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Dear Sirs,

## **Audits of Less Complex Entities**

We are pleased to have the opportunity to respond to the Discussion Paper “Audits of Less Complex Entities: Exploring possible options to address the challenges in applying the ISAs” (‘the Discussion Paper’). We set out below our overall comments on the issues raised in the Discussion Paper, followed by detailed responses to each question raised.

We believe that it is timely to challenge the premise that all entities require an “audit” as currently defined and would urge the IAASB to think more broadly in developing a response to the issues facing Less Complex Entities (‘LCEs’). In particular the IAASB appears wedded to the current definition of an audit and the notion that “an audit is an audit”. We believe that a more fundamental question to consider is whether or not LCEs actually require a traditional audit or whether an alternative form of assurance may be more appropriate. We outline our thoughts in more detail below.

## **Overall Comments**

### *Context*

This discussion forms a critical part of the ongoing discussions around the world on the “future of audit” in its many guises. Whilst many of the ongoing reviews in different jurisdictions are focused on the audit of Listed and Public Interest Entities (‘PIE’), it is clear that the future of auditing LCEs, which form a significant part of the economy in most, if not all, jurisdictions is just as important and that auditing such entities presents a different set of challenges.

After many years where the focus has been on maintaining a single set of auditing standards relevant to the audits of all entities regardless of size, nature and complexity, it is increasingly apparent that this model may no longer be fit for purpose. The auditing standards, as published, are increasingly focused on the needs of regulated entities, such as Listed Entities and Public Interest Entities with the requirements of the ISAs increasingly onerous and, equally importantly, ever more rigorously applied by audit regulators.

We believe, therefore, that the time may have come to look at alternative approaches for less regulated entities, and that we may be reaching a tipping point where a separate set of auditing standards, or perhaps even a new form of assurance, is required.

### *Suggested approaches to LCE assurance*

As part of considering the future of audits for LCE, we believe that the time is right to ask whether the age-old mantra of “an audit is an audit” remains appropriate and to ask whether an “audit” is what is required for such entities, or whether a different form of assurance may be appropriate in many instances. In suggesting that a different form of assurance might be appropriate, we are mindful that many LCEs may still require a full audit for its own reasons and therefore the option should remain for all entities to request a full audit, to be undertaken in accordance the full set of auditing standards.

The question is then what form of assurance is appropriate for LCEs if the full auditing standards are not to be applied. We believe that there are a number of options which could be considered and explored. In addition to the options outlined in the Discussion Paper we believe that the time may be right to consider alternatives that are not rooted in the notion of an audit, as currently defined. Two such suggestions are:

- *A completely new form of assurance* – in considering that the time may be right to consider whether “an audit is an audit”, it may be appropriate to consider a new form of assurance which could be provided for entities which do not require a full audit. This form of assurance would most likely lie somewhere between a Review Engagement and an Audit, with greater requirements than a Review but with less onerous requirements than a full audit. The starting point in drafting these standards may be a presumption that the audited entity, the LCE, is not likely to have a fully operational system of internal controls and governance processes that the auditor can place reliance on.
- *Modular assurance* – we have been considering whether there is scope, perhaps within option C of the Discussion Paper above, to introduce a new concept of “Modular Assurance”. Under such an approach there may be a core set of requirements, similar to the building blocks approach to developing the auditing standards. The difference here, however, would be a greater choice of “modules” which the auditor and the entity would select to provide the assurance required by the entity. For example, modules may include tests of controls, IT General Controls, Financial Statements Presentation (or compilation), Data Analytics, Safeguarding Assets, Specific attention on individual line items of relevance/importance to the entity, Sector Specific considerations, non-financial KPIs etc. The audit report would then be much more specific regarding the modules completed and the findings, making the audit report more relevant to the user of the financial statements and addressing the expectation gap by clearly describing what work the auditor has done.

### *Urgency of action*

We believe that the revision of auditing standards, or other forms of assurance, for LCEs is of the utmost importance. As noted during the LCE discussion meeting held in June 2019, 46% of jurisdictions are already looking at what can be done in relating to audits of LCEs. If we wish to maintain international standards for these entities, which are critical to many jurisdictions, it is imperative that the IAASB and others take timely action as a matter of priority in this area.

