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Washington, DC 20548

September 12, 2019

Ms. Beverley Bahlmann
Deputy Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
New York, NY 10017

GAO's Response to the International Auditing and Assurance Standards Board's Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*

Dear Ms. Bahlmann:

This letter provides GAO's comments on the International Auditing and Assurance Standards Board's (IAASB) discussion paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*. GAO promulgates generally accepted government auditing standards (GAGAS), which provide professional standards for auditors of government entities in the United States.

We note that governmental and non-profit entities may have unique considerations related to less complex entities (LCE) because of the nature of the entities, GAGAS reporting requirements, and laws and regulations. Specifically, the public interest in governmental and non-profit entities is different than that for private companies in terms of an entity's handling of the funds it receives and expectations of outsiders, such as taxpayers, for how efficiently and effectively the funds are spent. An entity in the public sector may have a small number of employees, a less complex internal control system, and a small amount of funding, but it nonetheless may be of great importance to the public sector. This may be based on a significant regulatory requirement that the entity monitors, a significant amount of assets (i.e., cash or bonds) for which the entity is responsible, or the sensitive nature of the entity's mission.

We have concerns about the IAASB's efforts related to LCEs and the potential for a stand-alone standard for the audit of LCEs. We believe that the possible action to create a separate standard should not be pursued, as it would create confusion and inconsistency in the profession. There is a risk that a separate standard would create the perception that an LCE audit is less robust and thorough than a non-LCE audit. Also, the separate standard may cause inconsistency in the application of the audit standards by auditors in the execution of an audit, regardless of the type. Also, we have concerns about how LCE is defined, as it may be difficult to implement the standard if an entity's complexity changes during the audit. The comparability of the audited information may be questioned if an audited entity is an LCE in one audit period and not in a subsequent audit period.

We believe that it is important to improve audit standards to address some of the existing issues related to applying standards to small-and medium-entities. We believe that the ISAs have become more prescriptive, particularly in the application guidance and newer standards. We suggest that the drafting of new standards move to a more principles based focus and eliminate

the prescriptiveness that has been added to the standards. This should provide the additional clarity for LCEs that the discussion paper is seeking.

The IAASB asked for responses to a number of questions related to the discussion paper. Our responses to the questions follow in an enclosure to this letter.

Thank you for the opportunity to comment. If you have questions about this letter or wish to discuss any of our responses, please feel free to contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,

A handwritten signature in black ink, appearing to read "James R. Dalkin". The signature is stylized with a large initial "J" and a long horizontal stroke at the end.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Enclosure

Responses to Questions on the International Auditing and Assurance Standards Board's Discussion Paper, *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs*

- 1. In your view, is the description appropriate for the types of entities that would be the focus of our work in relation to audits of less complex entities (LCEs), and are there any other characteristics that should be included?**

Overall, we believe that there are aspects of less complex entities (LCE) definition that raise concerns about how to apply the term. The definition of LCE risks causing confusion in the audit profession, both for auditors in how to define such entities and for those who rely on the audits. Also, the definition focuses more on for-profit entities than non-profit or public sector entities.

Specifically, we believe that the description of LCEs does not sufficiently address the types of entities in the public sector. There may be public sector entities that exhibit characteristics described in the qualitative characteristics of LCEs listed in the discussion paper, but it may not be appropriate to apply a different level of audit as considered for LCEs. There are also descriptions, such as those of ownership or management structure that may be different for public sector entities. These differences are not sufficiently addressed in definition.

In addition, the concept of LCEs is structured around a single audit period and does not consider the changes that may occur in an entity from one audit period to the next. A small-or medium-sized entity may not change significantly from one audit period to another, but an LCE may change in complexity from one audit period to another, or even during the period under audit. Also, the potential of an audit report to change from LCE to non-LCE can create confusion regarding whether the financial statements audit opinions are comparable.

Finally, the interpretation of the characteristics by auditors may be difficult with entities that may be "on the border" of being less complex. One auditor, based on their professional judgement, may determine to audit using the LCE standard while another may not.

