31 January 2022

Mr Willie Botha
Technical Director
International Auditing and Assurance Standards Board
529 5th Avenue
New York NY 10017
United States of America

Re: Comment Letter on IAASB 'Proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE)'.

The Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ) is pleased to comment on *Proposed International Standard on Auditing for Audits of Financial Statements of Less 'Complex Entities (ISA for LCE)'*.

AFAANZ is the peak regional academic accounting and finance association and counts among its membership the region's leading and emerging accounting and finance researchers. The Auditing and Assurance Standards Committee is an ad-hoc committee under the governance of AFAANZ's Auditing and Assurance Special Interest Group, formed to give a voice on standard-setting deliberations to the academic research literature.

The views expressed in the comments that follow are those of the undersigned Committee members based on the research reviewed and do not necessarily reflect the official position of AFAANZ. While the views expressed represent a consensus view of the Committee, they do not necessarily reflect the individual views of every member.

If you have any questions on our submission, please contact either of the Committee Co-Chairs (Noel Harding – n.harding@unsw.edu.au or David Hay – d.hay@auckland.ac.nz).

Yours Sincerely*,

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Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ)

Comments on IAASB's Proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE)

We begin by commending the International Auditing and Assurance Standards Board (IAASB) for their attention to the challenges of audits of less complex entities. The contribution of small to medium sized entities (many of which would not be complex) to local, regional, national, and global economies, and society more broadly, cannot be underestimated. Although smaller and less complex, reliable financial reporting remains crucial to the success of these entities and their effective contribution to society. Providing confidence in the financial reporting of these entities by way of independent assurance, however, presents numerous challenges.

The development of a universally applicable suite of auditing standards with relevance to entities of all sizes (and all jurisdictions) is increasingly coming under pressure, and the development of a standalone standard to be applied to the audits of less complex entities is a bold initiative. A standalone standard has the potential to contribute to confidence in the financial reporting of this important segment, while at the same time helping to ensure that the extant suite of auditing standards remains responsive to the increasing complexity of larger entities.

The challenges surrounding the provision of assurance on the financial reports of less complex entities, however, extend beyond standard setting (e.g., the availability of qualified practitioners to undertake audit work). An effective solution will require a multifaceted approach, and we encourage the IAASB to continue working with all stakeholders in improving the quality of financial reporting in less complex entities.

The Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ) is pleased to support work in this area by providing evidence-based comments on the proposed standard. There is an extensive academic research literature examining issues of relevance to deliberations in this area and our comments and recommendations are based on our review of that literature

Below we make comment on, and where relevant, provide recommendations on, issues relating to Questions 1a, 1b, 3b, 3d, 3e, 4a, 4b, 7a, 7c, 9, 10a, 10b, 17b, 22 and 26. Although there is an extensive literature informing our comments and recommendations, audits of less complex entities have not received the same research attention as that for audits of larger and listed entities. For several questions, we are unaware of academic research speaking to the issues raised in the question and do not, therefore, make any comment. Ongoing deliberations would benefit from more research, and the Audit and Assurance Standards Committee of AFAANZ stands ready to work with the IAASB should there be an appetite to further inform deliberations with evidence informed academic research.

In summary, while we believe that a standalone standard has the potential to contribute to the goal of improving confidence in the financial reports of less complex entities, and we encourage the IAASB to continue with this project, findings in the academic research literature suggest that the proposed standard, as presently drafted, will fall well short of realizing this potential. Our review of the relevant literature and evidence contained therein speaks to the following conclusions and recommendations in response to the questions posed by the IAASB.

- We believe that a standalone standard has the potential to meaningfully help in addressing the challenges that impact audits of less complex entities. We are of the view, however, that the proposed relationship between the standalone standard and the full suite of standards means that the approach is significantly impaired. (Question 1a)

- We agree with the title of the standard but caution that the Authority needs to be such that the perceived characteristics of entities scoped into the standard align with perceptions of what a less complex entity is. (Question 1b)

- We believe that the Authority may lead to confusion as to the applicability of the standard in that it will likely contribute to a disconnect between what is perceived to be a less complex entity and entities scoped into the standard. We recommend that the IAASB consider placing less emphasis on global prohibitions and place more emphasis on qualitative characteristics and jurisdictional discretion. (Question 3b)

- We do not believe that the Authority itself informs audit report users of the scope of the proposed standard and recommend that this be addressed by other means (e.g., education). (Question 3d)

- We believe that the role of legislative and regulative authorities is appropriate. (Question 3e)

- We do not agree with the use of specific prohibitions and believe that greater emphasis should be placed on jurisdictional discretion, and a greater focus be placed on principles based qualitative criteria. (Question 4a)

- We broadly agree with the qualitative characteristics specified, but recommend, following comments in response to other questions, that the criteria be expanded to include circumstances for which the auditor needs to refer to the full suite of standards and the need to use a component auditor. (Question 4b)

- We suggest that the approach employed in developing the ED-ISA for LCE is problematic in that it is based on the material contained in the extant suite of standards. This approach gives rise to the potential for key issues not included in the extant suite of standards, but critical to the achievement of reasonable assurance in an audit of less complex entities, being omitted from the standalone standard. (Question 7a)

- We believe that the material on professional skepticism, relevant ethical requirements, and quality management is incomplete and does not fully reflect the unique circumstances in which an audit of a less complex entity is undertaken. (Question 7c)

- We believe that Parts 1, 3, and 6 of ED-ISA for LCE can be improved. We also believe that ISA610 (Using the work of an Internal Auditor) should not be excluded from the standard. (Question 9)

- We broadly agree with the approach taken with regard to auditor reporting in that specific reference is made to the auditing standard with which the auditor's opinion is formed. We caution, however, that an unintended consequence may be that users incorrectly infer meaning from the use of the standalone standard and may perceive that a lower level of assurance is provided. We suggest that a broad education program would be necessary to address this potential unintended consequence. (Question 10a)

- We agree with the approach to include a specified format and content of an Auditor's Report as a requirement. (Question 10b)

- We do not believe that ED-ISA for LCE in its current form will meet the needs of stakeholders. We do not, however, discount the possibility of a revised standalone standard achieving the goal of meeting current challenges associated with audits of less complex entities. (Question 17b)

- We believe that group audits should not be universally excluded from the scope of ED-ISA for LCE. The judgment as to whether the standalone standard is appropriate in a group audit setting should be based on qualitative criteria supported by the inclusion of the use of component auditors as a factor that may suggest a level of complexity that would make the standalone standard inappropriate. (Question 22)

- We believe that the relevant requirements relating to group audits should be presented within each relevant part. (Question 26)

We elaborate on these points below.

Question 1a
Views are sought on: The standalone nature of the proposed standard, including any areas of concern in applying the proposed standard, or possible obstacles that may impair this approach.

We believe that a standalone standard has the potential to meaningfully help in addressing the challenges that impact audits of less complex entities. We are of the view, however, that the proposed relationship between the standalone standard and the full suite of standards means that the approach is significantly impaired.

Research highlights that the existing suite of standards require a level of understanding that many practitioners in small and medium practices do not believe is necessary or relevant given their portfolio of clients (e.g., van Buuren et al. 2018). In addition, research highlights the importance of experience, in addition to knowledge, when developing expertise (e.g., Davis 1996; Cahan and Sun 2015; Chi et al. 2017). To the extent that auditors do not have the opportunity to regularly apply the principles contained in the full suite of standards, even with knowledge, there is a risk that the application of the full suite of standards to audits of less complex entities will fall short of expectations. A separate standalone standard has the potential to address these issues, but the IAASB will need to consider the level of knowledge auditors applying the standalone standard would be expected to have.

