14 January 2022

Mr Matthew Zappulla
Technical Director
Australian Auditing and Assurance Standards Board
Level 20 500 Collins Street
Melbourne VIC 3000
Australia

Re: Comment Letter on AUASB Consultation Paper 'Exposure of the IAASB's *Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE)*; and Consideration of Possible alternative options for Australian LCE audits'.

The Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ) is pleased to comment on the Australian Auditing and Assurance Standards Board's (AUASB's) Consultation Paper 'Exposure of the IAASB's *Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE)* and Consideration of Possible alternative options for Australian LCE audits' as an input into the AUASB's deliberations on these topics and submission to the International Auditing and Assurance Standards Board (IAASB).

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 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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* All signed in their capacity as members of the AFAANZ Auditing and Assurance Standards Committee.

Auditing and Assurance Standards Committee of AFAANZ

Comments on AUASB Consultation Paper 'Exposure of the IAASB's *Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE); and Consideration of Possible alternative options for Australian LCE audits*.

We begin by commending the International Auditing and Assurance Standards Board (IAASB), and the Australian Auditing and Assurance Standards Board (AUASB) for working with the IAASB, to address the challenges of audits of less complex entities. Small and family enterprises, many of which would be considered less complex, have been described as the 'engine room of the economy, accounting for over 95% of Australian businesses and representing over 32% of the Australian economy' (Australian Small Business and Family Enterprise Ombudsman 2020). Similarly, 65% of Australian charities generate annual revenue of less than $250,000 (ACNC 2021). Many of these charities would be considered less complex. The contribution of less complex entities to the Australian economy and society cannot be underestimated, and the public interest is served by efforts to increase confidence in the financial reporting of these entities.

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 separate standard to be applied to the audits of less complex entities is a bold initiative that has the potential to contribute to confidence in the financial reporting of this important segment, while helping to ensure that the extant suite of auditing standards remain responsive to 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. We commend the AUASB for their initiative in exploring ways forward in addition to a standard setting solution.

The Auditing and Assurance Standards Committee of the Accounting and Finance Association of Australia and New Zealand (AFAANZ) is pleased to support this initiative by providing evidence based comments on the proposed standard, as well as the broader challenges in facilitating confidence in this significant and important segment of the economy.

We structure our comments around the questions posed in the AUASB's Consultation Paper. We have prepared a response to the questions posed in the IAASB's formal invitation to comment and our responses to the AUASB questions posed in Section A are consistent with the views expressed in the IAASB submission. We also respond to specific questions posed in Section B of the consultation paper that addresses the broader question of how, in addition to a standard setting solution, confidence can be facilitated and enhanced in this segment of the Australian market.

Audits of less complex entities have not received the same research attention as that for audits of larger listed entities. Ongoing deliberations would benefit from more research and the Audit and Assurance Standards Committee stands ready to work with the AUASB should there be an appetite to do so.

In summary, our review of the relevant literature and evidence contained therein speaks to the following conclusions and recommendations.

Part A

- We broadly support the introduction of a self contained standard focussed on the audits of less complex entities, qualified by the need to address a large number of current deficiencies.
- A separate self contained standard is likely to be an important part of addressing challenges in facilitating confidence in the financial reporting of less complex entities.
- There are challenges and potential unintended consequences in applying the authority for the proposed standard, and we recommend that the authority to use the self-contained standard for audits of less complex entities be more jurisdictionally focussed and market driven, with minimal use of universally applied prohibitions.
- There is a need to more effectively and completely acknowledge the differences between audits of more and less complex entities.
- There is a need to clarify the relationship between the self-contained standard and the full suite of auditing standards.
- The expected knowledge and experience of practitioners applying the self-contained standard needs to be clarified.
- Group audits should be excluded only to the extent that they involve a component auditor.
- The approach to auditor reporting is appropriate but there is a need to recognise an unavoidable consequence that users are likely to perceive the engagement as providing a lower level of assurance than an audit undertaken on the basis of the full suite of standards.

Part B

In considering options for further exploration, we believe that stakeholders could;

- Give attention to Section 600 of the Code to ensure that the independence provisions are appropriate for the effective provision of audit (and other assurance and non-assurance) services to less complex entities.
- Reflect on current regulatory and oversight approaches, and the impact that this is having on the profession's ability to attract the 'best and brightest'.
- Consider the level of knowledge and experience necessary in order to effectively audit less complex entities and develop decision aids that complement rather than substitute for appropriate knowledge and experience.
- Improve the understanding of all parties in the financial reporting ecosystem regarding different levels of assurance that can currently be provided.
- Reflect on whether the difficulties in scaling the requirements in auditing standards are an artefact of the requirements themselves (as is widely believed) or knowledge/understanding of those requirements.
- Recognise opportunities to extend the reach of audit and other assurance, rather than reduce the number of entities for which assurance is required / mandated.

We elaborate on these points below.

Part A – Questions of ED-ISA for LCE

1. Does the standard meet your needs for an engagement that enables the auditor to obtain reasonable assurance to express an audit opinion? If not, why not?

With reference to the approach taken to develop ED-ISA for LCE and research highlighting important differences between the audits of more and less complex entities, we believe that there is a risk that the standard will not meet the needs of practitioners auditing less complex entities.

