



INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB)

DISCUSSION PAPER: AUDITS OF LESS COMPLEX ENTITIES (LCEs)

RESPONSE FROM ICAS TO THE IAASB

11 SEPTEMBER 2019

Background

ICAS is a professional body for more than 22,000 world class businessmen and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

ICAS commends the International Auditing and Assurance Standards Board (IAASB) for attempting to address the complicated and difficult issue of audits of Less Complex Entities (LCEs). We welcome the opportunity to respond to the IAASB's Discussion Paper on Audits of LCEs.

As the discussion paper has highlighted, many jurisdictions have already introduced their own initiatives specifically targeted towards audits of LCEs, with some of them issuing separate stand-alone auditing standards for small entities. This demonstrates that there is clearly an issue, either in the way that the current International Standards on Auditing (ISAs) are interpreted and applied in the audits of less complex entities, or in the way that the ISAs have been drafted.

Furthermore, the rising number of these global initiatives increases the urgency for the IAASB to respond to this issue and engage with those undertaking audits of such entities. There is a risk that any further inaction at this stage might result in further fragmentation in the auditing standards environment and more widespread introduction of national and regional initiatives, thereby undermining the role and authority of the IAASB and the ISAs. In our opinion, this would not only be a regrettable development, but would also be damaging for the credibility of the audit profession as a whole.

ICAS, alongside many other professional bodies, has become increasingly concerned about the length and complexity of the current, and recently exposed, revisions to the ISAs which have become more prescriptive and appear to be primarily focused on larger Public Interest Entities. As a result, we understand the decision taken by some jurisdictions to introduce their own separate standard for smaller entities.

However, we are concerned that this might inevitably lead to a two-tier system whereby the audits of LCEs are addressed at a jurisdictional level but not based on any degree of standardisation or international agreement. We believe therefore that the optimum solution should be one that is based on the ISAs in order that it can be regarded as authoritative and provides the same level of assurance as the current ISA audit.

We believe that the IAASB should, therefore, prioritise their activities as follows:

Priority 1 – Develop a separate standard for audits of LCEs based on the key principles in the current ISAs that delivers the same level of assurance and has the same objectives as the current ISA audit.
 Priority 2 – The current ISAs should be redesigned and re-drafted to be fully principles-based using a 'plain English' language convention based on the same 'building blocks', or 'think simple first', approach adopted in the development of a separate auditing standard for LCEs as set out in Priority 1 above.

Adoption of a true principles-based approach will assist the firms in the more efficient use of technological advancements within their audit processes whilst still complying with the standards.

Priority 3 – In due course, more consideration should be given to converging the two activities above resulting in the ultimate desired option of a single suite of ISAs that can be applied to all audits regardless of size and complexity.

The ability and willingness of the IAASB to engage and communicate with all interested stakeholders and jurisdictions is vital to identify and develop a workable solution that will be adopted globally. This is particularly important now, at a time when the value and role of audit is under incredible scrutiny within certain jurisdictions. We would therefore urge the IAASB to remain flexible, open for dialogue and willing to consider all potential solutions.

Our responses to the specific questions are detailed below.

Specific questions

Question 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 1.

While the description of LCEs on page 4 of the discussion paper is a helpful starting point, as the paper states, these are drawn from the IAASB's current definition of a smaller entity and excludes the complexity perspective that the introductory section of the discussion paper takes great pains to emphasise. This is an unfortunate omission, or inconsistency, as it might give the impression that the IAASB considers that some of the identified challenges in applying the ISAs sit only with smaller entities. This is not the case in practice as we are aware that audits undertaken on some medium-sized, or even some large, entities, based on the current EU thresholds, also face similar challenges relating to the scalability and relevance of the ISAs.

In addition to those already listed, we believe that other potential characteristics could include:

- i. No significant, external third-party debt or financing arrangements.
- ii. Simple and easily understood business model and/or structure.
- iii. No complex financial reporting requirements, for example complex financial instruments.
- iv. No cross-border activity or operations spanning different jurisdictions.

As far as the definitions and characteristics themselves are concerned, we agree that it is correct for the IAASB to focus on the qualitative characteristics of an LCE in a short, well-defined list. This could also be used to ascertain which specific entities should be automatically scoped out of an LCE audit, such as listed entities or Public Interest Entities. Ultimately, of course, such matters would be primarily for local standard setters or regulators to determine as they best understand the needs of their respective markets.