We are, however, concerned with the explicit and implicit relationships and demarcation between the standalone standard and the full suite of standards. The current proposals forbid the 'topping-up' of the standalone standard with reference to the full suite of standards. In this situation, the standalone standard could not be used. This requires that all matters (current and future) relevant to an audit of a less complex entity have been captured within the proposed standalone standard. To the extent that requirements have not been included, the standalone standard cannot be applied, and the auditor would need to transition to an audit based on the full suite of standards.

As we discuss in our response to Question 7a, the approach to developing the proposed standard is such that it is unlikely to have incorporated all matters relevant to an audit of a less complex entity. For example, research suggests that the use of internal auditors in less complex entities may be more common than the IAASB believes to be the case (Carey et al. 2000) and, with reference to the current approach, would mean that an audit of an otherwise less complex entity would need to be undertaken with reference to the full suite of standards. With reference to research that speaks to the dimensions of complexity (e.g., Anderson 1999; Dooley 2002) and the proxies for complexity that are widely used in academic research (see our response to Question 4b), the need to seek further guidance from the full suite of standards is likely informative, but not definitive, of a more complex entity.

We further note that auditors draw on their knowledge and experience when making judgments (e.g., Libby and Luft 1993) and that some of these judgment processes may occur at a subconscious level (e.g., Kahneman 2011). Auditors with expertise in applying the full suite of standards are likely to, and would be expected to, draw on this knowledge and experience when applying the standalone standard. Does this mean that the standalone standard should not be used as it is being supplemented with material in the full suite of standards? To what extent is this really a standalone standard, and to what extent is any demarcation artificial and difficult to implement?

We recommend that the need to refer to the full suite of standards be a factor that may be indicative of complexity rather than as a definitive signal that the standalone standard cannot be used.

Question 1b
Views are sought on: The title of the proposed standard.

We agree with the title of the standard but caution that the Authority needs to be such that the perceived characteristics of entities scoped into the standard align with perceptions of what a less complex entity is.

The proposed title is focused on who the standard is for (i.e., less complex entities) rather than what the standard is (i.e., condensed ISA requirements). We do not object to the title, but note that there is a need for the authority to align with perceptions of what a less complex entity is. In this area, we are informed by the discussion of the title of the corresponding financial reporting standard (i.e., International Financial Reporting Standard for Small and Medium Entities) and note that the selection of the title was contentious (Perera and Chand 2015). Reference to SMEs in the title has caused some confusion in that the meaning of SMEs as per the standard does not always align with the meaning of SMEs in the jurisdictions and settings in which it is applied (Perera and Chand 2015). In addition, reference to the term has led to some dissonance in that ‘small/medium’ is not how those who might apply the standard perceive the entity and wish the entity to be perceived (Perera and Chand 2015).

With reference to the proposed standard under consideration, and with reference to the experience of the equivalent financial reporting standard, we believe that care must be exercised to align the authority (i.e., the applicability of the standard) with that which the term ‘less complex’ is understood to mean in individual jurisdictions. We do not believe that this is currently the case. As presently drafted, a more apt title would be ‘ISA for LCEs that are not listed entities, do not employ an internal auditor, ….’. In our response to Question 4a, we recommend that there be no global prohibitions and that the authority is based more on qualitative characteristics to help stakeholders identify when the standalone standard may not be sufficiently comprehensive for the circumstances. We believe that doing so would also help jurisdictions align the Authority with what is understood in that setting to be less complex.

Research also suggests that less complex entities will select the nature of assurance (if any assurance) that best suits their circumstances (e.g., Palazuelus et al. 2020; Gong et al. 2021).

To the extent that entities may feel that the use of a standard for less complex entities miscommunicates the nature of the entity (e.g., somehow less sophisticated), entities will choose an audit undertaken with reference to the full suite of standards.

The title of the standard also has implications for the way the audit is interpreted. As noted in our response to Question 10a, we agree with the proposed reference to the standalone standard in the Auditor's Report. We note, however, that users do not always appropriately interpret terms in auditor's reports (e.g., Maijoor et al. 2002; Gray et al. 2011) and suggest that the IAASB remain cognizant of the possibility that the standard(s) with which the audit is undertaken may signal incorrect meaning to users of the Auditor's Report (e.g., if an audit is undertaken in one year with reference to the LCE standard and in the following year with reference to the full suite of standard, does this signal something untoward – is more complex more risky?)

In this regard, we are informed by research on the perceived information content of KAM / CAMs. While research to date on the information content of KAMs (as it relates to information on the entity) reports mixed findings (Gold and Heilmann 2019), the research suggests that KAMs may be a factor in evaluating the entity. We believe, therefore, that there is the potential for reference to less complex entities in the title of the standard under which the audit will be undertaken (and referred to in the Auditor's Report) to be a factor in user interpretation of the entity being audited. A broad education program will be necessary to avoid incorrect inferences being drawn from referencing a standard with 'less complex entities' in its title.

In summary, we support the proposed title but recommend that the authority is revised such that jurisdictions are able to align the use of the standard with the meaning attributed to less complex entities and that attention be given to education of users of the meaning of audits being undertaken under the two approaches.

Question 3b
Views are sought on the Authority (or scope) of ED-ISA for LCE (Part A of the proposed standard). In particular: Are there unintended consequences that could arise that the IAASB has not yet considered.

We believe that the Authority may lead to confusion as to the applicability of the standard in that it will likely contribute to a disconnect between what is perceived to be a less complex entity and entities scoped into the standard. We recommend that the IAASB consider placing less emphasis on global prohibitions and more emphasis on qualitative characteristics and jurisdictional discretion.

We are concerned that the authority may be such that there is a disconnect between the entities for whom the standard is written (i.e., less complex entities) and the entities for whom the authority allows its use. With reference to the IASB standard for small to medium enterprises, research highlights potential consequences when there is a lack of correspondence between the entities for whom the standard applies (i.e., small to medium enterprises) and perceptions of the entities who can and cannot apply the standard (Perera and Chand 2015). To the extent that the authority scopes out entities that may otherwise be perceived to be less complex in the particular jurisdiction, this may lead to challenges in the implementation and use of the standard.

We recommend that the IAASB, in reflecting on the authority, allow for a closer alignment between what is understood to be a less complex entity and those entities scoped into the standard by focusing more on qualitative characteristics and jurisdictional discretion rather than global prohibitions.

Question 3d
Views are sought on the Authority (or scope) of ED-ISA for LCE (Part A of the proposed standard). In particular: Will the authority, as set out, achieve the intended objective of appropriately informing stakeholders about the scoping of the proposed standard?

We do not believe that the Authority itself informs audit report users of the scope of the proposed standard and recommend that this be addressed by other means (e.g., education).

The authority, of itself, will not inform users of the Auditor's Report of the circumstances underlying the scoping of the individual entity into or out of the proposed standard. Audit report users do not have a good understanding of the audit process (e.g., Maijoor et al. 2002; Gray et al. 2011) and are unlikely to know the circumstances allowing for the scoping in of a particular entity. For example, would users understand why an entity they believe to be less complex is not audited with reference to the proposed standard? For most users, the only link that they have to the proposed standard is via its title and reference to the standard in the Auditor's Report.