We are concerned that the approach to the development of ED – ISA for LCE has been such that there is a risk that the standard will not meet the needs for an engagement that enables the auditor to obtain reasonable assurance.

The approach adopted in preparing the proposed standard was to use the extant suite of auditing standards as a base from which to identify contents relevant for inclusion in a standard focussed on less complex entities. To the extent that important elements of an audit of a less complex entity (and characteristics of the less complex entities and users of the auditor's reports for less complex entities) are not captured in the extant suite of standards, these important elements may be omitted from the proposed standard such that there is an increased risk that the standard may not meet auditor needs.

Research highlights that less complex entities are more likely to be audited by a small practice (Ghosh and Lustgarten 2006). Smaller 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 ensure firm and engagement level quality (Sundgren and Svanstrom 2013). In smaller practices, threats to independence manifest themselves in different ways (Langli and Svanstrom 2014). Threats from social bonding may be a greater concern in audits of less complex entities while threats from economic bonding may not be as significant (Hope and Langli 2010). Importantly, reputation and litigation costs that drive positive behaviours 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).

In addition, research highlights that the agency relationships for which auditing reduces information asymmetry are different in private companies compared to public companies (Chen, Hope, Li and Wang 2011; Langli 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 Corton 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 businesses is relatively low (Abbott et al. 2013). Relatedly, the users of, and use for, audited financial information in private companies is different than in public companies (e.g., Dedman et al. 2014).

Where these unique circumstances have not been effectively captured, there is a risk that the proposed standard will not meet the needs of auditors. In this regard, research highlights that the standard may be deficient in the areas of quality management, professional scepticism, risk assessment, and using the work of internal auditors. We speak to each of these areas below but caution that there are likely to be other areas that have not been the focus of research attention. We do not suggest that these are the only areas in which the proposed standard may not meet practitioner needs.

Quality Management

We believe that there is a need to reinforce 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. We refer to differences in the structure and organisation of the small and medium practices that are most likely to perform audits of less complex entities (Ghosh and Lustgarten 2006) 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 and discuss difficult judgments with colleagues (Langli and Svanstrom 2014; Sundgren and Svanstrom 2013). They have less access to training and policy manuals and cannot easily access quality reviews (with many practices operating as sole practitioners or with a small number of partners) (Langli and Svanstrom 2014). Small to medium practices, instead, rely on other mechanisms to compensate for this knowledge deficit. This includes being part of accounting associations and networks (AANs) (Bills et al. 2018) and benefiting from the risk management knowledge of their insures (Frank et al. 2021). With reference to engagement level quality, 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).

Acknowledging that small to medium practices ensure firm and engagement level quality differently than large practices, we recommend that the AUASB work with the IAASB and small to medium practices to understand the way in which quality is maintained in these practices and consider whether these differences should be reflected in the proposed standard such that it more effectively meets the needs of practitioners.

Professional Scepticism

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 scepticism that are not as significant in audits of more complex entities. 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 scepticism 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 advice from colleagues with whom they have a stronger social bond and do not subject that advice to as critical an evaluation.

We recommend that the AUASB work with the IAASB to strengthen the underlying principle of professional scepticism in the unique circumstances characterising an audit of a less complex entity.

Risk Identification and Assessment

On the basis of research highlighting that small and medium size practices may not effectively apply risk assessment procedures as required in the extant standards, we are concerned that the material included on risk identification and assessment is not sufficient to meet the needs of practitioners auditing less complex entities.

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 ISA/ASA315), 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 conclude, therefore, that additional elaboration on the contemporary approach to risk identification and assessment is needed in order for the proposed standard to effectively meet the needs of practitioners auditing less complex entities. We recommend that the AUASB work with the IAASB with a view to including this material in future revisions of the proposed standard.

Excluding consideration of the work of internal auditors

ED-ISA for LCE explicitly excludes requirements relating to ISA/ASA610 'Using the Work of Internal Auditors'. This is justified on the basis that internal auditors are most likely to be engaged in larger entities and those with greater 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 for being considered a less complex entity. In circumstances where the client engages an internal auditor, the external auditor would necessarily need to 'top-up' their use of the self-contained standard with reference to ISA/ASA610. 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 standards. We do not believe that this is consistent with the objectives of the proposed standard, and would mean that it would not meet the needs of practitioners auditing less complex entities that may engage the services of an internal auditor.

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 in Australia, 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. 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 owner/managers who are seeking reliable financial information on which to make decisions (Collis et al. 2004). While the complementary use of internal audit may not be as common in less complex entities, the assumption that an internal audit function is not employed in less complex entities may not be valid.

As the use of internal audit in less complex entities is likely to be more common than that envisaged by the IAASB in developing the standard, we believe that the exclusion of material on using the work of internal auditors will be detrimental to the needs of practitioners auditing less complex entities. We therefore recommend that the AUASB work with the IAASB in order to include this material in the revised standard.

While we note above some areas where research speaks to potential omissions from the proposed standard, we repeat our earlier caution that there are likely to be important differences in audits of less and more complex entities that have not been identified in the research literature. A thorough response to our concern that the standard may not meet the needs of practitioners auditing less complex entities will require an in-depth inventory of differences, and then a detailed consideration of whether inclusion of material around those differences would help meet practitioner needs.