### **Questions for Respondents**

***NOTE: In answering the questions which follow we are working on the premise that there will be a different approach to LCE audits versus, say, a listed entity or complex entity audit. In the comments which follow we will refer to Listed Entity and other complex audits as “full audits” (i.e. applying the full auditing standards as written today) and audits of LCEs as “LCE audits” (i.e. whatever new approach is taken to writing standards for LCEs) for the sake of simplicity.***

- 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?

**Response:**

If we accept the premise that there is a different approach to auditing LCEs then the definition of what comprises an LCE is critical to the success of any changes to standards. We prefer the term “definition” to the “description” used in the Discussion Paper although we do acknowledge that defining what an LCE is on a global basis is extremely difficult.

We believe that it would be more appropriate to define complexity rather than to define what is “less complex”, applying the “full audit” to those entities defined as complex, with the LCE audit being available to other entities. Defining which entities would be subject to a “full audit” would be much more straightforward. On a global level this could be restricted to Listed and Public Interest Entities (as defined on a jurisdictional basis) and any other criteria that an individual jurisdiction may wish to include relating to privately owned entities (e.g. number of employees, complex group entities operating in several countries or industries etc.). Then, by extension, auditors of other entities may be entitled to apply the LCE approach. This would therefore leave adoption and acceptance of the LCE audit approach with individual jurisdictions, and better reflect the fact that the largest element of the expectation gap is the listed/PIE where there should be no scaling back of requirements except where the requirements are not applicable to an entity. That said, we believe that entities which would otherwise meet the definition of LCE, should have the option to select a “full audit” if they so wish for their own purposes or for the purposes of assurance for stakeholders.

We agree with the IAASB that the focus should be on complexity, rather than size and do not consider that the size of an entity necessarily equates to complexity. We would therefore strongly encourage the IAASB, and individual jurisdictions, to avoid using size as a criterion for defining whether an entity is a LCE. Indeed, on the global level, we do not think it is possible to apply a size criterion.

Focusing on the specific description included in the Discussion Paper, we believe that such a description is difficult to apply consistently in practice and may lead to counter-intuitive outcomes. We make the following comments on the individual elements of the description presented:

- *Concentration of ownership* – The description appears to preclude a larger number of individuals from having ownership, but there are many entities which require audit which may have many owners, but which are otherwise a LCE in nature. For example, a golf club which is a simple business but with several hundred “owners” (i.e. members). Similarly, there may be privately owned entities with few owners but which have significant complexity; for example, a large high street chain in the UK with hundreds of stores which, ultimately, ceased to exist, thereby impacting many thousands of jobs and the associated pension schemes.

- *Straight forward or uncomplicated transactions* – At a principles-based level this is likely a core element of the definition, however, it is difficult to define what are straight-forward, uncomplicated transactions, particular in relation to increasingly complex financial reporting standards. For example, under new Revenue Recognition standards any transaction with a service period component, or construction contracts, may be considered complex even though they are routine transactions for the entity.
- *Simple record keeping* – As above, how do we define “simple” record keeping? Without explanation, example and definition it is difficult to consistently determine and act on. Indeed, the existence of “simple” record keeping may not necessarily be appropriate for a particular entity and may in fact raise the associated risks with the audit, rather than necessarily implying less underlying complexity.
- *Few lines of business and few products* – While the number of lines of business may indicate greater complexity, the definition of what constitutes a “line of business” is critical to consistent application (e.g. is selling trucks a different line of business to selling cars?). Similarly, with products, a large number of similar products may not necessarily indicate additional complexity.
- *Few internal controls; few levels of management* – It is difficult to define and apply a term such as “few” consistently. Also, while fewer controls may be an indicator of a less complex entity, an LCE could conceivably still have a number of controls. Furthermore, the description doesn’t take account of the nature of the controls (e.g. are controls documented, designed and operating effectively or are they largely manual without full documentation or consistent application?) or those complex entities which have insufficient controls.
- *Few personnel* – As above, limited numbers of staff may be indicative, but not definitive, as to whether the business is complex. This criterion appears to be straying into the “size” of the entity rather than its complexity. The nature of the business and its transactions is more likely to define the complexity of the entity. Also, how do we define “few personnel” and apply this consistently in all jurisdictions? Furthermore, with ever increasing automation the number of employees in an organisation may become less relevant to many businesses.