We recommend that, at a minimum, the authority be supplemented by education of users of the scope of the proposed standard and, potentially, further disclosures in the Auditor's Report when referencing audits undertaken according to the proposed standalone standard.

Question 3e
Views are sought on the Authority (or scope) of ED-ISA for LCE (Part A of the proposed standard). In particular: Is the proposed role of legislative or regulatory authorities or relevant local bodies with standard setting authority in individual jurisdictions clear and appropriate?

We believe that the role of legislative and regulatory authorities is appropriate.

Auditing is seen in most jurisdictions as a public good such that it is mandated. Different jurisdictions apply this mandate in different ways (Minnis and Shroff 2017). For example, private firms are generally neither required to disclose their financial results nor have their financial statements audited in the US and Canada. By contrast, many firms with limited liability in other countries are required to file at least some public information and are required to have their financial statements audited.

We believe that it is appropriate for individual jurisdictions to make informed decisions, on the basis of their individual circumstances, about when the proposed standalone standard can be employed.

Question 4a
Do you agree with the proposed limitations relating to the use of ED-ISA for LCE?
- Specific prohibitions

We do not agree with the use of specific prohibitions and believe that greater emphasis should be placed on jurisdictional discretion, and a greater focus be placed on principles based qualitative criteria.

We believe that there should be no specific prohibitions on the use of a standard for less complex entities, except for discretion afforded to national jurisdictions (as is currently contained in paragraph A7c(v)). Global prohibitions have the potential to constrain public interest benefits from the introduction of the standard for less complex entities, denies the existence of important differences across jurisdictions, and will likely contribute to confusion as to the purpose of the standard and the entities that are, and are perceived to be, less complex but unable to employ the standard. The authority should be focused on assisting stakeholders identify when the standalone standard may not be appropriate on account of its contents not being sufficiently comprehensive to allow for reasonable assurance to be provided.

We base our recommendation on research examining a number of related issues.

<u>There is evidence that entities will voluntarily choose the appropriate level of assurance that suits the requirements of their financial report users.</u>

A large body of research highlights that entities voluntarily opt for high-quality accounting and auditing information to facilitate better access to and conditions in capital markets (e.g., Allee and Yohn 2009; Van Caneghem and Van Campenhout 2012; Vander Bauwhede et al. 2015; Palazuelos et al. 2020; Briozzo and Albanese 2020; Gong et al. 2021). Less complex entities are, themselves, in the best position to decide whether a reasonable level of assurance is required and, if so, whether this should be achieved via an audit based on the full suite of standards or a self-contained standard for less complex entities. It is likely that entities prohibited from using the standard based on the proposed authority would otherwise prefer to use the proposed standard. Moreover, many entities (especially in developing nations) may look to the proposed standard to enhance confidence in their financial reports. To the extent that entities are explicitly prohibited from using the standard, opportunities for the entity, governments, and others in the financial reporting ecosystem to enhance confidence may be lost.

<u>The need for audited financial reports varies depending on other aspects of the jurisdiction such as shareholder or stakeholder orientation, management practices, and company characteristics.</u>

Research suggests that users of small and medium enterprise (SME) financial reports differ across jurisdictions (Gassen 2017). In addition, the need for audited financial reports varies depending on other aspects of the jurisdiction such as shareholder or stakeholder orientation (Barrosso et al. 2018), management practices (Niemi et al. 2012; Weik et al. 2018), and entity characteristics (Collis 2010; Dedman et al. 2014; Niemi et al. 2012; Weik et al. 2018). Research also highlights differences in voluntary audits across jurisdictions. In a review of prior studies on this topic, Weik et al. (2018) summarize that companies opting for voluntary audit are less common in Germany (12% of their sample) than in other countries analyzed in prior literature (between 26% and 80% in Australia, Canada, Denmark, Finland, and the UK). We believe, therefore, that globally enforced prohibitions are unlikely to be effective in meeting the unique needs of individual jurisdictions.

<u>Some listed companies are considerably less complex than others.</u>

We note that listed entities, in particular, are specifically excluded from using the standard. While many listed entities are likely to be complex, complexity is not a precondition for listing, and many listed companies could be categorized as less complex entities. Our analysis of Australian listed entities (see Appendix B) suggests that this is the case in Australia, and we believe that it is a result that would apply in many other jurisdictions.

In Australia, a large proportion of listed entities have audits that appear to be conducted on a small scale and are not complex. The lowest decile, representing the 10% of companies with the lowest audit fees, has mean audit fees of $A14,000 (see Table 1 in Appendix B). These entities are not complex and would be scoped into the standalone standard if it was not for the fact that they are listed. Indeed, it is not until we examine the top 40% of listed companies that the mean audit fee exceeds $A100,000, at which point it would be reasonable to assume that all entities would be sufficiently complex so as to render the standalone standard inappropriate (and for which the application of the qualitative criteria would effectively highlight that the standalone standard would not be appropriate). In the lower 60% of listed entities, there are likely to be entities that are considered more complex, and entities considered less complex.

To the extent that the proposed self-contained standard for LCEs achieves a reasonable level of assurance and sufficiently captures provisions that currently apply to listed entities (e.g., the reporting of KAMs in the Auditor's Report), an audit of these less complex entities should be manageable with reference to the proposed self-contained standard.

We do not discount the public interest arguments for excluding listed and other public interest entities from the use of the standard (notwithstanding that they may be less complex), but believe that this can be effectively addressed within the discretion afforded to individual jurisdictions in paragraph A7c(v). It is reasonable to acknowledge the existence of various characteristics among different jurisdictions. Minnis and Shroff (2017) document that private firms face differing financial disclosure and auditing regulations around the world. For example, private firms are generally neither required to disclose their financial results nor have their financial statements audited in US and Canada. By contrast, many firms with limited liability in other countries are required to file at least some financial information publicly and are also required to have their financial statements audited. We believe that it is appropriate for individual jurisdictions to make informed decisions, on the basis of their individual circumstances, about when the proposed standalone standard can be employed.

Question 4b
Do you agree with the proposed limitations relating to the use of ED-ISA for LCE?
- Qualitative characteristics

We broadly agree with the qualitative characteristics specified, but recommend, following comments in response to other questions, that the criteria be expanded to include circumstances for which the auditor needs to refer to the full suite of standards and the need to use a component auditor.

We note research that speaks to dimensions of complexity (e.g., Anderson 1999; Dooley 2002) and remind the IAASB of the multidimensional character of complexity. This, in turn, highlights the difficulty in establishing rules based bright line criteria for scoping entities into and out of the proposed standalone standard. Therefore, we recommend that the authority be focused on qualitative criteria allowing for professional judgment to take into account idiosyncratic auditor, client, and jurisdictional circumstances.

A large body of research in auditing (and corporate governance) has considered factors that make an audit more complex, usually in order to control for differences among clients. The most commonly used measures for firm complexity in the research literature are; number of subsidiaries, number of geographic or business segments, number / percentage of foreign subsidiaries, percentage of foreign assets, foreign income/sales, national and multinational operations, auditor-related factors, firm age, merger and acquisition activities, ownership structure, technology-related issues, and labor intensity (number of employees). We reference the extensive literature supporting each of the measures in Appendix A to our submission.

We also note our response to Question 22 and Question 1a and suggest the possibility, depending on the direction that the IAASB take on group audits and the standalone nature of the standard, of including the use of component auditors and the need to refer to the full suite of standards for guidance as indicators, but not definitive of, complexity that may render the standalone standard inappropriate.