2. Is the separate standard for use in Australia an appropriate solution? Please explain your response.

A separate standard is likely to be part of the solution to the challenges faced with regard to audits of less complex entities and will add to a portfolio of options available to effectively meet the idiosyncratic needs of practitioners, less complex entities, financial statement users, and other stakeholders.

The unique characteristics of this segment of the market, both from the supply and demand side (which we elaborate on in our response to Question 1), mean that a single solution will likely be insufficient to effectively address the challenges currently faced in facilitating confidence in this important segment of the economy / society. We speak to complementary options that have been suggested by the AUASB in our response to the questions posed in Part B of the Consultation Paper. Research suggests, however, that a separate standard is likely to be an important part of the solution.

Research has shown that less complex entities are likely to voluntarily choose an appropriate level of assurance for their circumstance since opting for credible financial information allows them to obtain access to credit and better financing conditions (Allee and Yohn 2009; van Caneghem and van Campenhout 2012; Vander Bauwhede et al. 2015; Palazuelos et al. 2020). Research also points toward variation in the way less complex entities facilitate reliable financial reporting (Chen et al. 2011; Bigus and Hillebrand 2017; Yang and Simnett 2020). The addition of a separate standard to the suite of options increases choice which means that an effective match to the needs of the market is more likely.

We do note that our conclusion is based on the potential usefulness of a separate standard to the auditee (i.e., the less complex entity). The current exposure draft, however, does not effectively consider the needs of less complex entities as part of the standard's authority. In this regard, we refer the AUASB to our comments in response to Question 6.

3. Do you support the adoption of ED ISA – LCE? Please explain your response.

Qualified by the need to address the current deficiencies with the standard, we support the adoption of a self contained standard for audits of less complex entities.

With reference to the idiosyncratic nature of the supply and demand of assurance services in this segment of the economy (e.g., Langli and Svanstrom 2014; Vanstraelen and Schelleman 2017), and evidence pointing toward an apparent maturity around voluntarily selecting the most appropriate service for the circumstance (e.g., Briozzo and Albanese 2020; Palazuelos et al. 2020), we support expanding the suite of options to include an audit undertaken with reference to a self-contained standard. We are, however, concerned that the relationship between the new proposed standard and the existing suite of standards, and the knowledge expected of the practitioner who will be applying the separate standard, is not clear. This has the potential to impede the effectiveness of the proposed separate standard. We speak to these issues in our response to other questions and we recommend that the AUASB work with the IAASB in clarifying these issues.

4. Do stakeholders support that the proposed standard is to be implemented without additional reference to the full suite of standards? That is, where a more complex issue arises, auditors do not ‘dip in to’ the full suite of standards to understand additional audit procedures. Please detail any areas of concern.

Qualified by the need to clarify the relationship between the self contained standard and the extant full suite of standards, and the level of knowledge expected of practitioners applying the self contained standard, we believe that there is merit in implementing the standard without reference to the full suite of standards.

We believe that there is merit in a self contained standard that can be applied without reference to the full suite of standards. There are, however, a number of issues for which research suggests that caution should be exercised by the IAASB and AUASB.

- Research suggests that one of the challenges faced by auditors in small to medium practices is their ability to stay abreast of the increasingly complex full suite of auditing standards (e.g., van Buuren et al. 2018). These auditors do not have access to the same resources that are available to their auditor colleagues in larger firms. Moreover, most of the provisions in the full suite of standards are not relevant to the circumstances of the engagements that auditors in small to medium practices perform. To the extent that practitioners applying the separate standard are still required to have the knowledge and expertise in applying the full suite of standards, a separate standard may not meet the needs of practitioners.
- Research highlights that the quality of audit judgments is a function of factors that include not only knowledge, but also experience (e.g., Libby and Luft 1993). To the extent that the effectiveness of the proposed self-contained standard is dependent on the practitioners applying it having an ability to conduct an audit with reference to the full suite of standards, the standard may fall short of its objectives. Even if practitioners have knowledge of the full suite of standards (which is a debatable proposition), to the extent that practitioners do not have experience in applying the requirements of those standards, then the expertise assumed of practitioners applying the self contained standard may fall short of expectations.
- The proposed standard is principles based, which we support. In applying a principles based standard, however, the practitioner is expected to draw on a range of experience and knowledge (and this is often at the level of the subconscious – especially for more experienced auditors). To what extent, therefore, is the standard truly independent of (or separate from) the full suite of standards? It is likely that auditors will be ‘dipping into’ the full suite of standards for guidance, even if they are not aware that this is the case.
- Care is needed to avoid unintended consequences when an audit of an otherwise less complex entity gives rise to an issue that is not addressed in the self contained standard. To the extent that practitioners need to be guided by requirements in the full suite of standards (because it is not covered in the self-contained standard), this would scope the engagement out of the standard (notwithstanding that it is otherwise considered a less complex entity). As an example of the risk, we note above the prospect of a less complex entity engaging the services of an internal auditor which would, as presently drafted, mean that the self contained standard could not be used. We speculate as to whether the need to refer to the full suite of standards is a potential indicator of complexity, rather than a determinant of complexity (as is implicitly the case).