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.

**Response:**

- ISA 240.27 – LCEs may often have few or no significant risks of material misstatement relating to fraud in revenue recognition. The current examples in the standards for rebuttal of the presumption of fraud in revenue recognition are restrictive and may need revision in the context of LCEs.

- ISA 300.21 - The level of documentation expected and required for a “LCE audit” may be different to that for a “full audit”. Regulatory expectations appear to be considerably higher than audit professionals consider appropriate in some cases and the extant standard does not provide sufficient examples or guidance as to what is considered acceptable, primarily due to the lack of clarity of what the minimum requirements are.
- ISA 315 - The required level of documentation of the control environment is not consistent with the concept of an LCE and we believe that this aspect of the Risk Assessment standards should be significantly revised for the “LCE audit” approach. By the very definition of an LCE, it is highly unlikely that the entity would have a complex control environment which maps to the elements of the COSO Framework and many such entities would not have, for example, documented Risk Assessment Processes etc.
- ISA 315 – We believe that the extent of work required and the associated documentation in the extant standards is appropriate for listed entities and other more complex entities. However, notwithstanding comments in the application material around scalability for smaller entities, the extant standards are overly onerous for many LCE audits. As a result, many firms and software providers have tried to develop means of streamlining the documentation of the risk assessment for such entities. These approaches run the risk of auditors not fully complying with the extant standards. For example, the application of the COSO Framework in establishing a control environment at LCEs is much less likely and goes beyond merely having “informal” and undocumented arrangements in many of the areas considered by ISA 315. The Risk Assessment is an area where either a “building blocks” or “modular” approach may be most effective.
- ISA 315 - The statement that there may be increased risks in smaller entities, whilst true in some cases, is not guidance which assists the auditor perform a more efficient audit. In fact, this “guidance” on the face of it creates greater work for audits which are already under significant fee pressure, given the need to apply the full extant standards to LCEs. The current guidance is not helpful in the audit of LCEs, and further indicates the need for the standards to be built from a set of core minimum requirements rather than the highest level of requirements. Further, the requirement that audit evidence is obtained from a combination of enquiries and other procedures such as observation, with the acknowledgement that smaller entities or LCE may have limited documentation of, say, the control environment makes it difficult to define how much evidence an auditor can take from inquiry alone.
- ISA 500 and Data Analytics – Data Analytics and similar technologies may provide high quality audit evidence for all entities, including LCEs, in an efficient manner. However, there is currently a lack of clarity around whether data analytics techniques provide substantive audit evidence or are merely risk assessment tools which may be useful in identifying transactions at greater risk. The IAASB and others (e.g. standard setters and regulators) need to provide greater clarity over the evidence which analytical techniques provide to enable the audit profession to move forward in this area.
- ISA 540 (Revised) – In previous consultations and other forums, many commentators have expressed concern over the increased complexity of the requirements for auditing estimates. While for Listed/PIE and more complex entities this may be reasonable, it is likely that an overly onerous set of requirements for even the more straightforward estimates may adversely impact on the audit of LCEs.

- ISA 530 – The extant guidance and standards in relation to Audit Sampling are relatively high level and it is left to audit firms to develop their own methodology for sampling, be that using statistical or non-statistical techniques. For audits of LCEs, it may be possible to provide greater clarity over the appropriate extent of work to be undertaken when using sampling. Indeed, given that many firms around the world are known to use certain sample sizes (e.g. 10 or 20), if a different form of assurance were to be adopted, it may be appropriate to establish “normal” sample sizes for use in such situations.
- Information Provided by the Entity (IPE) - There is currently only limited coverage of IPE in the extant standards. However, the generation and potential “manipulation” of such information is an area of audit risk for all entities. Greater clarity over the work required to enable the auditor to place reliance on IPE would be helpful for all audits, but especially for LCE which may utilise more “off the shelf” accounting products or perhaps even rudimentary systems for recording financial information (e.g. Excel spreadsheets).
- ISA 570 – the requirement to evaluate management’s assessment of the entity’s ability to continue as a going concern. This assumes that the entity has the capability and capacity to make a going concern assessment which may not always be the case for LCEs.