To further inform an understanding of the factors that may be indicative of complexity, we examined the audit fees of Australian companies. Audit fees are a function of the resources necessary to achieve effective audit outcomes and likely depend on the inputs and their associated costs (Knechel and Sharma 2012). To the extent that these inputs are indicative of complexity, there should be an association between complexity and audit fees.

Due to data limitations, we restricted this analysis to listed companies. While we acknowledge that listed companies are, as the proposed standard is currently drafted, scoped out of the standard, the analysis is informative in understanding the correspondence between entity characteristics and complexity. Employing data for ASX-listed companies from 1995 to 2021, the analysis reveals that companies paying higher audit fees, and therefore indicative of greater complexity, have significantly higher total assets, a greater number of geographic and business segments, have foreign operations, and have higher levels of inventory and receivables. We have not analyzed data in other jurisdictions but have no reason to believe that results would be meaningfully different. On the basis of this analysis, the indicators of complexity appear appropriate, but we do note that a large proportion of the listed entities in our sample appear to be less complex, and we refer the IAASB to our comments in response to Question 4a. We provide further details of this analysis in Appendix B.

Question 7a
Views are sought on the key principles used in developing ED-ISA for LCE as set out in this Section 4C.
- The approach to how ISA requirements have been incorporated into the proposed standard (see paragraphs 74-77).

We suggest that the approach employed in developing the ED-ISA for LCE is problematic in that it is based on the material contained in the extant suite of standards. This approach gives rise to the potential for key issues, not included in the extant suite of standards, but critical to the achievement of reasonable assurance in an audit of less complex entities, being omitted from the standalone standard.

As noted in paragraphs 74 to 77, the approach to incorporating ISA requirements in the proposed standard was to use requirements in the ISAs as a base. We are concerned that this approach detrimentally constrains the effectiveness of the proposed standard in meeting the purposes for which it is being drafted. The approach is problematic in that the content of the proposed standard is limited to that which is already included in the suite of ISAs (that have been written and subsequently revised with a more complex entity in mind).

Research highlights that the agency relationships for which auditing reduces information asymmetry are different in private companies compared to public companies (Chen et al. 2011; Langi and Svanstrom 2014). In this regard, agency conflicts in private firms are more likely to be between majority and minority shareholders and between ownership interests and debtholders than between ownership and management (as is the case in public companies) (e.g., Carey et al. 2000; Niskanen et al. 2010; Schierstedt and Corten, 2021). Compared to publicly listed firms, private firms have fewer incentives to report high quality earnings (Ball and Shivakumar, 2005) and the cost of switching auditors for small business is relatively low (Abbott et al. 2013). Relatedly, the users of, and use for, audited financial information are different in private companies (e.g., Dedman et al. 2014).

In addition, less complex entities are more likely to be audited by a small practice (Ghosh and Lustgarten 2006). Smaller professional practices conduct audits in smaller teams (Langli and Svanstrom 2014), with different relationships among team members (Harding and Kim, 2021), and rely on different knowledge sharing and support networks through which to support firm and engagement level quality (Sundgren and Svanstrom 2013). In smaller practices, threats to independence manifest themselves in different ways (Langli and Svanstrom 2014), and threats from economic bonding may not be as significant (Hope and Langli 2010). Importantly, reputation and litigation costs that drive positive behaviors in larger audit practices are not as salient in small to medium practices (Johnstone and Bedard, 2003; Bell et al. 2015; Hardies et al. 2018).

We encourage the IAASB, in addition to referring to the suite of extant ISAs, extensively engage with practitioners likely to employ any standard focused on less complex entities to ensure that any material relevant to the audit of less complex entities, material that may not have been captured in the extant suite of standards, is not omitted from the standalone standard. In our response to Question 9, we note a number of specific areas where we believe that the proposed standard is incomplete.

Question 7(c)
Views are sought on the key principles used in developing ED-ISA for LCE as set out in this Section 4C.
- The principles in relation to professional skepticism and professional judgment, relevant ethical requirements, and quality management (see paragraphs 81-84).

We believe that the material on professional skepticism, relevant ethical requirements and quality management is incomplete and does not fully reflect the unique circumstances in which an audit of a less complex entity is undertaken.

We provide comment in response to this question under the headings of 'Professional Skepticism', 'Relevant Ethical Requirements', and 'Quality Management'.

<u>Professional Skepticism</u>

The stronger relationship between the auditor and client management / personnel in audits of less complex entities gives rise to unique threats to the exercise of an appropriate level of skepticism that are not as significant in audits of more complex entities. The past experience that the essential explanatory material associated with paragraph 1.4.6 refers to is likely to be more salient, and a greater threat, than is the case when auditing more complex entities (where there are fewer opportunities to develop strong social bonds). We recommend that the essential explanatory material be strengthened to remind auditors that strong and long-standing relationships, and beliefs as to management honesty and integrity that these relationships foster, does not relieve the auditor of the need to remain skeptical. We recommend that the expression of the underlying principle of professional skepticism be strengthened.

We note literature highlighting the increased significance of social bonding in audits of private companies (and by inference, audits of less complex entities) (Langli and Svanstrom 2014). This has implications for the exercise of professional skepticism in that research has shown that objectivity can be compromised when the auditor identifies with their client (Bamber and Iyer 2007; Stefaniak et al. 2012) and when a social bond exists between the auditor and the client by way of audit firm alumni associations (Favere-Marchesi and Emby 2018). Similarly, Kadous et al. (2013) find that auditors employ a trust heuristic (or rule of thumb) when evaluating the advice from colleagues with whom they have a stronger social bond and do not subject the advice to critical evaluation.

Relevant Ethical Requirements

We recommend that the IAASB liaise with IESBA as the project progresses with a view to considering the appropriateness of Section 600 of the Code and the current restrictions on the provision of non-assurance services to less complex (owner manager) clients.

We recognize the importance of complying with a high ethical standard when performing audits (and other assurance and related services). This is the case, irrespective of the nature of the practitioner and client. However, given the objective of this project, and with reference to extant research literature, we recommend that the IAASB give greater attention to the unique independence issues that are present in audits of less complex entities and liaise with the IESBA with a view to being satisfied that current ethical requirements around the provision of non-assurance services (i.e., Section 600 of the Code) are fit for purpose and complement the application of the proposed standard. Guo et al. (2021) review PCAOB disciplinary orders on small US domestic audit firms and find that concerns around auditor independence frequently arise. Small and medium audit practices tend to have closer connections to local businesses (Louis 2005), and social bonding with owners/managers is a greater threat to independence in audits of less complex entities than is the case for larger, more complex entities (Svanstrom 2013; Langli and Svanstrom 2014).

We also note ongoing discussion around the provision of non-assurance services by small and medium practices to their less complex (owner-manager) clients. With regard to the impact on audit quality of the provision of non-assurance services to private companies, the research is mixed. Svanstrom (2013) reports results consistent with the understanding that there are knowledge spillovers associated with the provision of non-assurance services such that audit quality is improved. Bell et al. (2015), on the other hand, find that audit quality decreases with the provision of non-assurance services to privately held clients. We further note in our response to Question 9 that the performance of risk assessment in an audit of less complex entities is a challenge, and the increased knowledge (and the positive spillover effects often associated with the provision of non-assurance services) may go some way to alleviating this threat to audit quality.

Quality Management

We recommend that the IAASB reinforces the principles of firm and engagement level quality control in an audit of a less complex entity by supplementing the material currently presented in the proposed standard to reflect important differences between small to medium practices and those larger practices for which much of the material in ISQM 1, ISQM 2 and ISA 220 is written.

