Audit of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs

DISCUSSION PAPER

QUESTIONS FOR RESPONDENTS

QUESTION 1:

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?

COMMENTS FOR QUESTION 1:

In our opinion we consider that the definition of LCE is in general terms well understood, however as this definition may be relevant in order to follow a different set of ISAs for LCE, we believe that certain elements, need to be clearer and more objective.

Even if using professional judgment in this regards, we consider that, in some cases, it would be difficult to decide if an entity meets the LCE criteria or not, based on the current proposed LCE description.

We provide comments to some of the proposed criteria:

i. Straightforward or uncomplicated transactions: A definition of these type of transactions may be required, as some transactions may be complex to different users.

ii. Simple record-keeping: Similarly, we consider this needs to be more clearly described.

iv. Few internal controls: The lack of internal controls in an entity may require a more robust and complex audit procedures.

We also consider that the definition should include certain particular conditions such as when an entity cannot be considered as a less complex entity; for example, where the use of specialists is need, type of technological systems used or if the entity is a public entity or a public interest entity.

Another aspect to consider is to analyze what happens when an entity changes from one period to the following one from being a LCE to an entity that does not meet the criteria to be considered a LCE. Is there a need to re-audit because of possible use of different standards?

We consider that additional guidance may be required in order to more clearly detail when an entity can be considered a less complex entity and when the entity cannot be considered as a LCE, so it is clear to interested parties what would be the audit approach.
**QUESTION 2. a.:**

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.

**COMMENTS FOR QUESTION 2. a.:**

In our opinion, the follow aspects are considered difficult to apply in the Mexico audit practices:

The overall risk-based audit approach (Assessment and response), especially in the following ISAs

- ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- ISA 320, Materiality in Planning and Performing an Audit
- ISA 330, The Auditor’s Responses to Assessed Risks

In general terms audit practices in México have difficulties in determining how the entities internal control affect the overall risk assessment and responses for the audit work as sometimes are considered to be subjective or complex to apply for some firms or practitioners.

**QUESTION 2. b.:**

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:

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?

**COMMENTS FOR QUESTION 2. b.:**

- It is necessary to note that in México for more than 30 years, tax regulations required the filing of a tax report which was prepared as part of a financial statements audit. This requirement resulted in many small and/or not complex entities needing to audit their financial statements only to comply with this tax regulation. This originated the need of complying with audit requirements, either Mexican audit standards and/or International audit standards. If such law would not require the audits, many entities would have not requested assurance services.
• An additional aspect that we consider is important for some Firms and Practitioners, is the lack of guidance on how to apply the concepts included in the ISA’s for planning, execution and documentation of the audit. Some Firms may develop different strategies, software and systems to comply with ISAs; however, big difference result from these in terms of how each audit practice conclude about the topics mentioned above. In addition, other small and medium size firms do not have access to software and/or guidance in how to apply the ISAs effectively as a whole and efficiently.

**QUESTION 3**

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?

**COMMENTS FOR QUESTION 3:**

A) **Legal and Other Requirements for an Audit**

Prepare guidance and/or explanatory material for the entities that require financial statements audits (governments, regulators, financial institutions, etc.), in regards to better understand the scope of a financial statements audits, where in certain situations such audit may not be feasible or necessary to the particular requirements of such regulator or entity. Such guidance may include certain situation where a different report is needed, different from an audit report, such a review report, attestation report, agreed-upon procedures report, audit of a single financial statements, among others.

B) **Technology / Methodology**

Collaborate with the proper entities or institutions (government or private) for the development of audit technology aids and methodology in different languages, where such tools can be obtained and used by firms involved in audits of LCE.

C) **Education and People**

Collaborate with the different international and local professional institutions for the wide spread distribution of IAS guidance in different languages, which can assist audit firms (specially LCE audit firms) in complying in an efficient and comprehensive manner with IAS. Such guidance may include presentations, videos, templates, methodology, etc.
QUESTION 4. a.

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.

COMMENTS FOR QUESTION 4.a.

Our comments for each of the possible actions:

A. Revising the ISAs

As a fundamental principle, ISAs have been developed as a single, integrate and scalable set of standards, which are to be adjusted and adaptable on the type of entities (sizes and types).

Based on the risks that are specific to the entity in the particular engagement circumstances, the application of ISA’s on a consistent basis, drives audit quality and it is significant for the public interest. Therefore, it is critical that any proposed solution(s) should retain the fundamental principle of a single set of ISA’s and accordingly it is difficult to support the development of a separate approach. Instead, it is necessary to provide support to LCE auditors in guiding which ISAs specific aspects and requirements would usually apply to an audit of LCE’s.

Examples of some ISAs that could not be fully applicable to LCE are the following:

a) ISA 402 “Audit Considerations Relating to an Entity Using a Service Organization.
b) ISA 610 “Using the Work of Internal Auditors”
c) ISA 620 “Using the Work of An Auditor´s Expert
d) ISA 701 “Communicating Key Audit Matters in The Independent Auditor´s Report”
e) ISA 720 “The Auditor´s Responsibilities Relating to Other Information

We consider that revising the suite of ISA’s (instead of the other proposed IAASB actions) would have the following positive consequences:

- Would facilitate a universal application of the international audit standards worldwide.
- Would avoid the use of subjective criteria over the definition of LCE.
- Consistency with an increase in the rules requested by international and internal regulators.
- Avoid possible uncertainty of the users of the financial information over the application by auditors of more simple set of international standards, in regards to the levels of assurance.
Summarizing, the main benefit of this action (and not other actions) is the retention of a single set of ISA’s which are applicable all entities maintaining a standardized audit quality and public interest expectations.