- 2. In relation to the challenges that we are looking to address:**
 - a. What are the particular aspects of the ISAs that are difficult to apply? It would be most helpful if your answer includes references to the specific ISAs and the particular requirements in these ISAs that are most problematic in an audit of an LCE.**
 - b. In relation to 2a above, what, in your view, is the underlying cause(s) of these challenges and how have you managed or addressed these challenges? Are there any other broad challenges that have not been identified that should be considered as we progress our work on audits of LCEs?**

We believe that ensuring the consistent application of the audit evidence standard is particularly important for LCEs. Specifically, obtaining sufficient appropriate audit

evidence is important for auditing LCEs, as there would potentially be an insufficient amount of audit evidence obtained to address the audit risk.

In addition, we have concerns about peer review and the engagement quality review process. Specifically, creating an LCE audit area, particularly by the creation of an LCE audit standard, may introduce additional risks to the review of an LCE audit. In the event of a peer review, the peer reviewer may not reach the same conclusion regarding whether the auditor's decision to apply the LCE standard was appropriate, which raises concerns about whether the audit opinion should be continued to be relied upon.

The potential for threats to an auditor's independence may arise because of a perception that an LCE audit may be less time-consuming and costly to an entity, so entities may try to shop for an auditor that will provide an LCE audit with less concern over audit quality.

We believe that for LCE audit the IAASB should consider an engagement similar to a review attestation engagement (limited assurance engagement), which would provide less assurance than a full audit. If this type of engagement would be considered, it would need to be clear in the report the level of assurance provided.

Finally, the topic of reporting for an LCE audit should be addressed, as reporting consistent with a non-LCE audit may not be appropriate. At the same time, an audit report that distinguishes an LCE audit may create a view that it is not the same quality as a non-LCE audit or may confuse users.

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

We believe that the factors driving challenges that are not within the IAASB's control outlined in section II should not be scoped out of the process for many of the identified challenges. The effect of decisions made related to LCEs in the audit area will need to be addressed in other types of engagements, particularly what the comparative level of work that goes into an LCE audit versus an attestation or direct engagement and the perceived level of assurance provided by each. In addition, public perception will not be improved by moving toward a separate audit standard for LCEs as it would create additional questions from the public regarding the potential value and perception of what an audit provides.

Also, we believe that the ISAs have become more prescriptive, particularly in the application guidance and newer standards. For example, the revised ISA 540 includes 61 pages of requirements, application guidance, and appendixes. We suggest that the drafting of new standards move to a more principles-based focus and eliminate the prescriptiveness that has been added to the standards.

- 4. In relation to the potential possible actions that may be undertaken as set out in Section III:**
- a. For each of the possible actions (either individually or in combination):**
 - i. Would the possible action appropriately address the challenges that have been identified?**

- ii. **What could the implications or consequences be if the possible action(s) is undertaken? This may include if, in your view, it would not be appropriate to pursue a particular possible action, and why.**
- b. **Are there any other possible actions that have not been identified that should be considered as we progress our work on audits of LCEs?**
- c. **In your view, what possible actions should be pursued by us as a priority, and why? This may include one or more of the possible actions, or aspects of those actions, set out in Section III, or noted in response to 4b above.**

We believe that the possible action to create a separate standard should not be pursued, as it would cause confusion and inconsistency in the profession. There is a risk that a separate standard would create the perception that an LCE audit is less robust and thorough than a non-LCE audit. Also, the separate standard may cause inconsistency in auditors' application of the audit standards and execution of audits, regardless of the type.

We believe that the creation of an audit guide should not be pursued. The time and effort to create and then update a guide based on changes in standards would be burdensome. In addition, the translation of such a guide would make it difficult to ensure consistent application across languages.

We believe that the ISAs have become more prescriptive, particularly in the application guidance and newer standards. We suggest that the drafting of new standards move to a more principles-based focus and eliminate the prescriptiveness that has been added to the standards. We believe that this approach can help address some of the challenges identified in section II, such as the concerns about the complexity of standards. This project can be approached on a standard-by-standard basis, rather than all at once.

5. Are there any other matters that should be considered by us as we deliberate on the way forward in relation to audits of LCEs?

We do not have any additional matters that should be considered beyond those covered above.