most appropriate action. Specifically, we suggest changing the structure of ISAs by making two categories of requirements: core requirements for all audits, and other requirements that are applicable depending on the circumstances. The latter category includes requirements that are applicable to audits of listed entities or PIEs, as well as requirements that are applicable in certain circumstances. According to this approach, the core requirements will correspond to "Separate Auditing Standard Based on the Existing ISAs" in *B. Developing a Separate Auditing Standard for Audits of LCEs*.

We recognize that this approach will take a lot of time; it is necessary to allow sufficient time to discuss what core requirements are. However, there is a need to seek a global solution that is appropriate for all stakeholders, and such solution requires innovative thinking. We believe that this approach is the only appropriate solution for all stakeholders and that the IAASB, as a global auditing standards setter, should therefore seek this approach. By clarifying the core requirements to achieve the objectives of the ISAs, this approach will benefit all stakeholders, including not only for audits of LCEs but also audits of complex listed entities. We believe that clarification of the core requirements applicable to all audits would enable all auditors to sufficiently understand the principles and their intents underlying the risk-based audit approach, which would help improve the quality of audits over the long term.

We believe that just seeking *B. Developing a Separate Auditing Standards for Audits of LCEs* is not an appropriate solution for all stakeholders. The length and complexity of ISAs, which makes it difficult to understand the purpose of the requirements, is an underlying cause of the challenges not only in audits of LCEs but also in audits of complex entities. It would also not be possible to solve the problem by just seeking *C. Developing Guidance for Auditor of LCEs or Other Related Actions*. In addition, we believe it is inappropriate to seek to develop separate auditing standards based on the different frameworks as proposed in B. In addition to taking a great deal of time for seeking such an approach, we believe it would be very difficult to ensure the consistency of such a standard with the ISAs, and to explain that it provides the same reasonable assurance as the ISAs.

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?

(Our Comment)

We believe that technological advances will also affect LCEs. Therefore, it is necessary to closely monitor the impact of technological developments on audits of LCEs in the process of seeking possible actions.