With reference to quality management, we concur with the principle that those practitioners completing an engagement with reference to the proposed standard are subject to the IAASB's Quality Management standards (or national equivalents that are at least as demanding). At the same time, however, we highlight differences in the structure and organization of the small and medium practices that perform these engagements and note the need for additional essential explanatory material in Section 1 as it relates to firm quality management and Section 3 as it relates to engagement quality management.

Research highlights that auditors in small and medium practices do not have the same opportunities as auditors in larger practices to seek advice from colleagues (as they have fewer colleagues) (Langli and Svanstrom 2014; Sundgren and Svanstrom 2013). Small to medium practices, instead, rely on other mechanisms to compensate for this knowledge deficit (such as formal networks and insurers) (Bills et al. 2018; Frank et al. 2021). Research further highlights that differences in the interpersonal relationships and interactions between engagement team members across large and small practices means that partners in small practices need to be especially careful in directing the work of their subordinates, or otherwise risk inappropriately influencing the audit judgments of those subordinates (Harding and Kim 2021).

Question 9: Please provide your views on the content of each of Parts 1 through 8 of ED-ISA for LCE, including the completeness of each part. In responding to this question, please distinguish your comments by using a subheading for each of the parts of the proposed standard.

We believe that Parts 1, 3, and 6 of ED-ISA for LCE can be improved. We also believe that ISA610 (Using the work of an Internal Auditor) should not be excluded from the standard.

In our response to Question 7a above, we note our concern around the approach to developing ED-ISA for LCE, in that it is limited to circumstances already included in the extant suite of ISAs and, as a consequence, excludes the consideration of circumstances that are unique to an audit of a less complex entity. We are of the view that broadening the base from which the contents of the proposed standard are sourced (to important but unique circumstances prevailing in audits of less complex entities but not noted in the current suite of ISAs), will improve the effectiveness of the proposed standard. We first speak to our concerns around the exclusion of material relating to using the work of an internal auditor and then turn our attention to Parts 1, 3 and 6 of the proposed standard.

<u>Excluding consideration of the work of internal auditors</u>

ED-ISA for LCE explicitly excludes requirements relating to ISA610 'Using the Work of Internal Auditors'. This is justified on the basis that internal auditors are most likely to be engaged in entities with higher complexity and, therefore, the requirements relating to the use of the work of the internal auditor are not relevant to audits of less complex entities.

We are concerned that this may lead to the unintended consequence of scoping entities out of the proposed standard when they engage an internal auditor (in-house or outsourced), notwithstanding that they may meet all other requirements. In circumstances where the client engages an internal auditor, the external auditor would necessarily need to 'top-up' their use of the standard for LCEs with reference to ISA 610. This is not permitted and would scope the engagement out of the standard, forcing the practitioner into a new engagement under the full suite of ISAs. We do not believe that this is consistent with the objectives of the proposed standard, nor in the public interest. Moreover, research suggests that the use of internal audit may be more common in less complex entities than is currently understood to be the case.

Carey et al. (2000) report that among family businesses, internal audit was more common than external audit, and that unlike the situation in listed public companies, internal auditing is seen in family businesses as a substitute rather than a complement to external audit. Indeed, when requesting an audit in a voluntary environment, the needs of less complex entities are such that internal audit services are often seen as being more appropriate. This is consistent with the understanding that significant users of the audited financial statements in private companies are the entity's owners/managers who are seeking reliable financial information on which to make decisions (Collis et al. 2004).

Given the potential unintended consequences of excluding coverage of internal auditors in the proposed standard, the apparent greater use of internal audit (or similar) service in less complex entities than that recognized when justifying the exclusion of this material from the proposed standard, and the emphasis on internal audit relative to external audit in less complex entities, we recommend that the IAASB reconsider the exclusion of ISA 610 material from the proposed standard. We also refer the IAASB to our commentary on the appropriateness of Section 600 of the IESBA Code, which limits the provision of non-assurance services to audit clients, including internal audit work

Part 1 – Fundamental Concepts, General Principles, and Overarching Requirements

We are of the view that the coverage of material on relevant ethical requirements and firm level quality management (Section 1.2), as well as professional skepticism (Section 1.4.5 – 1.4.6), needs to be elaborated upon in order to reflect unique but important characteristics of less complex entity audits.

While we acknowledge that responsibility for ethical standards lies with IESBA, we are concerned that extant ethical requirements, especially as they relate to the provision of non-assurance services (i.e., Section 600 of the Code), are such that they may potentially impede the realization of the public interest benefits of the proposed standalone standard. We encourage the IAASB to liaise with IESBA with a view to considering whether, as is the case with audits of public interest entities, practitioners performing audits of less complex entities should be subject to different requirements when ensuring independence.

Consistent with research focused on publicly listed entities (see Beardsley et al. 2021 for a recent summary), the limited research addressing private companies reports mixed results as to the effect on audit quality of auditors also providing non-assurance services to their clients. Svanstrom (2013) reports that the provision of non-assurance services is positively associated with audit quality, while Bell et al. (2015) report that audit quality decreases with the provision of non-assurance services to privately held clients. We discuss below concerns we have with regard to risk assessment in audits of less complex entities, and the provision of non-assurance services may be associated with knowledge spill overs that improve the auditor's understanding of the client and its environment. We also note research reporting that the demand for audit in a voluntary environment is positively associated with the provision of non-assurance services (Dedman et al. 2014). We recommend that the IAASB liaise with IESBA with a view to being confident that Section 600 of the Code as it relates to the provision of non-assurance services to less complex clients remains fit for purpose and facilitates, and does not inhibit, the achievement of a high-quality audit under the proposed standalone standard.

Independent of the appropriateness of Section 600 of the IESBA Code to less complex clients, we are of the view that, given the fundamental importance of complying with ethical requirements, and unique issues impacting audits of less complex entities, reference to the ethical requirements in Section 1.2.1 warrants the addition of essential explanatory material (at present, this material is limited to reference to firm level quality management).

Less complex entities are more likely to be audited by smaller practices (Ghosh and Lustgarten 2006), and threats to independence manifest themselves in different ways when small to medium practices audit less complex entities. While social bonding and familiarity threats may be more of a concern in audits of less complex entities (e.g., Langli and Svanstrom 2015), threats from economic bonding may be less of a concern (Hope and Langli 2010). In addition, research highlights that the voluntary demand for audit in private companies is associated with the demand for non-assurance services (Dedman et al. 2014), putting additional pressure on practitioners to remain compliant with ethical standards. We recommend that the essential explanatory material associated with Section 1.2.1 be elaborated upon to reinforce auditors' responsibilities in this regard.

We also believe that the proposed standard can be enhanced to reinforce opportunities to improve firm level quality management in small to medium practices. Practitioners working in small to medium practices do not have the same opportunities as auditors in large practices to seek advice from colleagues and to discuss difficult judgments. They have less access to firm training and policy manuals and cannot as easily access quality reviews (with many practices operating as sole practitioners or with a small number of partners) (Langli and Svanstrom 2014). This can impede the effective application of the proposed standard for less complex entities and even cloud judgments as to whether the proposed standard remains applicable in circumstances of increased complexity.

Challenges in managing firm level quality in a small practice are significant. In addressing these challenges, Frank et al. (2021) report that smaller practices can benefit from the risk management knowledge of their insurers, and Bills et al. (2018) find that small firm membership of accounting associations and networks (AANs) can help build competencies and improve audit quality (as well as enhance market legitimacy).