(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.

**Response:**

As set out in our earlier comments, we believe that the underlying cause of the challenges with applying auditing standards to the audits of LCEs is the ever-increasing complexity and additional burden of standards which are really only required/applicable to Listed/PIE and more complex entities.

We believe that simplification of the requirements for LCE, via either a building blocks approach, separate audit requirements or a new form of assurance (including modular assurance) is required for LCE assurance.

2) 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?



**Response:**

We believe that the IAASB should work with other stakeholders, such as national standard setters, regulators, etc. to identify how best to take forward the agenda for LCEs. To maintain international standards, it is imperative that the IAASB liaises with national standard setters in particular given the feedback that nearly half of jurisdictions are already considering how to address this issue themselves.

With regard to key actions, we consider that the following should be prioritised:

- *Use of Data Analytics and similar technologies* – the IAASB should work with technology providers, other standard setters and regulators to ensure that there is clarity over the audit evidence provided by such technologies and techniques. The ability to amend or change standards in this regard is directly within the capability of the IAASB and would potentially have the greatest impact on all audits, including those of LCEs.
- *Regulators and compliance* – the IAASB should work with regulators to clarify requirements in the standards and associated application material/guidance. Many regulators take a “checklist” approach to compliance with standards which are written on a principles basis. It is therefore important that the IAASB is aware of the impact of statements included in application material which are often taken as “requirements” by regulators.
- *Addressing the expectation gap* – working with other bodies in the profession and stakeholder bodies, the IAASB and others should focus on clarifying the public expectations of an audit to help reduce the expectation gap. Furthermore, it should work with appropriate bodies in the financial statements supply chain to make clear that audit quality and compliance can only improve where there is a suitable fee to perform such work and where the entity itself has the capability to prepare good quality financial statements. We believe that some of our suggestions around the level of assurance provided to LCEs and audit reporting would also go some way to addressing the expectation gap.
- *Enhanced requirements of ISQM1* – The IAASB may wish to consider whether the additional requirements of its proposed ISQM1 are appropriate to providers of assurance to LCEs, particularly those small and medium practices which provide assurance to LCE but which may not be members of an international association or network.

3) 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.

**Response:**

As outlined above, we believe that it is timely to challenge the premise that all entities require an “audit” as currently defined. We would urge the IAASB to think more broadly in developing a response to the issues facing LCEs and to consider whether or not LCEs actually require a traditional audit or whether an alternative form of assurance may be more appropriate.

With regards to the possible actions set out in the Discussion Paper we make the following points:

*A – Revising the ISAs*

In the Discussion Paper the IAASB sets out alternative approaches to revising the ISAs. We do not support the addition of further application material to be applied in the context of LCEs, including more material on scalability and proportionality. One of the criticisms of the ISAs for use in LCE audits is the length and complexity of the extant ISAs and, by adding yet further material, we believe this will merely further increase the length and complexity of the ISAs. Further, the IAASB needs to be cognizant of the impact of guidance included in application material which is, often, taken as a requirement by regulators and others.

Of the options for revising the ISAs, the option which we would support is a “building blocks approach”, setting out the basic requirements for all audits with additional requirements for more complex situations (e.g. Listed entities etc.). This is clearly, in our view the best of the alternatives provided. However, we consider that using a building blocks approach would enable auditors to understand a single set of auditing standards which could be applied in all circumstances.

With respect to the ways in which a revision of the ISAs could be undertaken, the most appropriate means of changing the ISAs would be to revise all of the ISAs as a single project, to incorporate the building blocks approach. However, we accept the scale and complexity of this task would be significant (reflecting the scale and complexity of the ISAs themselves) and so it may be more appropriate to focus on a rolling plan of individual standards, tackling those with the greatest impact first (e.g. ISA315).