However, we do not underestimate the challenge of creating a comprehensive definition of a less complex entity. When devising such a definition, the parameters and language need to be sufficiently clear to enable consistent interpretation and application, and importantly, to avoid future regulatory challenge.

It may be necessary therefore to include some quantitative measures as part of the classification criteria for entities that might be categorised as LCEs. While the IAASB could provide some indicative guidance as to the type of entities that might be considered LCEs, and those which would not, we believe that it would ultimately be a matter for individual regulatory bodies to decide which entities would be considered LCEs based on the market composition and structure in their individual jurisdictions. This is similar to the approach for the application of the IFRS for SMEs.

One final consideration is the need for care to be exerted when creating the definition of an LCE not to unintentionally exclude certain types of entities from the LCE environment as a result of some of the specific aspects of these entities. There is a danger that in certain jurisdictions all charities, for example, because of their specific accounting requirements and public good objectives, might be considered specialist entities and, as a result, judged by some to fail to satisfy the definition of an LCE. Such a blanket approach is to be avoided as it fails to take account of the specific circumstances.

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 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?

Response 2.

- a. We believe that many of the difficulties experienced in the application of the ISAs for audits of LCEs relate to what are perceived to be onerous documentation requirements, particularly at the planning and completion stages. For example, the need under ISA 230 Audit Documentation, for the auditor to document why a specific audit procedure has not been performed is considered excessive, as it requires consideration and documentation of all such audit procedures and is more representative of a compliance-based approach.

Paragraph A16 of the application material of ISA 230 states that 'The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity', but there is no further guidance in this respect. As a result, it is not clear as to the extent of audit documentation required and raises the risk of either insufficient documentation or too much documentation. Neither of these situations is ideal; the former runs the risk of regulatory challenge and the latter risks inefficiencies as a result of over-auditing.

A further challenge in the application of ISAs in the LCE environment is that, in many of these entities, there may be little in the way of formal or structured internal controls in operation on which the auditor can place reliance. This is primarily because such a formal control environment may not be warranted in such entities. As a result, the auditor will undertake more substantive procedures which often involve excessive sample sizes and documentation requirements relative to the size of the entity.

Finally, as stated in our opening comments, the overall length of the most recently exposed and revised ISAs, along with the degree of prescriptive language included and overlapping requirements, present difficulties in the application of the ISAs in audits of LCEs. We recognise that the IAASB is in a difficult position, trying to balance requests from some stakeholders for more prescription to avoid future regulatory challenge, against those performing audits of LCEs seeking shorter and more principles-based standards. We believe that the adoption of a different language convention might be helpful in tackling this difficulty. The use of more easily translated and understandable terminology, which is less likely to be interpreted differently by different audiences, would be beneficial.

- b. With regard to 2a above, in response to the excessive documentation requirements in audits of LCEs, we believe that it would be helpful to establish a minimum documentation level, which could be augmented according to the nature of the engagement, to demonstrate the minimum quantity expected, in terms of documentation, for audits of the smallest and simplest of entities. This could incorporate minimum requirements over documentation of the internal control environment and the rationale for the absence of reliance being placed on internal controls.

In relation to the lack of reliance capable of being placed by the auditor on the internal control environment of an LCE, we would suggest that it should be made possible for the current risk-based approach under ISA 315, along with the excessive documentation requirements, to be bypassed in such audits where there are few, if any, internal controls in existence. The auditor could be asked to document in the planning memorandum, details of the substantive approach adopted to the audit and the justification for that approach based on his/her professional judgement.

Question 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?

Response 3.

We note the list of factors driving challenges that are not within the IAASB's control. We believe that the IAASB has a role to play in relation to some of these. Specifically, that of education and people. While the IAASB is not directly responsible for how auditors are trained, nor the attraction and retention of audit trained personnel, we believe that engaging in a programme of outreach and communication with education providers would be beneficial for all parties. Outreach activities of this nature would enable the IAASB to understand some of the practical challenges faced by the training bodies. It might also present an opportunity for the IAASB to support the training bodies by helping to promote the value of audit to society so that it is perceived as an attractive career option by those considering, and embarking upon, a career in the accounting profession. We also believe that there would a role here for the successor body to the International Accounting Education Standards Board (IAESB).

Finally, although we agree that developing or promoting technological tools or methodologies sits outside the remit of the IAASB, there is a need to keep abreast of developments in technology in the marketplace in order that any initiatives remain future proof and relevant as firms, and audited entities themselves, increase the use of technology to enhance their processes and business systems.

