



Tel: +1 212 885 8000
Fax: +1 212 697 1299
@: bdo@bdointernational.com
www.bdo.global

BDO International Limited
Contact:
100 Park Avenue
New York, NY 10017
United States of America

12 September 2019

Mr. Willie Botha
IAASB Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
529 Fifth Avenue
New York, NY 10017
USA

Re: IAASB Discussion Paper: *Audits of Less Complex Entities - Exploring Possible Options to Address the Challenges in Applying the ISAs*

Dear Mr. Botha

BDO International Limited¹ (BDO) is pleased to have the opportunity to comment on the International Auditing and Assurance Standards Board (IAASB) Discussion Paper - ***Audits of Less Complex Entities (LCEs) - Exploring Possible Options to Address the Challenges in Applying the ISAs***.

In general, we are very supportive of the IAASB undertaking this project as the audits of LCEs represent a significant part of many of our firms' practices. We believe many of the challenges to improving the effectiveness and utility of the audits of LCEs need to be considered in a holistic manner and urge the IAASB to work closely with other standard setters, regulators and stakeholders as part of its considerations in developing appropriate solutions. As a global network with a significant portion of its business base that performs many audits of LCEs, we confirm our active participation in further deliberations the IAASB undertakes, including our commitment to conduct local country outreach to preparers and users of the audit service.

Our views in response to the specific questions posed are as follows:

(1) 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 work in relation to audits of LCEs, and are there any other characteristics that should be included?

The shift in focus from 'size' to 'complexity' is a positive one, reflective of the fact that smaller entities may still be complex and larger entities may not be complex. Standards are intended to be scalable based on risk and we agree that risk relates much more to complexity than size.

We welcome the change in terminology from small and medium-sized entity (SME) to less complex

¹ BDO International Limited is a UK company limited by guarantee. It is the governing entity of the international BDO network of independent member firms ('the BDO network'). Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium. Each of BDO International Limited, Brussels Worldwide Services BVBA and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA and/or the member firms of the BDO network.

entity (LCE). However, with respect to the definition of LCEs provided on page 4, we note that this definition has been carried over from the previous SME definition and has not been changed. The characteristics therefore continue to focus on size and volume as opposed to complexity.

It is unclear if the 'complexity' determination is considered from the entity's perspective or from the auditor's perspective. For example, a simple, straightforward entity with a control environment where there are few controls may actually result in complexities for the auditor in how to approach the audit. We believe that the term 'complexity' refers to the entity itself rather than whether the audit may be complex.

While we largely agree with the characteristics described in parts a and b, we note that certain points could be clarified further and/or additional characteristics included. We suggest the following points that provide further clarity on the characteristics of LCEs and therefore could be incorporated into the definition of LCEs:

- A business model that is easy to understand
- Business risks that are easy to identify and assess
- A control environment that is easy to comprehend
- A possible lack of segregation of duties and established procedures due to limited numbers of staff employed by the client
- Less complex financial reporting standards (e.g. IFRS for SMEs)
- Stable legal and regulatory environment
- Operations that are less likely to be impacted by rapid technological change
- An entity that is less likely to be subjected to public scrutiny.

The LCE definition will be critical when deciding on the appropriate course of action. For example, if the IAASB decides to adopt a single standard for LCEs, then we must have a clear way of determining the audits that could be scoped into this standard

A useful consideration when rewriting the LCE definition could be to differentiate between internal factors based on the nature of the entity (i.e., control environment, stakeholders) and external factors (i.e. industry, legal and regulatory environment, accounting frameworks, technology changes).

(2) Section II (pages 10-13) describes challenges related to audits of LCEs, including those challenges that are within the scope of work in relation to audits of LCEs. In relation to the challenges, the IAASB is 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 problematic in an audit of an LCE.

As we have noted in previous comment letters, developing a body of ISAs that are now so prescriptive (covering the 'what' and 'how to' apply the ISAs) has caused the standards to move away from being a principles-based set of requirements and has encouraged users (auditors, regulators, etc.) to adopt a checklist approach to auditing. This has also led to an increased disconnect from users' needs with respect to audits of LCEs that has been so well articulated in the IAASB's discussion paper.