With reference to this research, we recommend that the IAASB elaborate on the essential explanatory material in paragraph 1.2.1 to increase the salience of the unique challenges in small to medium practices and to reinforce the need to manage these unique threats to quality management.

Research also highlights opportunities for the proposed standard to note unique circumstances impacting the exercise of professional skepticism in an audit of a less complex entity and, in doing so, make it more likely that auditors will exercise a level of professional skepticism appropriate to the circumstances. Research notes that social bonding is a greater threat in audits of less complex entities as auditors build strong, often long term, relationships with owner-managers (Langli and Svanstrom 2013). Research highlights that objectivity can be compromised in circumstances where the auditor identifies with the client (Bamber and Iyer 2007; Stefaniak et al. 2012) and Kadous et al. (2013) suggest that auditors may be overly trusting when there is a strong social bond. We recommend that the essential explanatory material associated with paragraph 1.4.6, and in particular the material on past experience with the entity's management, be elaborated upon such that the auditor using the proposed standard is aware of the threats to the appropriate exercise of professional skepticism that they must address.

Part 3 – Engagement Quality Management

The material on engagement quality management, quite appropriately, emphasizes the direction, supervision, and review of members of the engagement team. Research, however, highlights that there are differences in the relationships between members of the engagement team across large and small practices (Langli and Svanstrom, 2014; Harding and Kim 2021). Given that audits of less complex entities will often be undertaken by small to medium practices (Ghosh and Lustgarten 2006), we are of the view that the material in Part 3 could be usefully expanded to increase the salience and implications of these different relationships. Research highlights that the interpersonal relationships between members of the engagement team in small practices are such that partners may inadvertently and inappropriately influence the judgments of their subordinates when directing and supervising their work (Harding and Kim 2021). In particular, Harding and Kim (2021) find that auditor judgments are more aligned with their superior's preference in smaller practices. We recommend that the IAASB consider elaborating on the essential explanatory material accompanying paragraph 3.2.4 such that the practitioner is cognizant of the need to avoid inappropriately influencing a subordinate's judgments through their direction, supervision, and review.

Part 6 – Risk identification and assessment

On the basis of research highlighting that small and medium sized practices may not effectively apply risk assessment procedures as required in ISA315, we are concerned that the material included on risk identification and assessment is inadequate for the purposes of conducting this critical component of the audit process.

Van Buuren et al. (2014) find that auditors in small and medium sized audit practices often do not apply business risk perspectives (as required in ISA315), choosing instead to follow a more historic systems or substantive approach. Subsequent work by the same authors (i.e., van Buuren et al. 2018) finds that many auditors in small and medium practices have not embraced business risk auditing, believing it to be too complex and that previous approaches remain effective.

We recommend, therefore, that the IAASB reinforce the importance of contemporary risk assessment, based on business risk, in achieving a reasonable level of assurance by expanding on the essential explanatory material associated with Section 6.1.1, and reminding auditors of less complex entities that the contemporary approach to risk assessment is required, even in less complex entities. We also note our comments above with regard to restrictions on the provision of non-assurance services and the potential impediments that this may pose to fully understanding the client and its environment and, therefore, the effective conduct of risk assessment.

Question 10a
For Part 9, do you agree with the approach taken in ED-ISA for LCE with regard to auditor reporting requirements, including: The presentation, content and completeness of Part 9

We broadly agree with the approach taken with regard to auditor reporting in that specific reference is made to the auditing standard with which the auditor's opinion is formed. We caution, however, that an unintended consequence may be that users incorrectly infer meaning from the use of the standalone standard and may perceive that a lower level of assurance is provided. We suggest that a broad education program would be necessary to address this potential unintended consequence.

In the interests of transparency, we support the Auditor's Report referring to the standalone standard as the basis upon which work has been undertaken and the opinion formed. We do note, however, that a consequence of this is that users may look to infer characteristics of the entity from the use of the standalone standard. There is some research evidence to suggest that users may look to make inferences about the entity on the basis of the information contained in KAMs (see Gold and Heilman 2019 for a review), and information on the standard(s) used to achieve reasonable assurance may similarly lead to inferences that may be incorrect. For example, is 'less complex' 'less sophisticated'? Will a transition from the standalone standard in one year to the full suite of standards in the following year be seen as indicating greater risk or something untoward?

We are also concerned that users may incorrectly perceive the level of assurance associated with an engagement undertaken with reference to a standalone standard. Research highlights that users do not well understand the audit process and the level of assurance provided in an audit (e.g., Maijor et al. 2002; Gray et al. 2011). Moreover, users may perceive a lower level of audit quality with work undertaken in smaller practices (Mock et al. 2013). To the extent that users perceive this as an engagement designed for small to medium practices, and for which less work is required (i.e., audit light), it is likely that they will perceive the level of assurance to be lower than that provided by an audit undertaken with reference to the full suite of standards (and some less complex entities may prefer an audit undertaken with reference to the full suite of standards for this reason). We believe that this is an unavoidable and necessary consequence that must be borne to be transparent in reporting how the audit was undertaken. We recommend that a broad education program would be necessary to address this potential unintended consequence.

We also support the exclusion of KAMs reporting in the proposed standard (except to the extent that listed entities may be scoped into the standard), in that while users may react more to the reporting of KAMs by non Big 4 auditors (who are more likely to audit less complex entities) (Moroney et al. 2021), research investigating the merit of mandating the reporting of KAMs is mixed (e.g., Gold and Heilman 2019) and KAMs may distract readers from the core information in an auditor's report (Moroney et al. 2021). Therefore, we see little merit in requiring KAM disclosures in audits of less complex entities.

Question 10b
For Part 9, do you agree with the approach taken in ED-ISA for LCE with regard to auditor reporting requirements, including: The approach to include a specified format and content of an unmodified auditor's report as a requirement?

We agree with the approach to include a specific format and content of an auditor's report as a requirement.

Consistent with the desired standalone nature of the standard, we support the approach taken in including a specified format and contents of an unmodified report as a requirement. While research suggests that the auditor's report is seen as being largely symbolic with little communicative value (e.g., Coram et al. 2011; Mock et al. 2013), variations across reports for audits undertaken with reference to different standards will likely undermine the engagement as one that provides reasonable assurance. Therefore, we support the consistency in reporting across audits undertaken with reference to the full suite of standards and audits undertaken with reference to the proposed standalone standard for less complex entities.

Question 17b
In your view, would ED-ISA for LCE meet the needs of users and other stakeholders for an engagement that enables the auditor to obtain reasonable assurance to express an audit opinion and for which the proposed standard has been developed? If not, why not?
- Whether the proposed standard meets the needs of auditors, audit entities, users of audited financial statements, and other stakeholders.

We do not believe that ED-ISA for LCE in its current form will meet the needs of stakeholders. We do not, however, discount the possibility of a revised standalone standard achieving the goal of meeting current challenges associated with audits of less complex entities.

Our comments in response to other questions highlight risks that ED-ISA for LCE will not meet the needs of stakeholders. We believe that the unique characteristics of an audit of less complex entities have not been effectively captured in the proposed standard (see our response to Questions 7a, 7c, and 9), the authority does not allow for the idiosyncratic need of stakeholders in the financial reporting ecosystem to be incorporated into a decision as to whether to employ the standard or not, and the specific prohibitions stymie governments and regulators' attempts to improve financial reporting quality in their specific jurisdiction (see our response to Question 4a), and may contribute to misunderstanding as to the appropriate use of the standard (see our response to Question 1b).

