PITCHER PARTNERS

Level 13, 664 Collins Street
Docklands, VIC 3008

Level 1, 80 Monash Drive
Dandenong South, VIC 3175

Postal address
GPO Box 5193
Melbourne, VIC 3001

p. +61 3 8610 5000

Ref: KLB/TN

22 August 2019

The Chairman
Auditing and Assurance Standards Board
PO Box 204, Collins Street West
Melbourne Victoria 8007

Dear Chairman,

SUBMISSION – AUDIT OF LESS COMPLEX ENTITITES

We appreciate the opportunity to provide comment to the International Auditing and Assurance Standards Board on *Discussion Paper: Audit of Less Complex Entities*.

Pitcher Partners is an association of independent firms operating from all major cities in Australia. Firms in the Pitcher Partners network are full service firms and we are committed to high ethical standards across all areas of our practice. Our clients come from a wide range of industries and include listed and non-listed disclosing entities, large private businesses, family groups, government entities, and small to medium sized enterprises.

We support the International Auditing and Assurance Standards Board's efforts to facilitate greater consultation in the standard setting process. In its current form the consultation paper is focused on areas which by the Board's own estimation it has no control over such as the definition of LCE, consequently the Board would be better focused on re-writing the auditing standards to focus on the "minimum" requirements for an audit, i.e. one suitable for LCE, with additional guidance for entities requiring additional work such as listed or public interest entities. The determination of what entities can apply this "minimum" approach can then be determined by the various jurisdictions, with local additional requirements as necessary which would also support the IAASB drive for compliance with the ISA's as all audits would comply with a "minimum" approach. Identification of what is required for a "minimum" approach is within the power of the Board to determine and consequently, would be a more effective use of the Board's time. Further understanding the requirements of a "minimum" approach would facilitate jurisdictions to determine where it would be applicable to use such an approach and where additional work is required to provide the appropriate audit quality and assurance.

Our detailed responses to the questions contained in *Discussion paper: Audits of Less Complex Entities* are attached to this letter and we would welcome the opportunity to engage in any further discussion of this topic with other interested parties.

Please contact either myself or Tim Nesbitt, Director - Audit & Accounting Technical (03 8612 9596 or tim.nesbitt@pitcher.com.au), in relation to any of the matters outlined in this submission.

Yours sincerely,

K L Byrne
Partner

T Nesbitt
Director, Audit & Accounting Technical

Consultation Paper: *Audit of Less Complex Entities*

Overall Question

1) **We are looking for views about how LCEs could be described (see page 4). In your view, is the description appropriate for the types of entities that would be the focus of our work in relation to LCEs, and are there any other characteristics that should be included?**

The current definition of a smaller entity which the IAASB suggests may share many characteristics of a Less Complex Entity "LCE" is:

"An entity which typically possesses qualitative characteristics such as:

a) *Concentration of ownerships 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:*
    a. *Straight forward or uncomplicated transactions;*
    b. *Simple record keeping;*
    c. *Few lines of business and few products within business lines;*
    d. *Few internal controls; few levels of management with responsibility for a broad range of controls; or*
    e. *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."

The above definition of an LCE is challenging in a number of ways, while allowing that the IAASB is not responsible for defining for each jurisdiction what entities may apply any developed LCE approach / guidance or standards (herein referred to as the "minimum" approach). A definition which allows some, all, or even presumably none of these factors to be present but others to be present resulting in an entity being considered LCE renders any definition redundant as it is not a definition but a number of suggestive factors. Therefore, what is the purpose to "defining" an LCE if the IAASB cannot mandate the acceptance of said definition or is it simply a question of acknowledging that the concept exists that there is a minimum audit for LCE and there are higher expectations and requirements for other types of entities. Ultimately local jurisdictions will determine the applicability of the "minimum" approach and what entities require further procedures.

The comments on the definition of LCE does not remove the need for the standards to be revised to address what the minimum requirements of an audit are i.e. to facilitate LCE audit.

That said analysis of each of the characteristics if the IAASB is to continue with trying to define LCE also presents challenges:

Concentration of ownership – the extant definition appears to preclude a larger number of individuals from having ownership, but there are many entities which require audit in our

jurisdiction which may have quite sizeable numbers of "owners" such as companies limited by guarantee but which otherwise are often LCE in substance, therefore adoption of a limited ownership limitation may preclude entities from being included in the use of LCE. An example might be a company limited by guarantee running a golf club, simple business, comparatively small, but potentially with 500 or 1000 "owners" as members. Further the number of owners does not as a default position make any indication that the business itself is complex although it is a reasonable indicator that it may be less complex it should not preclude wider ownership businesses from being considered non-complex.