One of the main aspects of the ISAs that is, and will continue to be, difficult to apply is that of identifying and assessing the risks of material misstatement, (ISA 315 *Identifying and Assessing the*

Risks of Material Misstatement Through Understanding the Entity and Its Environment). As outlined in [BDO's comment letter](#) to proposed ISA 315 (Revised) dated 1 November 2018, we identified a number of concerns that some of the requirements are overly complicated and possibly onerous to apply to smaller, less complex entities. Specifically, the following elements of ED 315 are of concern:

- The extent of work and documentation required with respect to assessing design and implementation of controls when one plans a purely substantive audit and has no intention of relying on controls (which is quite common for audits of LCEs)
- Due to the complexity of the standard, the focus on controls relevant to the audit has diminished the focus on understanding the information systems resulting in inadequate risk identification for all entities, including LCEs
- Guidance on the minimum documentation to meet the requirements relating to controls (notably in paragraphs 38, 39 and 42) would be beneficial. Excessive documentation in an area with little to no impact on the audit can pose as a threat to audit quality as it moves focus and resources away from important engagement risks (e.g. going concern or related parties)
- ED 315 is more complex than the extant standard, as shown through the multiple flowcharts needed to illustrate the risk assessment process. This is partly due to the definitions and requirements related to inherent risk, control risk and risk of material misstatement.

Other ISAs which pose difficulties in applying to audits of LCEs include:

- *ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* - The extent of work required to respond to management override and test journal entries does not appear scalable.
- *ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements* - The nature and extent of audit procedures to be performed in identifying instances of non-compliance with laws and regulations in the context of LCEs are extensive and does not appear scalable.
- *ISA 260 Communications with those Charged with Governance* - The extent of communication to be performed in the context of LCEs are extensive and does not account for the circumstances that LCEs often only have a one-tier management structure with minimal consequence to users of the financial statements (who may be owner-managers as well).
- *ISA 540 (Revised) Auditing Accounting Estimates and Related Disclosures* - The nature and extent of audit procedures to be performed in auditing estimates (including obtaining relevant understanding of the entity) in the context of LCEs are onerous which is not commensurate with the degree of complexity (or simplicity) of the financial statements of LCEs.

- (b) In relation to 2(a) 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 work progresses on audits of LCEs?

In spite of all efforts to set meaningful standards for audits, one of the underlying causes to the challenges raised is often the lack of financial reporting sophistication of the preparers of financial information. This lack of sophistication impacts both an entity's ability to create a strong control environment, to apply the relevant accounting framework and to provide auditable support for assertions made in the preparation of financial statements. As the IAASB continues to deliberate

possible options to address the challenges in applying the ISAs, standards should be based on this assumption and addressed accordingly.

To this point, we raise the following additional comments:

- In recent years the strategy for ISAs has been to scale them up but not scale them down. For example, ISA 540 has been scaled up to deal with IFRS 9 *Financial Instruments*, and that scaling up to deal with the accounting complexity has made it difficult to practically apply the standard to simpler estimates. To date there is little evidence of ISAs being scaled down for LCEs because the IAASB has continued to apply the guiding principle that the requirements apply to all audits. Further, the standards seem to be driven by regulatory considerations which can lead to overly long and complicated standards that are difficult to apply to LCEs and in many cases may lack relevance.
- With specific reference to ED 315, we believe the increased length of ED 315 alone is a potential barrier to its understanding and application to LCEs. It could be argued that the ED (and other auditing standards such as ISA 540 (Revised)) was drafted for larger, complex entities with guidance added on for scalability to LCEs. While we support IAASB efforts to continue focus on scalability as part of the revisions, it would appear that, as all requirements apply to all entity audits (with no deduction for LCEs), the standard setting model has an inherent bias towards the most complex entities.

Therefore, we believe that the time required to perform a less complex audit engagement and to comply with the full body of ISAs is still very significant.

(3) With regard to the factors driving challenges that are not within the IAASB's control, or have been scoped out of explanatory information gathering activities (as set out in Section II, pages 10-13), if the IAASB were to focus on encouraging others to act, where should this focus be, and why?

In terms of the factors outside of IAASB's control, we believe any additional focus should be on technology, methodology and training auditors. Acknowledging that the ISAs do not prescribe how auditors are trained, additional guidance and/or practical case studies could be beneficial to audit practitioners and audit firms when training staff on various standards and how they are applied to entities of varying sizes and complexities, but particularly to LCEs.

We also believe that regardless of actions taken by the IAASB regarding audits of LCEs, no strategy will be completely successful without a re-examination by the International Accounting Standards Board (IASB) of the accounting standards applicable to LCEs. IFRS for SMEs exists already but it would be helpful if the IASB would re-consider if additional amendments are possible to make the accounting standards more relevant to LCEs.

