

12 September 2019

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Dear Sir,

**RESPONSE TO THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB) DISCUSSION PAPER, AUDITS OF LESS COMPLEX ENTITIES: EXPLORING POSSIBLE OPTIONS TO ADDRESS THE CHALLENGES IN APPLYING THE ISAs**

The Institute of Singapore Chartered Accountants (ISCA) appreciates the opportunity to comment on the above Discussion Paper (DP) issued by the IAASB in April 2019.

To solicit meaningful feedback for this topic, ISCA undertook the following initiatives to seek views from key stakeholders:

- (i) Conducted a one-month public consultation to seek feedback from its members;
- (ii) Organised a focus group discussion to engage key stakeholders to obtain their views on the DP; and
- (iii) Obtained the views of members of the ISCA Auditing and Assurance Standards Committee.

Our comments to selected questions in the DP are as follows:

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

**Description of LCEs in DP**

While we agree with the IAASB's approach in focusing on the complexity of the entities rather than size, further clarity and guidance would be welcomed given the level of judgment which may be involved based on the current description of qualitative

characteristics in the DP. For instance, it would be helpful to provide examples and clarity as to how one assesses if transactions are straightforward or if record-keeping is considered simple. Also, the term 'few' appears in several characteristics such as few lines of business/products, few internal controls, few levels of management with responsibility for a broad range of controls and few personnel.

Without sufficient guidance or clarity, the ambiguity of these terms will inevitably lead to divided opinions as there will be heavy reliance on each audit team's judgment and interpretation. This may also lead to the development of local yardsticks; in Singapore's context, comparisons may be drawn with one of the Accounting and Corporate Regulatory Authority's (ACRA) small company qualification criteria for audit exemption of not more than 50 employees. A 'wrong' assessment may potentially come with serious ramifications depending on the course of action taken by the IAASB pursuant to this DP. The fear of getting this 'wrong' in the eyes of a regulator or internal inspection reviewer may then discourage auditors from adopting the course of action pursuant to this DP and may lead to them reverting to the status quo to be 'safe'. This is particularly crucial if a separate auditing framework for audits of LCEs is developed as a result of this DP.

In addition to the qualitative characteristics listed in the DP, we believe that consideration of the complexity of an entity's IT environment is also meaningful in assessing if an entity is a LCE.

We are of the view that there should be clarity or guidance on how auditors should weigh the importance of each characteristic when determining a LCE. A pertinent concern would be on how auditors deal with situations where there are a mix of characteristics. In this regard, we recognise that it may be challenging to strike a balance between developing sufficient guidance and being too prescriptive. One suggestion we have is that the description of characteristics of LCEs may be further supplemented with examples of characteristics of entities which should not be considered as LCEs.

Additional guidance on specific sectors which typically exhibit a mix of characteristics will definitely be helpful in addressing this matter. For instance, charity organisations or not-for-profit entities would typically meet the qualitative characteristic in the DP on low concentration of ownership (in fact, no ownership in many circumstances) and management. However, such entities are arguably accountable to many stakeholders with varying degrees of influence. Also, while such entities may have relatively few internal controls, there is inherently a heavy emphasis, by its stakeholders, on the control environment of these entities. As these situations are not uncommon, guidance and examples may be viewed as a necessity rather than a good-to-have.

### **Other considerations**

Defining complexity by transactions instead of by entity may result in a wider net being cast given that many entities which meet many of the qualitative characteristics of LCE may enter into the odd complex transaction. A start-up may issue preference shares or derivatives with complex terms. Naturally, there will also be situations where an entity straddles between the characteristics/definition of LCE within a financial period. It may be

confusing for the auditor to determine whether such entities should be considered as LCE for the year-end audit.

We also hear concerns in the potential difficulties faced by auditors in the planning stage of such audits. Realisation of certain complex transactions or agreements mid-way through the audit may result in an entity no longer being considered a LCE and cause significant changes to the audit strategy and procedures (again depending on the course of action taken by the IAASB as a result of this DP). Some may take the view that, to avoid risking the progress of the audit, they may need to assess all transactions before being able to determine that an entity is a LCE, which may not be feasible at the planning stage of an audit.

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

**(a) What are the particular aspects of the ISAs that are difficult to apply? It would be most helpful if your answer includes references to the specific ISAs and the particular requirements in these ISAs that are most problematic in an audit of an LCE.**

**(b) In relation to 2a above, what, in your view, is the underlying cause(s) of these challenges and how have you managed or addressed these challenges? Are there any other broad challenges that have not been identified that should be considered as we progress our work on audits of LCEs?**

We hear from our stakeholders that, while they appreciate the design and the principles-based approach of the ISAs, the perception is that the ISAs are designed with large and complex audits in mind. This consequently results in a long list of requirements which auditors may not consider to be necessary or applicable for less complex audits.

In certain LCEs, particularly owner-managed entities, weak control environment and the risk of management override of controls are common. In such entities, it is not unusual to see factors which increase the risk of material misstatement due to fraud or error. Such factors include a low emphasis on governance, lack of segregation of duties and relatively weak finance department. Unlike larger corporations, there may not be adequate factors to constrain improper conduct by the owner-manager. Such entities may therefore be more vulnerable to incidences of misappropriation of assets and both intentional and unintentional misstatement or omission. In such entities, the lines between the entity's and owner's interests also tend to be blurry.