Related to the self-contained nature of the standard, we refer the AUASB to our comments below on potential user perceptions of an audit undertaken with reference to a self contained standard, and that research would suggest that users may perceive this engagement as providing something less than what would be provided under an audit using the full suite of standards. To the extent that the IAASB (and AUASB) are including implicit links back to the full suite of standards so as to maintain the equivalence of the two types of engagements, this may not be possible. The costs of the implicit links back to the full suite of standards may not be offset, to the extent believed to be the case, by the purported benefits of maintaining the equivalence of the two different audit approaches.

5. Do stakeholders expect there to be a reduction in audit effort as a result of using the LCE Standard?

We are not aware of any research that speaks to this question and do not, therefore, offer any comment.

6. Is the authority of the standard able to be implemented? If not, why not?

There are challenges in specifying an appropriate authority and we recommend consideration also be given to client driven authority informed by whether an audit conducted in accordance with a self contained standard would meet their needs. The qualitative criteria is consistent with the proxies used for complexity in auditing and corporate governance research.

We note research that speaks to the dimensions of complexity (e.g., Anderson 1999; Dooley 2002) and draw the IAASB's and AUASB's attention to the multidimensional character of complexity, which highlights the difficulty in establishing a rules based bright line criteria (and even qualitative guidance) for being able to use the standard.

With regard to what makes an entity complex, 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 labour intensity (number of employees). We reference the extensive literature supporting each of the measures in Appendix A to our submission.

The current exposure draft appears to effectively capture these characteristics as they relate to the client. However, we recommend that consideration be given to also including auditor characteristics such as knowledge and ability that may impact perceptions of what is more or less complex and may interact with complexity to affect audit quality (e.g., Bonner 1994), as well as (dependent on the direction that the IAASB and AUASB take on group audits) the use of component auditors (see our response to question 12) and (dependent on the direction that the IAASB and AUASB take on the self contained nature of the standard) the need to refer to the full suite of standards for guidance (see our response to Question 4).

To further inform an understanding of the factors that may be indicative of complexity in the Australian market, 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 proxies for complexity in the Australian setting. 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. On the basis of this analysis, the indicators of complexity appear appropriate, but we do note that a large proportion of our listed company sample appear to be less complex and we refer the AUASB to our comments in response to Question 7. We provide further details of this analysis in Appendix B.

Focussing on the issue of the authority more broadly, we note that the authority as to who can use the standard rests with standard setters, national regulators and, with reference to the qualitative criteria, the practitioner. Auditing is seen in many jurisdictions as a public good such that it is mandated. Different jurisdictions apply the mandate differently (Minnis and Shroff 2017), and we concur with the jurisdictional discretion recognised in paragraph A7(a). Beyond this, we do question the merit of standard setters and practitioners being the parties to determine the authority of the standard beyond suggesting factors that may be considered in guidance. Auditing addresses information asymmetry in agency relationships (e.g., Watts and Zimmerman 1983) and these agency relationships do not involve standard setters or practitioners. Research highlights that less complex entities are likely to voluntarily engage an optimal level of assurance for the circumstance (e.g., Palazuclos et al. 2020; Gong et al. 2021). In Australia, medium sized charities can elect to have their financial report reviewed or audited, but approximately 90% choose a reasonable level of assurance[1], most likely in recognition that a higher level of assurance more effectively addresses agency conflicts. The challenges associated with specifying the authority for the standard may be an artefact of the IAASB attempting to solve a problem that is not as significant as they assume (i.e., inappropriate use of the standard). We recommend that the AUASB reflect on the merit of a client driven authority supported by appropriate guidance as to what is a less complex entity. Such an approach would, in our view, not only more effectively address the agency relationships in less complex entities, but would minimize many of the challenges and potential unintended consequences of the current authority.

7. Do you agree with the proposed limitations relating to the use of ED ISA – LCE? Are there specific types of entities or industries in Australia that should specifically be allowed to, or prohibited explicitly from using such a standard (in addition to the prohibition suggested by the IAASB)?

We do not agree with the proposed universally applied prohibitions on the use of the proposed standard and believe that the authority should be more client driven and principles based with discretion around prohibitions based on jurisdictional considerations.

Further to our comments above on the potential merit of a client driven authority, we recommend that the AUASB reflect on, and if appropriate work with the IAASB to address,

[1] We thank Dr Yitang (Jenny) Yang from UNSW Sydney for this information based on her research.

whether the specific prohibitions on the use of ED ISA-LCE for listed entities and entities with certain characteristics should be removed. We base our recommendations on a number of factors.

<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 (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.

<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 analysed in prior literature (between 26% and 80% in Australia, Canada, Denmark, Finland, and the UK). We believe, therefore, that universally enforced prohibitions are unlikely to effectively meet the unique needs of individual jurisdictions, including Australia.

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

While many listed entities may be considered complex, complexity is not a precondition for listing and many listed companies could be considered as less complex entities. Our analysis of audit fees among listed companies (See Appendix B), suggests that this is the case in Australia.