Additionally, although not within the scope of this discussion paper, increasing awareness of the benefits of reviews and other types of assurance engagements to the users of financial statements and the law makers may address some of the concerns regarding the audits of LCEs. If a lesser degree of assurance was acceptable to users, more LCEs could request assurance engagements other than audits. Awareness about the cost and complexity of an audit may also be helpful to users in determining the level of assurance and type of engagement that would meet their needs.

(4) To be able to develop an appropriate way forward, it is important that the IAASB understands 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 (pages 14-17):

- (a) For each of the possible actions (either individually or in combination):
- i. Would the possible action appropriately address the challenges that have been identified?
 - ii. What could the implications or consequences be if the possible action(s) is undertaken?
This may include if, in your view, it would not be appropriate to pursue a particular possible action, and why.

Option A - Revising the ISAs

Rewriting the ISAs using simpler language and a simpler structure would greatly benefit LCE auditors and would make it easier for these auditors to find the specific requirements that apply to their situation. This will also help auditors of other types of entities. This is in contrast to the existing method of having to distil complicated, lengthy standards into more basic procedures. We can therefore see a number of advantages of revising the ISAs to a ‘think small first’ or ‘building blocks’ approach whereby complexities can be added to each ISA depending on facts and circumstances linked to the audit of a certain entity. By adopting this approach it may also encourage practitioners (and regulators) to adopt a more thoughtful consideration of what is required for the purposes of each audit (moving their thinking from a checklist/compliance approach to a more tailored judgment-based approach).

We acknowledge that this would be a very lengthy and costly exercise in terms of usage of the IAASB’s resources. Also, considering the maturity of the ISAs and the fact that they were recently clarified to make them easier to understand, we recognise that this may not be a realistic option. Given the IAASB already tries in each standard to write requirements that are clear and principles-based, it may not be possible to make significant improvements to the requirements. Further, if the application guidance needs to cover LCEs and more complex entities, there is the risk that the application guidance would become even longer than it is now, which doesn’t solve the problem of lengthy standards.

Option B - Developing a separate auditing standard for audits of LCEs

There are a number of obvious advantages to having a separate standard that might overcome the challenges outlined in Option A. A separate standard would ultimately provide a solution that allows for quicker responses to the issues of applying the ISAs to the audits of LCEs as opposed to the time needed to redraft or revise all the ISAs. In addition, it would enable users to find all the requirements and LCE definition in one place rather than having to read across the suite of ISA standards.

However, more clarity is needed on whether this option means developing a single standard for audits of LCEs which include all simplified requirements and application guidance applicable to LCEs (i.e., there is only one all-encompassing standard), or whether the IAASB means a separate suite of LCE auditing standards that are simplified (i.e., for each topic, there is a separate LCE standard). The former would be a very long standard that would be quite unwieldy. We believe the latter would be better for auditors as each standard would be short enough to be understandable, and the listing of standards would be similar to what they are used to now.

Irrespective of the mechanism for publishing the LCE standard discussed above, we believe there are two options for developing separate auditing standards for LCEs:

- Option B1 - developing separate auditing standards based on existing ISAs
- Option B2 - developing separate auditing standards based on a different framework.

Option B1 (i.e. separate auditing standards based on existing ISAs) has a lot of appeal as it can be built from the ground up to specifically address the audits of LCEs, may provide the same level of assurance and be without the length and complexities of the existing ISAs. However, further questions would need to be answered such as:

- Whether the requirements would be the same as the ISAs, or more principles-based / less prescriptive
- Whether it would be possible to obtain the same level of reasonable assurance if the requirements are different, or whether there are gradations of reasonable assurance. At some point, the differences in the levels of reasonable assurance may require different wording in the auditor's report to communicate a different level of reasonable assurance. This concept would need to be discussed with users of the audited financial statements to determine if such a report would meet their needs.
- Whether the application guidance in the LCE standard should be detailed (while still being relevant only to LCEs) or whether it should also be principles-based, with detailed guidance being included in non-authoritative sources outside the ISAs.
- Whether reduced documentation requirements for LCEs would be feasible.
- Whether the separate standard sits within or outside the body of ISAs.

We believe that consideration of these questions would be a worthwhile exercise.

Regarding option B1, we also suggest that there should be some flexibility allowed here to apply a 'full' ISA when appropriate (i.e. a truly scalable approach). For example, depending on the final characteristics/criteria of an LCE, there may be circumstances where most of the audit meets the definition of an LCE audit but there is one specific area that is considered complex. A mechanism could be made available to allow the auditor to apply the separate auditing standards for LCEs and to use professional judgment in applying the full ISA for this one complex area.

The definition of an LCE will be important if this scalable option is adopted and may be challenging to differentiate when such a standalone LCE standard is applied or when full ISA application is appropriate.