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. (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.

Response 4.

We have inserted our views on each of the three possible actions under the relevant headings below, however, in our opinion, the IAASB should prioritise their activities as follows:

Priority 1 – Develop a separate standard for audits of LCEs based on the key principles in the current ISAs that delivers the same level of assurance and has the same objectives as the current ISA audit.

Priority 2 – The current ISAs should be redesigned and re-drafted to be fully principles-based using a 'plain English' language convention based on the same 'building blocks', or 'think simple first', approach adopted in the development of a separate auditing standard for LCEs as set out in Priority 1 above.

Adoption of a true principles-based approach will assist the firms in the more efficient use of technological advancements within their audit processes whilst still complying with the standards.

Priority 3 – In due course, more consideration should be given to converging the two activities above resulting in the ultimate desired option of a single suite of ISAs that can be applied to all audits regardless of size and complexity.

a. Revising the ISAs

We are not convinced that this potential solution will be successful in achieving its objective within an acceptable timescale. Given the importance of this issue, and the discussions that are taking place within individual jurisdictions, the need for some urgency is evident. We do not believe that a full-scale revision of the entire suite of ISAs will be possible in a short enough timescale to meet the need, or appetite, for a short-term solution.

However, we do believe that it might be possible to undertake a targeted update of some of the key ISAs, for example ISA 200; ISA 230; ISA 315; ISA 500 and ISA 540, based on a 'think simple first' or 'building blocks' approach. This could then form the basis for a review of the remainder of the ISAs once this targeted update had been completed.

b. Developing a separate auditing standard for audits of LCEs

There are concerns that the development of a separate standard for auditors of LCEs might lead to a two-tier audit system thereby increasing the risk of creating confusion in the marketplace and the impression that an LCE audit is of lesser quality and value.

However, we believe that this could be avoided if the starting point for any separate auditing standard is the existing requirements and objectives within the current suite of ISAs tailored to the audit of an LCE. In order to avoid the creation of a two-tier audit environment, the overall objectives and assurance provided on the application of a separate standard for audits of LCEs would need to be consistent with those in a full ISA audit.

We also believe that, during this process, lessons and good practice might emerge that could be adopted in the development of future ISAs as part of a building blocks/think simple first approach.

Whilst a stand-alone standard would include all the key requirements of the ISAs, if further application guidance was required, the auditor would be directed to the text of the full standard for further reference. An example of this type of approach can be found in the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) which appears to work successfully in practice and is available for any jurisdiction to adopt, whether or not it has adopted full IFRS Standards. It is down to each jurisdiction to determine which entities should use the Standard.

We believe that a similar simplified approach to that adopted in the IFRS for SMEs could be incorporated within a separate audit standard for LCEs. The types of simplification adopted in the IFRS for SMEs from full IFRS standards could be adapted for an audit standard for LCEs. These simplifications could include:

- The omission of some topics contained within the ISAs because they are not relevant to LCEs;
- Simplification or removal of many of the risk requirements and procedures to develop a less onerous methodology in an audit of an LCE;
- Substantially less documentation required for an audit of an LCE;
- Redrafting of the ISAs in 'plain English' for easier understandability and translation.

Additionally, the UK has used the IFRS for SMEs as the basis for its main financial reporting standard, FRS 102, which can be used by all types and sizes of entities other than those which are required to apply IFRS. This illustrates that it is possible to tailor similar provisions to different sizes of entity whilst still maintaining a similar output that meets the needs of its constituent community.

Therefore, we believe that the preferred starting point for the working group should be the development of a separate auditing standard for audits of LCEs. We would also advise that the need to have sufficient and appropriate input from LCE practitioners and stakeholders would be essential in this regard.

c. Developing guidance for auditors of LCEs or other related actions

We are not supportive of this as a proposed solution at this stage but, potentially, depending upon the selected solution, there may be a role for further guidance, or an update to the current IFAC guidance, at some point in the future.

Question 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?

Response 5.

We believe that the IAASB should remain mindful of some of the criticisms and debate around the future of audit that are currently taking place at a global level, most notably in the UK and the Netherlands. Whatever the outcome of these discussions and debates, there are likely to be global consequences and implications.

Therefore, we would encourage the IAASB to continue to keep a watching brief over these international developments and attempts to re-establish audit as a force for public good in order that any proposed solutions can be incorporated into the IAASB strategy, and work plan, to ensure that future projects reflect the direction of travel.