

Feedback on the Audit of LCEs

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:

1. We gathered informal feedback from auditors in New Zealand and the Pacific Islands that we support with our software, most of which include a large proportion of LCEs in their client base.
 - a. From this feedback it seems that the greatest mis-match between ISAs and the needs of the entity are for the audit of smaller not-for-profits, associations, clubs and charities.
 - b. The discussion in the paper doesn't seem to give much regard to these types of entities and their specific needs, but instead concentrates on for-profit LCEs.
 - c. In New Zealand this LCE NFP sector represents the bulk of our audit work – more I suspect than in many other jurisdictions.
 - d. I would propose therefore that “less complex” in New Zealand could be represented by “Tier 3” and “Tier 4” charities, Associations and Clubs, and For-Profit Entities that qualify for Special Purpose reporting. (i.e those outside of IFRS or large PBE financial reporting standards).
 - e. I think that aligning “Less Complex Entity” to the financial reporting requirements makes sense in a New Zealand context with some provisos (see 3-4 below).
2. In my view “Less Complex Entity” is a better description than “Small” as this is can mean very different things in different contexts.
 - a. For instance the Nordic Standard ties its criteria for small entities into the mandatory threshold for the UE accounting directive.
 - b. In New Zealand many of these “small” entities are not likely to align with “less complex” to any great degree. The criteria on page 4 are better.
3. I would add to the characteristics on page 4 another differentiating factor: *that the entity has limited or no overseas interests*. If the entity has any sort of overseas ownership or subsidiaries or significant trade whereby suppliers or customers relied on the audit work they would be required to produce audit reports in terms of the ISAs.
4. This would effectively remove the need for compliance with international standards at all - which changes the whole discussion. I base this on:
 - a. One of the issues that IAASB had with the Nordic Standards for Small Entities was that they were just applicable to the Nordic countries and they were wanting to develop an international standard or standards for LCEs (p7). But if one of the criteria for LCEs was that it was only operating within the country of region then maybe it is acceptable for each country or region to adopt their own LCE standards?
 - b. It could actually be a good thing for these standards to *not* be international as the audit requirements can be localised for the specific regional

environment and also be easier to maintain without a full international adoption process.

- c. In New Zealand this would probably remove the majority of our audit work from the ISA net without any risk to our international reputation, and enhancing our charities and social services sector and SME sector of our economy.

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

1. One of the problems our users seem to comment on regularly is the increasing complexity of the audit report, and understanding the need for four standards around reporting (ISA 700,701,705,706).
 - a. The complexity of the audit report flows across to more complex engagement letter and other communication requirements.
 - b. Simplified reporting for LCEs would be a cheap and effective “win”.
2. Simplified reporting for LCEs would also help to make audit reports and associated communications more accessible to end users, who in general tend to be less sophisticated in their understanding of audit and financial reporting than those of larger/more complex entities.
 - a. Feedback I have is that overly complex audit reports for LCEs do not add to the perception that the audit is useful or providing value.
 - b. Readers of reports for LCEs need Plain-English reporting. Again an easy and cheap “win”.
3. My discussion with and review of work done by many of our smaller user firms confirms that:
 - a. Identification, assessment and evaluation of risk in relationship to materiality is a significant problem (ISA NZ 320).
 - b. Then tying that assessment into responding to those risks with appropriate tests to reduce the risk of material misstatement, (ISA NZ 330) including tying risk in a meaningful way back to how much reliance to place on TOD (tests of details), OSP (other substantive procedures), SAP (substantive analytical procedures) (ISA NZ 530 etc) is not often well done or documented.
 - c. The standards give little concise practical guidance on these points.
4. Service Performance auditing is also presenting significant challenges to many of our users (we now have our own standard for this - NZ AS 1).

- 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

1. As part of my research and reflection I reviewed the pre-ISA *New Zealand Codified Auditing Standards and Audit Guidance Standards (November 1998)* and also the older *New Zealand Auditing Standards and Guidelines (March 1996)*.
 - a. The 1996 standards (AS 1-11 and AG 1-23) had been in development since 1973 and were an attempt to set some basic markers and guidance for audit work in New Zealand based on best auditing practice applied to our context. In my opinion they actually read very well in many respects, explaining concisely the key issues of risk-based auditing.
 - b. The 1998 Codified Standards were the first attempt to move towards full ISAs. In trying to bridge auditors over they had some improvements but I think they also lost some of the clarity of the earlier work.
 - c. The obvious observation after reading through these older standards was (as noted in the paper) the sheer bulk of the ISAs (approximately 1200 pages) compared to the 1998 codified standards (330 pages), and the 1996 standards (265 pages including guidance).
 - d. I was surprised how clear the 1996 standards were and imagined how easy and useful it would be just to go back to those for New Zealand LCEs (with some appropriate updates of course for the changing business environment since the 1990s).
 - e. It seems that much of that which was changed between these original standards to the ISAs was to address issues that have arisen out of the complexities of globalism and the subsequent impact of the Global Financial Crisis of 2008. Although these international issues had little direct effect or relevance to LCEs in New Zealand the flow on effect was a crippling audit fee increase for LCEs without any real quality gain.
2. From the perspective of LCE auditors, in the process of trying to create internationally applicable standards in the context of globalism and the GFC the ISAs have become more broadly vague and wordy without any real clear prescriptive guidance on how to actually do the audit work.
 - a. Instead they make prescriptive requirements in terms of reporting, risk assessment, fraud and estimates that are not actually helpful to LCE auditors or the users of their reports.
 - b. As a result in New Zealand we have had many provincial firms that carried out perfectly adequate audit work at a scale appropriate to LCEs drop out of auditing because they do not have the time, staff or resources to carry out compliant ISA audits.
 - c. In turn the entities they previously audited have had to either pay much higher fees to large city firms, stop being audited voluntarily (if under the threshold for compulsory audit) or potentially close because they are already financially pressed and dependant on overstressed volunteers.