Straight forward or uncomplicated transactions – At a principles-based level this is likely a core element of the definition, however, in of itself it has no definition i.e. what is straight forward or uncomplicated. A basic cash transaction for a good is likely to be commonly considered to be both straight forward and uncomplicated, but if a service is involved while it can be simple the amendments to the Accounting Standards on revenue recognition potentially mean that any transaction with a service period component would be considered complex, or a split settlement such as for construction contracts, however, for these businesses they are business as usual and would not be considered anything other than straight forward and uncomplicated. A definition using words without clear or defined meaning is likely to lead to dispute on whether the LCE approach is acceptable and therefore potential misapplication.

Simple record keeping – Similar to straight forward transactions, the word simple is an undefined term, or to reverse the question what is complex record keeping? This would be a good conceptual starting point but without explanation, example and definition is difficult to consistently determine and execute on.

Few lines of business and few products – While the number of business lines may indicate greater complexity what a business line is would enhance any definition if this is to be used as a term, e.g. is this something with different accounting treatment, different nature of product different product? Is selling trucks a different line to selling cars? The lack of clarity in the definition of these terms means that a "definition or description" of LCEs may in substance create as many questions as it solves.

Few internal controls; few levels of management – While fewer controls may be an indicator of a smaller and/ or less complex entity, a business could operate in a simple manner but still have a number of controls. Also, the concept of a few is wide ranging is this a few in total? A few in each cycle? Are these documented controls which are documented, designed and operating effectively or are these controls largely manual in nature without necessarily full documentation or absolute operating effectiveness?

Few personnel – similar to the number of internal controls, limited numbers of people may be indicative but not definitive as to whether the business is complex. The nature of the transactions is more likely to define the complexity of the entity. This is something which seems inherently tied to size rather than complexity.

Also, without clarity on the consequences of being an LCE it is difficult to fully consider what the definition of an LCE should be. Particularly given that being or not being an LCE is seen as a binary outcome with binary consequences, when in practice there may be many areas of a file where a minimum approach is appropriate to obtain evidence and others where it is not.

Without understanding the impact of determining an entity as LCE it is difficult to determine the appropriate definition.

Lastly definitions or examples currently included in the auditing standards are typically interpreted by regulators as the minimum requirements, and therefore essentially render that example or definition a compliance or usage definition. An example of this approach is the rebuttal of the presumption that there are risks of fraud in revenue recognition refer *ISA 240 para A30*

> *"the presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relation to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property."*

This has been interpreted by our regulator as being the definition of rebuttal and anything other than this is considered not to be appropriate to rebut the risk of material misstatement due to fraud in revenue recognition.

Therefore, the idea that there is an LCE approach as a concept is crucial to respond to the substantive realties of auditing in a public or listed environment as opposed to a private environment, but the use and acceptance of this should likely be left to the various jurisdictions to determine where and when it is appropriate.

Perhaps it would be substantially easier to define what characteristics absolutely prevent an entity from using only the minimum approach e.g. Listed / Public entities, rather than describing the LCE with a definition which suggests a range of items without clarity on the quantum, or number of those which must be present to determine that the entity is an LCE, and consequently the additional work required for entities which are "not" LCE. This is especially relevant in the current litigious environment where if an LCE approach is a path to less documentation/evidence/work then any debate over the definition of LCE, and therefore whether it is appropriate to use it, is a litigation issue waiting to occur. This would likely leave adoption and acceptance of the LCE approach with the jurisdictions, and better reflect the fact that the largest element of the expectation gap is the listed/public sector where there should be no scaling back of requirements except where they are not applicable to an entity.

In short defining what an LCE is does not appear to be an efficient or effective use of time as the applicability of any such approach will be determined in each jurisdiction, and it is only of practical relevance if the evidence gathering requirements of such an approach requires less audit evidence / effort than complying with the "full" audit standards.

2) **Section II described 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 to been identified that should be considered as we progress our work on audits of LCEs?