*B – Developing a separate auditing standard for audits of LCEs*

Although concerns have previously been expressed regarding development of a separate set of standards, it would appear that we may be reaching a tipping point where such an approach may now be more acceptable. Many in the profession have resisted the temptation of different sets of standards for different types of entities but it is clear that standard setters in many jurisdictions are considering how best to address the assurance needs of LCEs.

Whilst there is logic in having separate standard to some extent, we believe that a more appropriate means of achieving the IAASB’s aims, within the context of all entities requiring an audit as currently defined, would be to develop the “building blocks approach” set out in the Discussion Paper. A building blocks approach would ensure more consistency in approach and methodology for those firms which provide audits to both LCEs and more complex entities enabling them to simply add on the requirements for more complex situations. If a separate standard, taking a separate approach as outlined in the Discussion Paper, were adopted then audit firms and individual engagement teams may need to understand two different approaches/methodologies which may lead to confusion and a consequential negative impact on audit quality.



As set out in our overall comments we believe that it may be appropriate to consider more broadly the type of assurance required and, as a result, to consider a completely new type of assurance for LCE audits rather than simply develop a new set of standards for a traditional audit.

*C – Developing guidance for auditors of LCEs or Other Related Actions*

We do not support the notion of addressing the LCE audit through guidance in any of the ways outlined the Discussion Paper. Some of the concerns addressed in relation to applying the ISAs to LCE audits is the length and complexity of the material. Issuing further guidance which the auditor would need to understand, over and above an understanding the ISAs, would only further exaggerate the length and complexity of the material that auditors need to understand.

**ALTERNATIVE OPTIONS PROPOSED**

As outlined above, alternative suggestions for consideration, include:

- *A completely new form of assurance* – a new form of assurance would most likely lie somewhere between a Review Engagement and an Audit, with greater requirements than a Review but with less onerous requirements than in the full auditing standards.
- *Modular assurance* – under a “Modular Assurance” approach there may be a core set of requirements, similar to the core used in the building blocks approach to the auditing standards, with a choice of “modules” which the auditor and the entity would select to provide the assurance required by the entity.

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?

**Response:**

As noted earlier, we believe that it is timely to consider the level of assurance required in LCEs and whether or not an audit, as it is currently defined, is the appropriate response to the assurance needs of such entities. It is important, however, that if a new form of assurance were developed, an entity may still opt to have a full audit in accordance with the auditing standards.

Furthermore, alongside these different forms of assurance (and in particular “modular assurance”) we believe that greater transparency in auditor’s reporting of the work actually performed during an engagement will add value to users of the financial statements. (See response to Q4).

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?

**Response:**

We believe that the IAASB needs, as a matter of urgency, to reach a conclusion on the preferred way forward and then consult as soon as possible on its proposals. At this stage it is too early to say what the priorities would be given the range of options on the table. However, reducing the length of the ISA's themselves would likely be required.

**4) Are there any other matters that should be considered by us as we deliberate on the way forward in relation to audits of LCEs?****Response:***Enhancing transparency of auditor reporting*

We believe that it is also timely to consider the form of auditor reporting upon completion of all audits, regardless of whether Listed/PIE or LCE. We believe that greater transparency in the audit report of the work actually performed and the findings of that work would lead to more focused audit reports, relevant to the entity being audited and thereby add much greater value to users of the financial statements. We believe that Key Audit Matters are a step in the right direction, but greater clarity of the work performed during the audit may also assist in addressing the expectation gap.

For example, many users may expect that an auditor would undertake testing of controls during an audit. However, in reality for LCEs (and indeed many larger, more complex entities) most auditors do not undertake tests of operating effectiveness of controls. If the audit report stated whether or not the auditor had undertaken tests of controls, and the results thereof, this would give a much stronger indication of the controls in place at the entity. On the other hand, if the auditor does not test controls and includes this in the audit report, along with an explanation of why not (e.g. the auditor chose not to, or the entities controls are not sufficiently strong) this would also give an indication of the effectiveness of the controls in place at the entity which may be of interest to the user.

Yours faithfully,



**Dr Paul Winrow**

**Director of Professional Standards**