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 $14,000 (see Table 1 in Appendix B). These audits are very small, and would most likely be considered less complex if it was not for the fact that they were listed. Indeed, it is not until we examine the top 40% of listed companies that the mean audit fee exceeds $100,000 at which point it would be reasonable to assume that all entities would be sufficiently complex so as to render the self contained standard inappropriate.

In the lower 60% of listed entities, there are likely to be entities that are considered more complex and entities considered less complex. We do not discount the public interest arguments for excluding listed and other public interest entities from the use of the self contained standard (notwithstanding that they may otherwise be less complex), but believe that this can be effectively addressed within the discretion afforded to individual jurisdictions in paragraph A7(a).

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.

8. Are there any specific thresholds or criteria that would be appropriate to establish in Australia for when such a proposed standard may be used?

We do not believe that specific thresholds are appropriate.

We are unaware of any research that would clearly suggest that specific thresholds be considered to establish when a self-contained standard for audits of less complex entities could be used. Prior research investigating associations between economic size and the appropriateness of different accounting methods reports ambiguous results (Eierle and Haller 2009). While economic size may be a relevant factor in establishing whether reasonable assurance is appropriate (such as the level of assurance required for charities in Australia), there is no evidence that we are aware of that suggests that a threshold would be appropriate in order to decide which alternate pathway to reasonable assurance can be pursued.

To further inform the potential merit, or otherwise, of specific thresholds, we reviewed a number of thresholds applied in different settings in Australia (see Appendix C). These thresholds indicate a point within the broader qualitative criteria currently referred to in the proposed standard. Recognizing that these thresholds are set to differentiate entities for which different regulations apply, rather than capturing characteristics of the entity that would determine whether a self contained standard is fit for purpose, we caution against relying on the apparent appropriateness of thresholds in these settings to support thresholds for the use of the self contained standard for less complex entities.

9. Do you support the approach to Essential Explanatory Material (EEM) including the content and sufficiency thereof? Specifically, is there sufficient EEM to help an auditor who does not regularly use the full suite of ASAs to perform a high quality audit?

We support the approach to essential explanatory material but believe that it is currently not sufficient to meet the needs of a practitioner auditing a less complex entity. Research points toward the need for additional elaboration in the areas of firm and engagement quality management, professional scepticism, and risk identification and assessment.

As noted above, we feel that the principles applied in developing the standard gives rise to a risk that the Essential Explanatory Material (EEM) may be insufficient. While there are likely to be a number of areas where unique characteristics of an audit of a less complex entity would warrant additional EEM, the extant research points to three areas in particular; firm and engagement quality management, professional scepticism, and risk identification and assessment.

With reference to research highlighting differences in firm and engagement quality control in small to medium practices (e.g., Sundgren and Svanstrom 2013; Langli and Svanstrom 2014; Bills et al. 2018; Frank et al. 2021), we recommend that the AUASB work with the IAASB to 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.

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 AUASB work with the IAASB with a view to elaborating on the essential explanatory material accompanying paragraph 3.2.4 such that the practitioner is cognisant of the need to avoid inappropriately influencing a subordinate's judgments through their direction, supervision and review.

Research also highlights opportunities for the proposed standard to note unique circumstances impacting the exercise of professional scepticism in an audit of a less complex entity and, in doing so, make it more likely that auditors will exercise a level of professional scepticism 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). Related research highlights that auditor 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 EEM 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 unique threats to the appropriate exercise of professional scepticism they must address.

We further refer the AUASB to research highlighting that small and medium sized practices may not effectively apply risk assessment procedures as required in the extant standards. 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 the extant standards), 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 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. We recommend, therefore, that the AUASB work with the IAASB to 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.

10. Do you support the approach taken in relation to auditor reporting including the approach to including a specified format and content of an unmodified report as a requirement?

We support the approach taken in relation to auditor reporting.

Consistent with the desired self contained nature of the standard, we support the approach taken in including a specified format and content 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), variation across reports for audits undertaken with reference to different standards will likely undermine the engagement as one that provides reasonable assurance. We therefore support the consistency in reporting across audits undertaken with reference to the full suite of standards and audits undertaken with reference to the proposed self-contained standard for less complex entities.

We also support the exclusion of KAMs reporting in the proposed 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 Heilmann 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.

11. Do you support the auditor's report referring to ISA – LCE? Do you believe there may be a change in users' perception of the level of assurance provided in an audit performed using the proposed standard?

We support that auditor's report referring to ISA for LCE, but note that users will most likely view this engagement as providing a lower level of assurance than an audit based on the full suite of standards.

In the interests of transparency, we support the auditor's report referring to the self contained 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 incorrectly perceive the level of assurance associated with this engagement. Research highlights that users do not well understand the audit process and the level of assurance provided in an audit (Maijoor 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. 2009). 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 on how the audit was undertaken.

12. Should group audits be excluded from the scope of ED ISA – LCE? Please provide reasons for response.

We believe that group audits should be excluded from the scope of the audit, only to the extent to which they involve the use of component auditors.

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 criteria included in the standard's authority.

Research, however, suggests that the involvement of a component auditor be recognised as an additional criteria 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).

We recommend, therefore, that group audits be universally excluded from the scope of the standard only to when a component auditor is involved. The determination of whether a group audit is more or less complex in other situations can be left to the application of material included in the authority.