We do not, however, discount the possibility of a stand-alone standard helping to address the challenges of audits of less complex entities and encourage the IAASB to continue pursuing this project.

One of the current challenges facing audits of less complex entities is that many auditors of less complex entities do not believe that the full suite of standards are relevant given their portfolio of clients (van Buuren et al. 2018). A standalone standard may help meet the needs of auditors, but the IAASB will need to consider the level of knowledge necessary / expected to apply the standard and the actual (perceived) level of assurance that can be expected from a standalone standard.

Question 22
The IAASB is looking for views on whether group audits should be excluded from (or included in) the scope of ED-ISA for LCE. Please provide reasons for your answer.

We believe that group audits should not be universally excluded from the scope of ED-ISA for LCE. The judgment as to whether the standalone standard is appropriate in a group audit setting should be based on qualitative criteria supplemented by the inclusion of the use of component auditors as a factor that may suggest a level of complexity that would make the standalone standard inappropriate.

While many groups are likely to be complex, there are a large number of groups that will exhibit characteristics that are consistent with them being classified as a less complex entity. The characteristics that are indicative of complexity are applicable to identifying group entities that may be more complex (e.g., number of subsidiaries, geographic or business segments, percentage of foreign assets) and we recommend that a determination of whether a group entity is included within the scope of the standard, like other entities, should be made on the basis of qualitative criteria included in the standard's authority.

Research, however, suggests that the involvement of a component auditor be recognized as an additional criterion that may be indicative of complexity (and unique to a group setting) (Burke et al. 2020; Carson et al. 2021). Complexity in group audits may arise from coordination and communication challenges between group and component auditors (Downey and Bedard 2019; Downey and Westermann 2021) and cross-cultural differences and language barriers between group and component auditors (Saiwitz and Wang 2020; Downey et al. 2020).

Question 26
If group audits are included in ED-ISA for LCE, how should the relevant requirements be presented within the proposed standard (please provide reasons for your preferred option).

We believe that the relevant requirements relating to group audits should be presented within each relevant part.

To the extent that group audits may be included within the scope of a standalone standard for audits of less complex entities, we believe that the additional requirements be integrated within each relevant part of the standard. Moreover, research suggests that the understanding and integration of material is enhanced by grouping relevant material together in close proximity (e.g., O'Donnell and Schultz 2003), and this is facilitated by including the necessary additional material within each relevant part of the standard.

Appendix A

Here we refer to the research literature that we draw on to identify the different indicators /proxies of complexity and relevant to our response to Question 4b.

Number of Subsidiaries

The literature which uses this proxy for firm complexity suggests that a greater number of subsidiaries is an indication of diverse operations requiring broader skills in operations, accounting, and auditing (Abbott et al. 2003; Bugeja et al. 2016; Carcello et al. 2002; Davis et al. 1993; Francis 1984; Gul et al. 2003; Hay et al. 2006; Simon and Francis 1988; Simunic 1980).

Number of Geographic or Business Segments

The greater the number of business segments that a firm operates within, the more complex the firm's operations are likely to be. This requires the firm to demonstrate task diversity expertise and knowledge across different operating activities and regulatory requirements (Davis et al. 1993; Francis 1984; Simunic 1980). More recent studies use a similar approach (Abernathy et al. 2019; Ali et al. 2020; Bailey et al. 2018; Barroso et al. 2018; Hansen et al. 2021; Pittman and Zhao 2021; Sultana et al. 2020).

Firms that report a high number of segments can be viewed as more complex and complicated both from an operating and from a reporting perspective (Cohen and Lou 2012). Other studies that define complexity as number of geographical or business segments include Chakrabarty et al. (2018); André et al. (2019); Cassell et al. (2018); Pinto and Morais (2019); Zhong (2018); Hsu et al. (2018). Jaggi and Tang (2017) use product lines as a proxy for firm complexity.

The greater the geographic locations across which a firm operates, the greater the likelihood that the operations of the firm are complicated by different jurisdictional and operating conditions the firm has to adjust to and account for (Abernathy et al. 2019; Guo et al. 2021; Sultana et al. 2020). Yiu et al. (2020) also measure operational complexity as geographical diversity, arguing that there are challenges for firms to deal with geographically dispersed customers across different countries.

The existence of foreign segments combines the complexity arising from domestic business segments with the complexity arising from operations in a foreign country thereby magnifying the difficulties (Bailey et al. 2018).

Number/Percentage of Foreign Subsidiaries

Foreign subsidiaries essentially proxy foreign operations which, in turn, suggest a firm working across more than one jurisdiction. This requires the firm to be able to manage complexities arising from differing day-to-day operational activities and compliance with different regulatory requirements (e.g., accounting standards) (Abbott et al. 2003; Gul et al. 2003; O'Sullivan 2000; Simon and Francis 1988). Bugeja et al. (2016) and Cassell et al. (2018) argue that multinational diversification signals greater firm complexity.

Percentage of Foreign Assets

Firms with foreign assets experience similar complexities to those with foreign subsidiaries, that is, the need to operate outside of their home jurisdiction resulting in the need to be familiar with different operational models and compliance regimes (Carcello et al. 2002; Simunic 1980).

Foreign income/sales

The occurrence of foreign income/sales suggests that a firm operates across one national boundary and operations in another country and currency. This introduces a level of complexity that will require greater care in operational practices and accounting for such transactions by the firm (Abernathy et al. 2019; Ali et al. 2020; Azizan and Shailer 2021; Barroso, et al. 2018; Hansen et al. 2021; Kallunki et al. 2019; Pittman and Zhao 2021).

National and Multinational Operations

Firms with national and multinational operations have operations that are different, thus introducing complexity into their procedures as a result of changed operating conditions (Knechel and Payne 2001).

Auditor-related factors

The presence of auditors at multiple locations and the number of auditor reports issued to a client also suggests variety of firm tasks evidencing more complex operations, thus requiring greater auditor attention (Palmrose 1986).

Firm age

Older client firms are potentially larger and have more complex operations that require more complicated disclosures (Chakrabarty et al. 2018). Research in corporate governance also uses firm age as a measure of complexity. It is argued that older firms are potentially larger and have more complex operations that require more complicated disclosures (Chakrabarty et al. 2018).

Merger or acquisition activities

Firms with merger and acquisition activities have more complex operations and annual reports (Chakrabarty et al. 2018). Research in corporate governance also considers merger or acquisition activities because firms with merger and acquisition activities (MA) have more complex operations and annual reports (Chakrabarty et al. 2018).

Ownership structure

Hsu et al. (2018) argue that the increased complexity of ownership configurations as a result of cross-shareholding and pyramidal share structures typically makes it difficult for minority shareholders to detect and understand the relationship between ownership and control. As such, firms are likely to be complex if they have complicated ownership structures such as cross-shareholding and pyramidal share structures.

Technology-related complexity

Min (2018) uses two flow variables to capture technology-related complexity: R&D expenses scaled by sales and expenditure on machinery scaled by number of employees. Though not using specific measures, Darrat et al. (2016) suggest that technical sophistication has implications for complexity.

Labor intensity (number of employees)

Operational complexity has been measured as labor intensity and geographical diversity on account of it being more complex and challenging for firms to manage a large number of employees in operations and to deal with geographically dispersed customers across different countries (Yiu et al. 2020).

