mgi worldwide

Response to IAASB Discussion Paper

"Audits of Less Complex Entities: Exploring possible options to address the challenges in applying the ISAs"

Overview

MGI Worldwide welcomes the Discussion Paper as the majority of audits undertaken by our member firms across the globe are of smaller and less complex entities (LCEs). Feedback from Small and Medium-sized Practices (SMPs) within our membership and beyond agrees with the comments that "increases in the length and detail of the International Standards on Auditing (ISAs) can…..lead to increased documentation in audit files, with no perceived commensurate benefit." The results of our network's own Quality Assurance review process has also shown that the understanding of the ISAs is patchy, often due to the length of the requirements and the language used within the standards themselves. Although the Application Material in the ISAs is useful in many cases, it is not clear that many member firms are fully aware of it or how to apply the ISAs appropriately to each client, tailored for size and complexity.

Feedback from SMPs frequently focuses on the frustration of having to "check the box" on all the ISA requirements, even though some are less relevant given the nature of the entity being audited. This focus on completing audit programs can lead to a lack of challenge and scepticism amongst the audit teams as firms train staff who can complete the program, rather than engage in the audit. There is also great frustration at the need to follow the same standards on a small and LCE client, as that applied to a listed or public interest entity, especially when the SMPs suffer from the negative feedback / reputation to the profession caused by the bigger firm's failings on such audits.

Specific questions

IAASB

1. We are looking for views about how LCEs could be described (see below). In your view, is the description appropriate for the types of entities that would be the focus of our work in relation to audits of LCEs, and are there any other characteristics that should be included?

"An entity which typically possesses qualitative characteristics such as:

> *a. Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and*
>
> *b. One or more of the following:*
>
> > *i. Straightforward or uncomplicated transactions;*
> >
> > *ii. Simple record-keeping;*
> >
> > *iii. Few lines of business and few products within business lines;*
> >
> > *iv. Few internal controls;*
> >
> > *v. Few levels of management with responsibility for a broad range of controls; or*
> >
> > *vi. Few personnel, many having a wide range of duties.*

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics."

Response

When considering complexity in our members' client base, we agree that the focus should firstly be on the ownership/management structure. The historic rationale for an audit is based on the potential separation of the ownership and stewardship of a limited company and the need to report robustly on the results to the owners. Where there is in fact no separation (an owner-managed company or wholly-owned subsidiary company under parental control), the entity itself can present a lower inherent risk for audit.

The qualitative characteristics outlined in b. are also relevant, although we consider that an LCE should always have "straightforward or uncomplicated transactions", with the other points listed being more ancillary. An entity may concentrate responsibilities and controls in the hands of few individuals, or indeed, have few such controls, but the key should be that the underlying accounting is straightforward so that this "lack" of control does not present a heightened risk to the audit or can be addressed through appropriate substantive testing.

"Simple record keeping" needs to be defined to help SMPs consider whether their clients will meet the criteria. Will this exclude ERP systems and those that are bespoke to a client? Will "off-the-shelf" packages only apply? The focus (as noted above) should be on the complexity of the accounting, not necessarily the record keeping.

An LCE may also include an entity that operates significantly only in one territory as cross-border operations, whether through branches, subsidiaries or exports, may potentially increase the risk to the entity.

IAASB

2. Section II describes challenges related to audits of LCEs, including those challenges that are within the scope of our work in relation to audits of LCEs. In relation to the challenges that we are looking to address:

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

Response

We recognise the challenges outlined in section II, particularly agreeing with the feedback points on page 13. As a global network, one of the primary challenges faced by member firms is the language used within the existing standards and the length / complexity of the standards themselves. This is an issue for firms in both English-speaking nations as well as others.

Specific ISAs that cause problems for audits of LCEs in our experience include:

ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* – this standard is so long and detailed that many SMPs fail to document their understanding of the client. There can also be a tendency to document information in a permanent section of the audit file and fail to update this appropriately when required (maybe because of time / fee pressures but also because teams do not link the different "phases" of the audit documentation together). A key area which is generally poorly executed is the understanding of the internal control components (other than control activities) as this is often informal and not documented in LCEs. This also leads to a failure to adequately assess the design and implementation of relevant controls and to consider any IT / communication systems in use. Some firms are asking for guidance on how to address the understanding of the control components better, including through specific training events.

ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – the effectively mandatory expectation that there are significant fraud risks for management override of controls and revenue recognition causes further issues for audits of LCEs. In an owner-managed business, many firms rebut the management override risk inappropriately as they assess the actual risk to their client as low. The audit of journals is often weakly (or not) performed as a result and in LCE audits, the accounting estimates arising are often basic and not always material. Some firms will focus on "management" overriding controls, not picking up that finance staff in key positions (especially in smaller clients with less segregation of duties) can also override controls in place. We have witnessed files which explain that there is no risk as the owner-manager is hands off in relation to the accounting, but then indicate what the bookkeeper can do in relation to, say, expense approval and payment. In relation to revenue, we see firms either adopt an approach that Completeness is always the fraud risk (without justification) or that all assertions are affected. Audit teams know that there should be a significant risk here so are then auditing to the standards, rather than employing their knowledge and judgment to form an appropriate risk assessment.

ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* – understanding the risks apparent from laws and regulations for an LCE is often poorly executed, either too much detail (including copies of the related regulations) or only very high-level identification of standard regulations. There are two fundamental failings: staff undertaking this work don't have adequate knowledge of laws and regulations in general terms or specifically to the sector in which the client operates; and staff are unable to identify which of the laws or regulations create a relevant audit risk. Thus the work becomes generic and unfocused. This is often more of an issue in owner managed businesses as larger businesses might have a legal team or a compliance function etc., whereas, smaller businesses are sometimes not even aware of key legislation that is relevant to their operations.

This is often a documentation exercise not frequently revisited and then not linked into the audit work / considerations during the fieldwork. LCEs will often operate in a non-complex regulatory environment and the standard should provide guidance on a suitable level of documentation to be applied to such files.

ISA 520 *Analytical Procedures* – auditing using analytical procedures is poorly executed. Preliminary analytical procedures are often not linked to the risk assessment or audit work but are merely on file as the audit program requires them. Substantive analytical review is not generally understood by SMPs – a trend analysis of balances from prior year is a useful risk assessment tool but many firms try and use this as substantive evidence and they do not refer to the requirements of the standard, which require significantly more documentation (an independent expectation and substantive corroboration). This misunderstanding of what a substantive analytical review can be for an LCE also can lead to inappropriately reducing sample sizes for substantive tests of detail.

ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* – as noted in the Discussion Paper, the requirements around accounting estimates are unwieldy for many LCE audit clients. Most firms in our experience do not understand the retrospective review of the prior year accounting estimates and what it is designed to achieve. In some cases, the accounting estimates are calculated by the SMP as part of an accountancy service. The risk here is low but the documentation required again results in auditing to the standard. Where there are significant risks arising from accounting estimates (such as slow-moving inventory provisions for instance), teams are missing / not aware of the additional requirements for auditing such estimates.

ISA 500 *Audit Evidence* / ISA *402 Audit Considerations Relating To An Entity Using A Service Organisation* – where substantial amounts of year-end accountancy work is undertaken or the audit practice undertakes outsourcing functions (bookkeeping / management accounts / payroll), firms struggle to consider how to integrate and document any assurances already gained into their audit file and generally what audit approach to take. Plus whilst accountancy work may, for example, help to give assurances over one audit assertion, it may very well be irrelevant to others, and firms often fail to realise this.

ISA 550 *Related Parties* - problems here have been exacerbated by the issue of accounting standards for smaller entities in the UK, which reduce the amount of related party transactions which need to be disclosed. Firms now focus more than ever on the disclosure requirements, failing to fully identify / document all related party transactions. Additionally, the commerciality and purpose of transactions is often not fully assessed linking back to inadequate consideration of fraud

ISA 570 *Going Concern*– for many LCE audits, a client may not have formal forecasts and budgets to support the directors' assessment of going concern. As a result, audit teams can fail to adequately probe the risks here or will rely simply on verbal representations from the directors as there is a lack of other evidence. Greater guidance on the level of work required when going concern is NOT identified as a heightened risk would be useful across all audits.