13. If group audits are to be included in ED ISA – LCE, should all requirements pertaining to group audits be in a separate part or should requirements be contained within each relevant part of the standard.

We recommend that, if group audits are scoped into the standard (as long as there is no use of component auditors), the additional required material be integrated throughout the standard rather than included in a separate part.

To the extent that group audits may be included within the scope of a self contained standard for audits of less complex entities, but that group audits involving component auditors are excluded, we believe that the additional requirements would be minimal and could be integrated within each relevant part of the standard. Moreover, research suggests that 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 limited necessary additional material within each relevant part of the standard.

Part B – Questions on Australian options to further explore

1. Besides the matters identified in paragraph 26 of this Consultation Paper, what other options or matters, the AUASB should consider as it deliberates the direction of its work in this area?

In addition to the matters noted in paragraph 26, and the focus of the questions below, we encourage stakeholders to consider 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, as well as the appropriateness of current regulatory and oversight approaches as they relate to and impact the appeal of the profession to the 'best and brightest'.

Independence and non-assurance services

We recognise the importance of complying with a high ethical standard when performing audit (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 believe that there is a need to give greater attention to the unique independence issues that are present in audits of less complex entities and to be satisfied that current ethical requirements around the provision of non-assurance services 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 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 findings from the research undertaken are mixed. Svanstrom (2013) reports results consistent with the understanding that there are knowledge spill overs associated with the provision of non-assurance services such that audit quality is improved. Bell, Causholli and Knechel (2015), on the other hand, find that audit quality decreases with the provision of non-assurance services to privately held clients. We also refer the AUASB to our comments in Part A that performance of risk assessment in an audit of less complex entities is a challenge, and the increased knowledge (and the positive spill over effects often associated with the provision of non-assurance services) may go some way to alleviating this threat to audit quality.

Regulatory and oversight approaches

We comment below on the importance of effective monitoring and oversight of auditors to the success of any initiative to modify auditor designations. Here we note concerns around auditor commitment to the profession and the impact that a negative orientation to audit quality inspections and the reporting of inspection findings may have on professional commitment, professional turnover intentions and the number of qualified auditors available and willing to offer assurance services.

In this regard, Martinow et al. (2020) find that an overly critical inspection approach, rather than an alternate collaborative approach has a negative impact on auditor attitudes toward the profession and we suggest that the regulation and oversight of auditors is a matter that should be considered in terms of not only its impact on audit quality, but also its impact on the attractiveness of the profession to the 'best and brightest' such that there are sufficient auditors to service the less complex entity market.

2. If the most appropriate way forward is a combination of options, how should the AUASB prioritise them?

While the research that we review highlights the idiosyncratic nature of the less complex entity market, and supports a multifaceted approach, we do not rank the different approaches / options and note our belief in the complementary nature of many of these potential approaches.

3. Please rank the relative importance of the topics outlined in paragraph 26(a) of this discussion paper (with 1 being the highest priority). Please provide your rationale and views on the needs and interests that would be served by undertaking such work, which such topics are relatively more important to you or your organisation and any other relevant information to the AUASB.

While we do not rank the options put forward under this heading, where relevant, we review research that speaks to the different options. As noted above, the idiosyncratic nature of the demand and supply of assurance in this market means that a multifaceted approach, that includes adopting any international pronouncement in this area, is most likely to be in the public interest.

4. Do you consider making limited, targeted revisions to the ASAs, specific to LCEs, is an appropriate possible solution? If yes, please provide specific reference to specific requirements within the standards where attention is needed (i.e., standard x, paragraph y). Please explain your reasoning.

We believe that the veracity of this approach is dependent on the level of knowledge and expertise that auditors of less complex entities are expected to possess.

Research highlights that the existing suite of auditing standards require a level of knowledge that many practitioners in small to medium practices do not believe is necessary given their portfolio of clients (e.g., van Buuren et al. 2018). Increasing the length of the extant standards would likely exacerbate, rather than alleviate current concerns. Moreover, 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 regularly apply the full suite of standards, even with knowledge, the application of the principles to less complex entities is likely to fall short of expectations. There is a risk that LCE specific paragraphs will be extracted and applied without reference to the broad principles to which they relate. This risk is more effectively addressed within a self contained standard.

However, to the extent that practitioners auditing less complex entities are expected to have a level of knowledge and expertise that allows for the application of the full suite of standards, then a targeted revision to the extant standards has the advantage of maintaining the nexus between the underlying principle and the application of the principle in a less complex entity situation.

5. Do you consider developing targeted non-authoritative guidance, specific to LCEs, is an appropriate solution? If yes, please provide specific details as to the form and required content of such guides.

We are not aware of any research that speaks to this question and do not, therefore, offer any comment.

6. Recognising that AUASB standards currently facilitate reasonable assurance, limited assurance and agreed-upon procedures engagements, do you consider users, including legislators, understand the range of services that can be provided. If not, what can be done to assist users in understanding the 'right service'?