Appendix B

In order to more fully understand the proposed proxies for complexity (see Question 4b), and to explore the complexity of Australian listed entities (see Question 4a), we examine audit fees reported by Australian listed companies. Our analysis is based on the premise that audit fees reflect the effort and inputs into the conduct of an audit and that complexity increases audit fees. Currency is reported in Australian Dollars.

We first divide 25,140 company year observations into deciles based on audit fees (see Table 1). We find that client companies paying high audit fees have significantly higher total assets, geographic and business segments, foreign operations and inventory and receivables. The results are consistent for both the top and bottom decile. Low audit fees paying clients (mean=$14,000; median=$15,000) have significantly lower total assets (mean=$28.4m; median=$4.18m), number of geographic segments (mean =1.305; median=1) and business segments (mean=1.001; median=1), and foreign operations (mean=0.066; median=0). We also conduct a two-sample *t*-test to test whether the means of client company characteristics for the low and high audit fees groups are equal or not. Our sample of high fee companies has significantly higher total assets, geographic and business segments, foreign operations and inventory and receivables. The results are consistent for both the top and bottom decile. Low audit fee companies have significantly lower total assets, smaller number of geographic and business segments, less foreign operations and lower inventory and receivables.

We then conduct ordinary least squares regression analysis to examine to what extent these factors are related to audit fees (see Table 2). The audit fees regression model includes all available control variables extensively employed in the audit fees literature. Year and industry fixed effects are included to control for year and industry-specific effects on audit fees and standard errors clustered at the company level. We find that most of the model's independent variables related to client characteristics are significantly ($p < 0.01$) associated with audit fees and in the predicted direction. Client size (total assets), complexity (inventory, receivables, foreign operations, extraordinary financial items, number of business and geographical segments), and financial losses are positively associated with audit fees. In a sub-sample analysis, we also find the audit fee is positively associated with the number of employees working in the client company.

Table 1: Descriptive statistics for Australian listed companies by audit fee decile

Panel A: Means of descriptive statistics for Australian listed companies by audit fee decile

Decile	No. of client -year observations	Audit fees (millions)	Total assets (millions)	Receivables - Total	Inventories - Total	Intangible Assets - Total	PPE - Total (Net)	No. Geographical segments	No. Business segments	Foreign operations	Extra ordinary items	Operating income
1	2514	0.014	28.408	2.102	2.503	9.098	5.973	1.305	1.001	0.066	0.012	0.397
2	2514	0.025	13.248	0.621	0.388	1.211	6.644	2.100	1.012	0.129	-0.061	-1.585
3	2514	0.032	18.511	0.793	0.332	1.784	10.010	2.204	1.026	0.179	0.006	-1.950
4	2514	0.040	20.819	1.119	0.599	1.514	8.459	2.469	1.025	0.235	-0.010	-3.030
5	2514	0.053	25.355	1.633	0.882	2.220	11.851	2.427	1.018	0.277	0.007	-2.514
6	2514	0.072	51.513	3.787	2.018	4.132	18.327	2.878	1.023	0.322	-0.325	-1.889
7	2514	0.104	112.574	10.236	5.878	16.334	39.017	3.274	1.025	0.385	0.232	1.230
8	2514	0.165	189.918	18.931	11.690	31.820	76.856	3.754	1.040	0.441	1.782	10.774
9	2514	0.310	433.055	42.605	34.844	77.504	165.606	5.593	1.115	0.479	0.014	23.433
10	2514	9.251	4992.820	424.426	290.918	978.600	2334.940	7.100	1.261	0.492	5.121	455.552
Full sample	25140	1.006	578.379	49.749	34.399	111.285	263.051	3.310	1.055	0.300	0.669	47.066

Panel B: Median of descriptive statistics for Australian listed companies by audit fee decile

Decile	No. of client -year observations	Audit fees	Total assets	Receivables - Total	Inventories - Total	Intangible Assets - Total	PPE - Total (Net)	No. Geographical segments	No. Business segments	Foreign operations	Extra ordinary items	Operating income
1	2514	0.015	4.18	0.05	0.00	0.00	0.61	1.00	1.00	0.00	0.00	-0.66
2	2514	0.025	5.33	0.07	0.00	0.00	1.51	1.00	1.00	0.00	0.00	-1.06
3	2514	0.032	7.00	0.09	0.00	0.00	2.45	1.00	1.00	0.00	0.00	-1.45
4	2514	0.040	8.95	0.14	0.00	0.00	2.17	1.00	1.00	0.00	0.00	-1.75
5	2514	0.052	12.32	0.33	0.00	0.00	2.64	1.00	1.00	0.00	0.00	-1.89
6	2514	0.072	19.05	0.80	0.00	0.00	3.20	1.00	1.00	0.00	0.00	-2.04
7	2514	0.103	37.18	2.53	0.38	0.51	5.45	1.00	1.00	0.00	0.00	-1.10
8	2514	0.162	72.52	7.50	2.18	3.19	12.94	1.00	1.00	0.00	0.00	0.80
9	2514	0.295	221.73	23.15	8.34	13.88	36.40	1.00	1.00	0.00	0.00	11.16
10	2514	0.989	1679.62	168.40	61.75	252.20	372.42	1.00	1.00	0.00	0.00	100.06
Full sample	25140	0.061	18.52	0.66	0.00	0.00	4.59	1.00	1.00	0.00	0.00	-0.94

Notes: All figures for financial data are in the Australian Dollar in millions. Geographical and business segments are counts, and foreign operations is a categorical variable, with 1 indicating the existence of foreign operation, and 0 otherwise.

Table 2: Regression results for the audit fees model

Panel A: Only financial and operational variables

Variables	**Parameter estimate**	**Standard error**	**t Value**	**Pr > |t|**
Intercept	10.021	0.209	48.05	<.0001
Log of total assets	0.443	0.009	51.00	<.0001
Number of geographical segments	0.007	0.001	5.54	<.0001
Number of business segments	0.092	0.017	5.42	<.0001
Foreign operations	0.198	0.025	8.05	<.0001
Extraordinary items	0.222	0.045	4.97	<.0001
Inventory and receivables	0.969	0.076	12.75	<.0001
Special items	0.000	0.000	9.42	<.0001
Loss dummy	0.080	0.025	3.25	0.0012
Sales growth rate	0.000	0.000	-1.33	0.1851
Number of company-year observations	13,697			
Adjusted R^2	70.22%			
Industry fixed effect	Yes			
Year fixed effect	Yes			

Panel B: All variables

Variables	**Parameter estimate**	**Standard error**	**t Value**	**Pr > |t|**
Intercept	9.791	0.224	43.66	<.0001
Log of total assets	0.384	0.011	36.49	<.0001
Number of geographical segments	0.008	0.001	6.33	<.0001
Number of business segments	0.084	0.022	3.77	0.0002
Foreign operations	0.104	0.028	3.74	0.0002
Extraordinary items	0.169	0.050	3.36	0.0008
Inventory and receivables	0.815	0.090	9.05	<.0001
Special items	0.000	0.000	14.97	<.0001
Loss dummy	0.114	0.027	4.17	<.0001
Sales growth rate	0.000	0.000	0.30	0.7611
Qualified opinion	0.215	0.076	2.84	0.0045
Modified opinion	0.169	0.027	6.15	<.0001
Audit committee	0.056	0.029	1.94	0.053
Big-four auditor	0.425	0.030	13.97	<.0001
Number of company-year observations	7,714			
Adjusted R^2	74.36%			
Industry fixed effect	Yes			
Year fixed effect	Yes			

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