IAASB

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

Response

One of the challenges not within the control of the IAASB noted on page 11 is the continuing fee pressure on LCE audits. This is often linked to the perceived lack of value in the audit as a "box-ticking exercise" which clients refuse to pay an appropriate fee for. Whilst national governments will set audit thresholds and requirements and the IAASB cannot be expected to try and influence this, there must be focus on encouraging the national professional bodies to improve communication on, and perception of, value in the audit. This will also need to include addressing the expectations gap, which we know is a focus in many territories within our network. Press comments on audit are negative, focusing on those few audits that are performed poorly or where a company later collapses and the press / public look for someone to blame. There is not enough positive press about audit, except when audit thresholds are raised to reduce the "burden" on small businesses.

Training provided to students and existing auditors needs to be focused not only on the requirements of the standard but their practical application. Model audit files are useful to enable practitioners to visualise what is expected, however, there is a risk that they will simply end up being 'cut and pasted' into real audit files.

There are a number of audit systems on the market which are very checklist-orientated, and whilst their intention maybe that each question has supporting narrative this frequently does not happen.

Too often regulators' audit file reviews focus on the weaknesses in the audit, rather than providing guidance and training on how to avoid the issues going forward, suggestions for improvement etc. They also focus on rigid compliance with the ISAs on a line by line basis and no consideration is made as to whether 'holistically' the audit approach has addressed the key risks; this encourages excessive documentation and a tick box approach. More practical guidance and help needs to be given to SMPs in performing good quality audits.

IAASB

4. To be able to develop an appropriate way forward, it is important that we understand our stakeholders' views about each of the possible actions. In relation to the potential possible actions that may be undertaken as set out in Section III:

a. 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.

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

In your view, what possible actions should be pursued by us as a priority, and why? This may include one or more of the possible actions, or aspects of those actions, set out in Section III, or noted in response to 4b above.

Response

The possible actions are:

A. Revising the ISAs.

B. Developing a Separate Auditing Standard for Audits of LCEs.

C. Developing Guidance for Auditors of LCEs or Other Related Actions.

We feel that a separate auditing standard for audits of LCEs would be most easily adopted by our members. Such a standard would be a clear source of the relevant guidance and requirements for such an audit and would help to negate some of the issues regarding the complexity and length of the existing standards. Revising the existing standards to promote either a "building block" approach to the audit or to include additional guidance specifically for LCE audits will not necessarily address the issue with the standard's length or perceived complexity.

Given that the audit teams for LCE clients are often small and the timescale from planning to completion shorter, we welcome the idea to consider "mirroring the risk-based approach of the ISAs but be presented in a way that follows the work flow of an audit." This would help audit teams to better understand how the auditing standards affect the practical audit from start to finish.

Feedback from member firms on the increasing focus on documentation also means that we would welcome further guidance on the documentation standard that would be sufficient for LCEs, especially at the planning and completion stages.

We recognise that having a "two-tier" audit approach for LCE and other clients may result in some firms using the wrong set of standards and in the need to teach students and existing auditors two standards, but this is analogous with the accounting situation in many territories where the financial statements of a small company can look significantly different (and less complex) than those of a large or listed entity. This can be addressed through clear messaging on when the new LCE standard can be used, continued training and robust regulatory reviews to ensure that the appropriate standards are being adhered to at all sizes of firms.

Whilst we would welcome further "How to" guides (as mentioned in Option C), we feel that this would be of less benefit and ease of use than a new LCE auditing standard. There is already guidance available in the existing ISAs (the Application Material) and in other sources but this can be difficult to navigate through. It means that member firms have another reference point, as well as the standards themselves and any local regulatory guidance and this potential overload of information may be self-defeating in that firms do not take the time to read, review and apply on their audits. A new LCE audit standard would represent a clear change that we feel would be welcomed.

If the decision was made to revise the existing standards then ideally this should be done as a major project as some sort of LCE audit pack would need to be produced and this would be difficult to do if the standards were updated piecemeal. Also practitioners are more likely to actively consider a substantial change, whereas, a creeping change might be lost in the 'background noise'.

IAASB

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

Response

The timeliness of the decision-making process is key. The Discussion Paper indicates that option B above, if the potential new standard were not based on existing ISAs, would take significant time and effort to develop. Our member firms need to see that action is being taken in this area within a reasonable timeframe.

Technical Committee, MGI Worldwide
10 September 2019

Contact
Clive Viegas Bennett, CEO
clive.bennett@mgiworld.com
www.mgiworld.com