We first note research that highlights that the users of audited financial statements in a less complex entity situation is not clear. Handley et al. (2018) concluded that some users of SME financial statements would be satisfied with less complex reports that provide information regarding an entity's liquidity, profitability and solvency. Other users, who favour reporting according to a comprehensive set of accounting standards, were concerned about unspecified future needs for financial information, particularly in the event of financial distress. There is limited empirical evidence on the needs of SME financial report users (Devi and Samujh 2015; Gassen 2017). Moreover, the users of, and the use for, audited financial information is different in private companies (e.g., Dedman et al. 2014) and we note that agency relationships in private firms are more likely to be between majority and minority shareholders and between ownership interests and debtholders than between ownership and management (e.g., Carey et al. 2000; Niskanen et al. 2010; Schierstedt and Corton 2021).

It is likely, therefore, that the idiosyncratic needs of contracting parties in the less complex entity environment are likely to be met by a variety of means. 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 owner/managers who are seeking reliable financial information on which to make decisions (Collis et al. 2004).

Education of the merits of different engagements under the AUASB umbrella would be useful. However, we argue that education is necessary for those demanding different levels of assurance, those providing different levels of assurance, and those using different levels of assurance. There is insufficient knowledge among all these stakeholders. In this regard, we note that medium sized charities in Australia have an option to provide limited or reasonable assurance, but mostly choose reasonable assurance and that most limited assurance engagements are undertaken by larger practices. This suggests to us that there are concerns in this sector about user perceptions of limited assurance and a lack of knowledge among practitioners in small to medium practices as to how to perform a review.

7. Please rank the relative importance of the topics outlined in paragraph 26 (b) of this discussion paper (with 1 being the highest priority). Please provide your rationale and views on the needs and interests that would be served by undertaking such work, why certain topics are relatively more important to you or your organisation and any other relevant information to the AUASB.

While we do not rank the options put forward under the heading of Other Activities, we review research that speaks to the different options.

8. Do you consider developing specific industry guides / practice aids, work programs, templates, software solutions, specific to LCEs, is an appropriate solution? If yes, please provide specific details as to the form and required content of such guides as well as the bodies that should be involved in undertaking such work.

Research investigating the use of decision aids suggests that such tools developed to assist the auditor may, but not always, be useful by helping auditors to more effectively use their existing knowledge (see Bonner 2008 for a review of this literature). Where auditors lack the requisite knowledge, industry guides, practice aids, work programs, templates, software solutions, and other tools, are likely to fall short of expectations. In addition, auditors are often overconfident in their knowledge and ability (e.g., Kennedy and Peecher 1997) and may not fully realise the potential benefits of the decision aid (Arkes et al. 1986).

We believe that the development of different decision aids designed to assist in auditing less complex entities has merit, but as a complement to, rather than as a substitute for, appropriate knowledge and experience.

9. Do you consider education and understanding of the scalability of the ASAs impacts LCE auditors? If yes, what form of education would be beneficial?

The length and complexity of the current suite of auditing standards is a major impediment to the conduct of engagements that provide a consistent level of assurance. Practitioners note that the effort necessary to stay abreast of the extensive requirements and explanatory material is not justified by the return (e.g., van Buuren et al. 2018). Effectively scaling requirements requires, in the first instance, a deep knowledge of those requirements. We speculate on the extent to which the challenges around scalability are an artefact of the requirements themselves or a lack of knowledge of those requirements. To the extent that practitioners do not currently engage with the requirements, further education around the mechanisms of scalability may not be successful.

10. The AUASB standards provide for a reasonable and limited assurance engagements. Should a different level of assurance should be further explored?

Research suggests that the different levels of assurance are not well understood by users. Pany and Smith (1982) found that analysts could not distinguish between the two different types of assurance engagements. Johnson et al. (1983) examined lenders decision making and found that the level of assurance did not affect lending decisions. Nair and Rittenberg (1987) examined the messages conveyed by nine different forms of the auditor's reports to bankers. While differences were identified, this may have been an artefact of the research design.

Roebuck et al. (2000) examined whether assurance report users differ in their identified level of assurance as a result of the description of the nature of the engagement and the amount of work performed. They found a higher level of assurance attached to historical compared to prospective reports, but no differences between the reports attempting to communicate higher versus lower levels of assurance as a result of the description of the work performed.

In a monograph titled *The Determination and Communication of Levels of Assurance Other than High*, issued by the International Federation of Accountants (IFAC) in 2002, it was found that the difference between a moderate and a high level of assurance was not well understood by clients, and even less so by third parties (Maijor et al. 2002).

There is a risk, therefore, that an additional level of assurance would further cloud the assurance environment and lead to unintended consequences. However, research suggests that users may already differentiate audit quality between large and small to medium practices (e.g., Mock et al. 2009). We speculate that this will be even more the case in 'audits' undertaken under a self contained standard as users perceive the work effort applied to be lower than that for an audit using a full suite of standards. Even without formal acknowledgement and codification, a nuanced level of assurance (audit light) may very well naturally develop and there may be merit in the AUASB (and other standard setting stakeholders) to be actively engaged in the development of this new level of assurance.

11. Please rank the relative importance of the topics outlined in paragraph 26 (c) of this discussion paper (with 1 being the highest priority). Please provide your rationale and views on the needs and interests that would be served by undertaking such work, why certain topics are relatively more important to you or your organisation and any other relevant information to the AUASB.