- d. So the social cost of inappropriate audit standards may well be an overlooked factor in this discussion. At a social level it is critical that small charities and clubs and not-for-profits remain viable and accountable, as these entities create a disproportionate amount of social cohesion which flows down into all sorts of positive social outcomes.
- 3. To respond to the challenges outlined, we (Audit Assistant) have:
 - a. Designed workpapers that address all the prescriptive requirements of the standards, plus provided model reports and letters that meet the requirements.
 - b. Unfortunately the quantity of these requirements has made the “checklist-approach” (p6 of the paper) unavoidable. Instead of actually focussing on the obvious issues the auditor is distracted from the task by overly complex requirements.
 - c. As a result audit quality and usefulness to stakeholders is reduced, and cost is increased.
 - 4. Some of our users have (in the worst cases) responded by:
 - a. Deliberately cutting corners – using out of date but simpler engagement letters and reports, ignoring detailed risk assessment and analysis, skimping on planning and documentation of work done.
 - b. They do this to try to make the engagement economically viable (when in many cases they are already doing the work at cost for the social benefit to the community anyway).
 - c. This response is understandable but of course the work is sadly not compliant with the standards.

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

1. As noted, in many ways the problem is not completely with the ISAs as such but a problem with understanding the basics of risk based auditing.
 - a. Many of our users are practitioners trained before the advent of ISAs. They haven't caught up, and there are limited opportunities for them to do so. Consequently they don't coach or encourage their young graduates in best practice.
 - b. I often hear from our users that most of the training offered to audit practitioners is not especially helpful for auditors whose work is primarily for the charities sector which is dominated by LCEs.
2. I also hear from our users that many CAANZ practice reviewers come from a "high-street" perspective and do not fully appreciate the particular issues around the audit of LCEs.
 - a. They therefore do not give helpful advice to help practitioners do better LCE audits.
 - b. Perhaps there is a case for more helpful focus on these kinds of entities by CAANZ?
3. It appears that educational institutions in many cases continue to train graduates in auditing theory but not so much in practical auditing skills – especially as they pertain to LCEs. Or perhaps they are so focussed on the details of the standards that they miss the flow of the big picture – not understanding how the whole process fits together.
 - a. This is partly the fault of the standards as they don't provide a clear cohesive flow of how an audit fits together and partly of the educational institutions.
 - b. Maybe more connection between the standard setters and educational institutions would help, with a recognition of the needs of LCE audits?

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. 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.**
- d. Are there any other possible actions that have not been identified that should be considered as we progress our work on audits of LCEs?*
- e. 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

1. Perhaps there needs to be more done on creating a theoretical framework for a risk-based audit?
 - a. This would provide a sort of “road map” so an auditor can say “I am here”.
 - b. We have attempted to do this with Audit Assistant. The problem is that we really have to wrestle with the standards to give this kind of workflow. As the ISAs have evolved they seem to be lacking a useful cohesion.
 - c. I think there is great merit in revising the ISAs along these lines – more clearly setting out what the auditor is to do – fitting within a “theoretical framework”.
 - d. This would be helpful for all audits – not just LCE audits.
2. A revision of the ISAs should also include:
 - a. A Plain English rewrite.
 - b. Combining and harmonising standards where appropriate (e.g. just one reporting standard).
3. Alongside this I would suggest allowing individual jurisdictions to develop their own appropriate LCE approaches for entities that do not interact in any significant way outside of that jurisdiction (as already covered elsewhere).
4. I think that a modified risk-based approach (p16) is still appropriate for LCEs. Added to basic risk identification and assessment there could also be:
 - a. A more prescriptive approach that provides so definite testing programmes to follow assuming little or no reliance on controls.
 - b. More direction on appropriate levels of testing in response to risk.

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

All covered above.