ISA Reference	Cause of difficulty
ISA 240 para 27 and A30	• Regulatory attitudes to **examples in guidance** being treated as rules • LCEs would frequently have few or no risks of **material** misstatement due to revenue recognition
ISA 300 par 21 and A107-109	• The level of documentation actually expected and required for the audit of an LCE. Regulatory expectations appear to be considerably higher than audit professionals would consider appropriate in some cases and the extant standard does not provide sufficient examples or guidance as to what is considered acceptable, primarily due to the lack of clarity of what is the minimum requirements.
ISA 315 para A49	• The statement that there may be increased risks in smaller entities, while true is not guidance which assists the auditor perform a more efficient audit. In fact, the "guidance" creates work for audits which are already under the greatest of fee pressure. This consideration does not assist the auditor of an LCE, nor does it help address this other than to say there are more risks, which logically means there is more work to do. This risk assessment issue outlines clearly that the current guidance is not assisting in the audit of LCE, and further indicates the need for the standards to build from the minimum requirements rather than the top or a middle ground position.
ISA 315 para A79 and A85-87	• The requirement that audit evidence is obtained from a combination of enquiries and other procedures such as observation, with the acknowledgement that smaller entities or LCE may have no written code, how should this be documented and how much evidence can an auditor take from this particularly as inquiry alone is insufficient.
ISA 330 para 18	• Obligation to test a material balance even if there are considered to be no risks of material misstatement in the judgement of the auditor
ISA 500 para 6 and A10	• Inability to use advanced data analytics tools as audit evidence as they do not meet the definition of audit evidence under ISA 500. This is a significant barrier to efficient and effective audit of all entities but in particular LCEs.
ISA 520 para 5(d) and A16	• While A16 relates the amount of difference from the expectation that can be accepted without further investigation to materiality. It is unclear whether the threshold is limited to materiality. The size of the threshold is a significant factor in whether Substantive Analytical Procedures can be used to provide sufficient appropriate audit evidence in compliance with ISA 520.

There is one area which does not get direct attention from the auditing standards and that is information prepared or amended by the client, i.e. there is an expectation of work being performed on the General Information Technology Controls "GITC", but that report is then handled by the client in many instances prior to being presented to the auditor. What extent of work is expected to address this risk? Further associated with this is the use of client portals to obtain information in advance which means that some of the traditional checks such as observing the report being run are no longer practical as the client will run and lodge the report in the portal without any auditor observation.

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

Where to focus	Why
IAASB	The statement "Access to technology tools/methodologies that may help with the application of the ISAs in an audit of an LCE may be limited." This is categorically inaccurate. There are numerous tools that could enhance the execution of all audits and particularly audits in the LCE space were the audit standards revised appropriately. In particular the definition of evidence in ISA 500, and or a revision to ISA 520 such that a data analytic test is considered a substantive analytical procedure and therefore is a form of substantive evidence which would greatly enhance audit quality and efficiency. The ability to amend or change these standards is directly within the capability of the IAASB and would potentially have the greatest impact on audit. Adoption of a building block approach to standards from the ground up, i.e. the minimum requirements to perform an audit with guidance where additional work may be required is inherently more consistent with the idea that there is a minimum level of work to support a reasonable opinion.
Regulators	Regulators are taking a compliance and checklist mentality to audits which is adversely affecting the auditor's ability to focus on the areas of audit risk. Therefore, the IAASB should be cognizant of their role in explaining that guidance is guidance, not a mandate, and assist in limiting the checklist approach to standard setting and consequently regulatory review. A building blocks minimum audit requirements approach would also be consistent with this approach.
Public expectations/	Focusing on clarifying the public expectation and capabilities of the audit. In particular, in the light of findings from the UK and other territories would help reduce the expectation gap. This, in conjunction with actively

Commercial considerations	working to make clear that quality and compliance can only improve where there is a suitable fee to perform such work.

4) **To be able to develop an appropriate way forward, it is important that we understand our stakeholders's 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 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 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.**

Revising the ISAs

Revising the ISAs, the idea of a "building blocks" approach would seem to address the issues of scalability if the intent is that an audit always provides reasonable assurance then there logically is a minimum, level of procedures to generate evidence to support that outcome. Additional evidence would be required where certain criteria or circumstance exist, which would allow reasonable assurance to still be provided. Hence the suggestion in 1 that the Board focus on defining when additional procedures are required for example for listed entities rather than seeking to define what LCE is.

How this could be achieved? There are a number of individually identifiable standards which urgently need revision such as ISA 500, However, the interconnectivity of the standards and the evidence of the initial exposure draft of ED540. ED 540 contained proposals which would have had substantial issues with alignment to other standards. This is an example that if a truly impactful and substantive revision is proposed it needs to be as part of a comprehensive re-write from the ground up to reflect changed auditing landscape, addressing in its thinking the changing technology environment, litigation environment, auditing in a public/listed environment as opposed to a private/non-public environment and expectation gap.

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?**

Given the underlying statement from the *Chairman's foreword* that *"Smaller entities make a critical contribution to the economy, and quantitatively the majority of audits globally are audits of smaller entities"* building the standards to address smaller or LCE entities and having addendums for public or more complex entities would appear to be a more sustainable method of creating standards. Further those auditing public or more complex entities have more time and resources to meet the enhanced requirements rather than the LCE auditor attempting to scale or interpret the standards for the LCE space. Building from the ground up

would also be potentially beneficial in explaining how reasonable assurance is always achieved from compliance with the auditing standards.

This may prove more palatable than the current suggestion that “LCE” do less to obtain reasonable assurance, set the minimum requirements as the base and listed or other “special” types of entity do more with specific guidance for those types of entities to provide reasonable assurance aligning more coherently with expectations of the audit.