It is also worth noting that regulators would likely need to be involved in discussing such a solution as a standard with fewer requirements may be more challenging for regulators to enforce, or they may not be willing to accept more principles-based standards that are less prescriptive. Therefore, a consequence may be that regulated entities may not be allowed to use the LCE standards.

Regarding option B2 (separate LCE auditing standards based on a different framework), we believe that such a standard would not be able to provide a reasonable assurance opinion as it would potentially vary significantly from the scope and nature of work done in an ISA audit. There would also need to be some consideration on whether the fundamental principles would be the same as the ISAs (i.e. a risk-based approach and evidence gathering procedures using professional judgment and applying professional scepticism). While this option should not be ruled out, it would need to be discussed with users of audited financial statements and law makers as it would probably not be an audit level of assurance, but rather something between an audit and a review. This is a much longer term option that would not meet short-term objectives.

Option C - Developing guidance for auditors of LCEs or other related actions

As this would simply be a continuity of the work that has already been undertaken, it would be a relatively quick solution and consistent with previous projects undertaken. We would have reservations however that this would address the number of challenges noted above and could easily be perceived as just adding more reading material (outside the ISAs) to the lengthy ISA materials. Auditors of LCEs would still have to read and understand the full suite of ISAs and then would also have to read and understand even more guidance in other resources - which doesn't resolve the issue about the length of the ISAs.

Our thoughts regarding the specific alternatives presented in Option C are as follows:

- **Option C(a) - Working with IFAC to Enhance Their Comprehensive Guide for LCEs** - We believe this alternative has potential if there is a way to make the guidance concise and easy to apply. If this project is undertaken, feedback should be obtained from the many users of the current guide on why it is deficient in its present format.
- **Option C(b) - International Auditing Practice Note (IAPN) for Audits of LCEs** - If users are only struggling with particular standards, this may be a useful alternative. However, we don't think it would resolve the overall issue about how to apply the pervasive standards (risk assessment, responses to risk, fraud, etc.) more practically.
- **Option C(c) - Guides on Specific ISAs** - Similar to Option C(b), we don't believe that this piecemeal approach on its own would be sufficient for auditors to conduct LCE audits more effectively.
- **Option C(d) - Implementation packs for new/revised ISAs** - Such materials would probably be appreciated by practitioners in smaller firms. This option would be particularly helpful if done in conjunction with Option C(a)

If one of the alternatives under Option C is adopted, we would encourage the IAASB to provide hyperlinks from the ISAs to the relevant paragraphs in the supplemental guidance to minimize the time that auditors of LCEs need to spend searching through voluminous supplemental guidance.

- (b) Are there any other possible actions that have not been identified that should be considered as work progresses on the audits of LCEs.

While the IAASB has decided to exclude further consideration of engagements that are not audits (i.e. a different level of assurance besides reasonable assurance, like a review engagement), this leaves an unresolved question about what the stakeholders of LCEs actually need from an assurance perspective.

There is the possibility of developing a standard for 'direct' engagements whereby the audit practitioner is involved in the calculation of the closing entries and measurement of final estimates. This would be a combined engagement; a direct engagement on final estimates and an assertion-based audit on the overall financial statements. Considering the nature and structure of LCEs, quite often, the owner and/or manager will not be an expert in accounting and this would close the expectation gap of management with respect to their responsibilities. Under the IAASB framework, it is possible to provide assurance within such an engagement i.e. where the auditor directly measures or evaluates the underlying subject matter against the criteria. Safeguards would need to be implemented to address the self-review risk on these combined engagements.

- (c) In your view, what possible actions should be pursued by the IAASB 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 (pages 14-17), or noted in response to 4(b) above.

If not already done, it would be considered very helpful to understand the feedback from the various jurisdictions that have already adopted the approach of a separate LCE auditing standard (e.g. France, Belgium, Norway and Sri Lanka) in order that decisions about the future direction of the IAASB standards for LCEs would learn from their experiences. We would also strongly support further engagement with other standard setters, regulators and stakeholders, including LCE entity owners and/or management, in order to develop a targeted approach to resolving issues associated with audits of LCEs.

(5) Are there any other matters that should be considered by the IAASB as they deliberate on a way forward in relation to audits of LCEs?

We have no further comments.

Thank you for the opportunity to provide input on this important subject and hope that our comments and suggestions are helpful in your deliberations.

If you have any questions or need further clarification please feel free to contact me.

Yours sincerely,

BDO International Limited

Chris Smith

Global Head of Audit and Accounting