While we do not rank the options put forward under the heading of activities other than standard setting, we review research that speaks to a number of the possibilities noted in paragraph 26(c).

With regard to the introduction of additional practitioner designations beyond that of Registered Company Auditor (RCA) and SMFS Auditor, we note that audits in Australia are already being undertaken by practitioners with different designations, many of whom 'qualify' as an auditor by virtue of their membership of one of the three professional bodies (Bessell et al. 2017). The requirements for becoming and maintaining status as an RCA are considerably more demanding than that for other designations and the regulatory oversight far more stringent. This may account for the preponderance of statutes beyond the Corporations Act that require an RCA, rather than another designation, to conduct the audit. The success, therefore, of any initiative to broaden auditor designations will depend on the perceived expertise of those making up the designation and the effectiveness of regulatory monitoring and oversight (Francis 2011; Bessel et al. 2017).

We further note a long established line of research highlighting the importance of experience in making quality audit judgments and contributing to audit quality more broadly (e.g., Bonner 1990). We caution against creating a new category of auditor for which the experience requirements may not be sufficient.

We also caution against the introduction of new auditing and assurance reporting thresholds especially if such action, as suggested in paragraph 26(c) of the consultation paper, is taken to reduce the number of entities that require an audit. Research highlights the benefits associated with private company audits (see Vanstraelen and Schelleman 2017 for a review), and we believe that initiatives should be motivated, in addition to the maintenance of audit / assurance quality, by increasing rather than decreasing opportunities to facilitate confidence by way of assurance.

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 Part A Question 6.

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 (Hay et al. 2006; Abbott et al. 2003; Carcello et al. 2002; Davis et al. 1993; Francis 1984; Gul et al. 2003; Simon and Francis 1988; Simunic 1980; Bugeja et al. 2016).

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) uses 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 measures 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; namely 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 which 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.

Labour intensity (number of employees)

Operational complexity has been measured as labour 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 Part A - Question 6), and to explore the complexity of Australian listed entities (see Part A - Question 7), 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.

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			

Appendix C

A small business is defined differently by different regulators and laws. With the understanding that small size is a crucial, though not the only attribute of less complex entities, we collect the definitions from different Australian regulators and laws so as to shed light on the size perspective of less complex entities.

The Australian Securities and Investments Commission (ASIC) points out that a small business can be structured under a company, joint venture, partnership, trust or as a sole trader. In defining a small proprietary company, ASIC stipulates that from financial years commencing on or after 1 July 2019, a proprietary company is a small proprietary company for a financial year if it satisfies at least two of the following: (1) the consolidated revenue is less than $50 million; (2) the value of the consolidated gross assets is less than $25 million; and/or (3) the company and the entities it controls (if any) have fewer than 100 employees at the end of the financial year.

The Australian Taxation Office (ATO) provides different thresholds for various tax purposes such as small business income tax offset ($5 million turnover threshold), capital gains tax (CGT) concessions ($2 million turnover threshold), fringe benefits tax (FBT) concessions ($10 million threshold from 1 April 2017 to 1 April 2021 and increase to $50 million from 1 April 2021). The most relevant one is the small business entity concessions threshold - $10 million of turnover[2] (i.e., aggregated turnover), because this threshold specifically uses the term small business entity. As a related note, the ATO defines large businesses as those (including public, private and foreign-owned companies, partnerships, trusts and super funds) with combined turnover greater than $250 million. From the definition, it can also be seen that public firms could be small and yet private firms can be large.

The Office of the Australian Information Commissioner (OAIC) defines a small business as one with an annual turnover of $3 million or less where annual turnover includes all income from all sources and excludes assets held, capital gains or proceeds of capital sales.

Australian Financial Complaints Authority considers small business as those with up to 100 employees.

The definitions of small business from other legislation and rules are as follows:

(1) ASIC Act 2001, section 12BC(2) (consumer protection): the business employs less than 20 employees or 100 employees if the business is a manufacturing business.
(2) ASIC Act 2001, section 12BF(4) (unfair contracts for financial services): the business employs less than 20 employees, and the upfront price payable under the contract does not exceed $300,000 (or $1,000,000 if the contract has a duration of more than 12 months).
(3) Competition and Consumer Act, Schedule 2, section 23(4)(unfair contracts for goods and services): the business employs less than 20 employees, and the upfront price payable under the contract does not exceed $300,000 (or $1,000,000 if the contract has a duration of more than 12 months).
(4) Corporations Act 2001, section 761G(12) (small businesses as retail clients): the business employs less than 20 employees or 100 employees if the business is a manufacturing business.
(5) Australian Small Business and Family Enterprise Ombudsman Act 2015, section 5: the business employs less than 100 employees or the business has less than $5 million in revenue in a year.

[2] The threshold was $2 million before 1 July 2016.

(6) Fair Work Act 2009, section 23 (unfair dismissal): the business employs less than 15 employees.

(7) Banking Code of Practice: a business is a “small business” if at the time it obtains the banking service, all of the following apply: it had an annual turnover of less than $10 million in the previous financial year; and b) it has fewer than 100 full-time equivalent employees; and c) it has less than $3 million total debt to all credit providers.

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