However, it is to note, that one of the main challenges faced by auditors of LCEs is how to scale certain requirements and the revision of the ISAs could be time-consuming which may not respond to the LCE auditor needs and concerns.

In order to properly apply the ISA’s, an auditor needs to understand all context of such, therefore, it can be recommended to take a scalability approach in developing and revising ISA’s. In this sense, the requirements and applications material can begin with those that are applicable to all audits, including LCE audits, and go from a less complex entity approach to a complex entity approach (listed and regulated entities)

B. Developing a Separate Auditing Standard for Audits of LCEs.

This action would depart from the fundamental premise of a single set of audit standards, which may result in default the public interest that could result in a product lack of clarity as follows:

- LCE audits may be difficult to identify as an audit performed in accordance with ISA’s
- Could cause confusion to users as to what such a LCE audit involves and differences from a regular audit.
- Would not be clear as to what opinion does a LCE audit actually provides in terms of assurance
- The auditor’s report may clarify that this audit approach may not be a “full-scope” audit or an audit that may provide different assurance.
- Major guidance would be necessary to be provided to users of auditor’s report, and other stakeholders to avoid misunderstandings.

As commented in the Discussion Paper a potential IAASB action would be the development of a separate standard based on a different framework to the ISA’s involving a more substantive approach, however, such approach may not consider relevant issues such as ethical requirements, pervasive principles, exercise of professional skepticism and judgment that would therefore limit the use of the auditor’s report.

In addition it is expected that this possible action by the IAASB would result in a long-term project, where major resources are to be used to develop a new set of audit standards for LCE, which would not resolve the needs of LCE auditors and stakeholders on the short or medium term.

In conclusion, the major disadvantage we conclude exist for this action is the lack of clarity on the level of assurance on what the LCE audits will provide to the audit report users.
C. Developing Guidance for Auditors of LCEs or Other Related Actions.

The development of non-authoritative guidance would avoid the need for extensive changes to existing ISAs, however additional guidance may be viewed by practitioners as adding more material already available. In this way, it can be recommended the preparation and development of a concrete summarized guidance, which can be efficiently understood and applied in LCE audits.

We consider developing guidance for auditors of LCE would obtain the following positive impacts in audit practices:

- Quick and least expensive implementation, by developing and expanding existing guides and developing other mechanisms for IAS dissemination and training aids.
- Avoid changing the historical approach of ISAs from a conceptual framework to a compliance framework - particular rules.
- If a new suite of specific ISAS is developed a different conceptual framework may also be needed to be issued.
- Avoid possible adjustments necessary to the Code of Professional Ethics and the Quality Control Standard, if a new set of ISAs is issued.

Alternatively developing guidance for audits of LCE would result in the following negative impacts:

- The possibility that the guides do not meet the expectations of the auditors (and stakeholders) that the work is effectively simplified.
- The possibility that the application of the guidance do not comply with what is required by the ISA conceptual framework
- The need to continually adapt the guidelines for particular situations that arise in the future of operations, and the business environment of each country.

QUESTION 4. b.

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:

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?

COMMENTS TO QUESTION 4.b.

We do not consider there are other possible actions to be addressed, however as indicated a combination of these actions may be appropriate.
QUESTION 4. c.

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:

   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.

COMMENTS TO QUESTION 4.c.

In our opinion, the best possible action for the IAASB to pursue is a combination of action:

- C- “Developing Guidance for Auditors of LCEs or Other Related Actions” and
- A- “Revising the ISAs”, mainly focusing such revision on the ISAs that the public considers difficult to apply.

The main factors for our conclusion are the following:

a) The negative impacts of the audit report users perception on the differences of a regular audit and LCE audit reports
b) We consider this alternative is the less time and resources consuming alternative
c) Allowing to continue with one set of audit standards, with worldwide applicability.

QUESTION 5

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?

COMMENTS TO QUESTION 5.

We consider that, as part of this deliberation process the IAASB is currently analyzing, the following matters, should be taken into consideration, depending on the actions that are to be elected and resolved in regards to the LCE audits:

- Comprehensive review of other regulations that could be affect LCE audits such as Quality Management or Ethics regulations, given that if a new framework is required or developed it should be in accordance with these other regulations.

- It is to be acknowledged that the expectations of the practitioners and stakeholders to some extend would be that audits could be more efficient and/or less time consuming and this could generate expectations of the economics of the audits; therefore guidance or clear communications to international and local business communities or professional accounting associations could be required.

- In recent years reports from International Forum of Independent Audit Regulators (IFIAR), have been more closely followed and monitored by various regulators and stakeholders;
given this situation it may be needed to engage in communications with this entity so, in
the event a new set of LCE audit standards is issued, is not perceived as an audit with less
quality and assurance

• If a new set of LCE audit standards is to be issued, we consider special consideration is to
be given for regulators or investment bankers in regards to their possible requirements to
re-audit previous years audit when an entity operations changes from a year to another,
from a LCE to a non LCE entity.

• It is not clear if a different audit report is to be issued, if it is resolved that a LCE audit
standards are to be issued, whereas if this is the case, there would be the need of informing
audit report users, stakeholders and auditors the differences in the degree of assurance
and quality between a regular audit report and a LCE audit report.