With little structure, weak control environment and relatively high risk of management override of controls, auditors may find it challenging to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. In such audits, auditors will typically take a full substantive testing approach. However, there are limitations to this approach in addressing certain assertions such as completeness of revenue, liabilities and records (for

e.g. owner-manager may omit sales transactions to reduce earnings to minimise tax or omit recording certain liabilities to inflate earnings to secure bank financing or unqualified finance personnel may provide auditors with inaccurate or incomplete explanation/information). This may pose a challenge for an auditor in obtaining reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error, as required under ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* and as stated as the auditor's responsibilities in the auditor's report based on the requirements of ISA 700 *Forming an Opinion and Reporting on Financial Statements*. Given the nature of such entities, there may be limited additional procedures that the auditor could perform.

Another example where certain ISA requirements may not be seen as particularly useful in audits of LCEs is Para 22 of ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* which states:

*'The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.'*

In the case of certain LCEs as described above, compliance with the requirements of Para 22 above may appear as not particularly useful and performed only for the sake of compliance. In such LCE audits, auditors may have already decided that they will not rely on the LCE's controls after obtaining an understanding of the relevant controls and control environment under Para 12 to 21 of ISA 315. Thereafter, they may not see the need to further understand the entity's monitoring of controls. It is worth noting that, in LCEs which are less structured and with weak control environment, obtaining understanding of such major activities or controls may not always be straightforward as auditors may face situations where management may not be able to explain the relevant activities or controls involved or remedial actions. There may also be inconsistency in the management's practices or actions.

To help deal with the lengthy requirements of the ISAs, it is common to hear auditors adopting a 'checklist approach'. On one hand, many lament the need for such an approach as lengthy checklists coupled with time pressure result in little in-depth considerations and lack of critical thinking. On the other hand, auditors are concerned that, without checklists, audit teams may miss out on certain procedures or requirements. Another concern is that it may be challenging for auditors to demonstrate that they have considered all the requirements of the standards without such checklists.

Applying ISA 540 *Auditing Accounting Estimates and Related Disclosures* is also challenging in certain LCE audits as such LCEs may not have adequate internal expertise or process for making accounting estimates. Para A31 of ISA 540 highlights certain circumstances which auditors may consider that increase the likelihood that management needs to engage an expert. While Para A31 highlights estimates of specialized nature (such as mineral or hydrocarbon reserves) and models of complex nature, certain LCEs may even find difficulties in estimates which are less complex as they may not have the expertise to determine an appropriate approach/model and the necessary key inputs (such as WACC).

Such LCEs may also not be willing to incur resources in engaging external experts. There may also be an expectation for auditors to advise on the appropriate adjustment to the estimates recorded. This could result in the burden of ensuring the appropriateness of the estimates to fall on the auditor's shoulders. Consequently, auditors may find themselves in a tricky position of potentially compromising independence requirements for assuming management's responsibilities.

**4) In relation to the potential possible actions that may be undertaken as set out in Section III:**

**(a) For each of the possible actions (either individually or in combination):**

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

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

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

**Developing Guidance for Auditors of LCEs**

In our view, the development of additional guidance should be pursued as a priority. Additional guidance which are relevant and practical to aid auditors in applying the ISAs in LCE audits can help improve the efficiency of such audits to a certain extent. We hear from our stakeholders that they wish for measures which can be introduced quickly and this is understandably the least time-consuming course of action amongst those considered by the IAASB.

The downside of additional guidance will be that there will be more to read. As it is, there are already comments that the ISAs are lengthy. This may potentially discourage some auditors from reading all the available materials. It is also unlikely that additional guidance can be the sole solution in improving efficiency or narrowing expectation gap as there will be limitations to the areas which guidance can practically cover. As such, additional guidance is unlikely the ultimate solution but will serve well as an interim measure.

## **Revising the ISAs**

We find the building-blocks approach (where the standards are revised by setting out the basic requirements for all audits and expanded as needed to address more complex circumstances) to be a possibly viable option in addressing many of the challenges laid out in the DP. This approach will improve the scalability of the ISAs and auditors may scale-up or scale-down depending on the complexity of the audit. The cost of training for audit firms will be also be relatively lesser with this option as compared to the introduction of a separate standard for LCE audits.

While this approach may appear viable, it is unclear, however, if this option will result in any meaningful impact in terms of driving efficiency of LCE audits. Many take the view that 'an audit is an audit' and as such, it may be challenging to significantly reduce the requirements for a baseline audit. This approach may not address the challenges faced by auditors in obtaining sufficient appropriate audit evidence in audits of owner-managed entities with weak control environment and relatively high risk of management override of controls (as highlighted in our response to Question 2).

There will also be a need for clarity or guidance over what is expected of auditors in dealing with the incremental requirements which they find are not applicable in LCE audits. If this is unclear, auditors will find themselves back in a similar position of having to consider all requirements and document their justifications on why the incremental requirements do not apply.

Although the gap in public expectations is scoped out of this DP's exploratory activities, we think that, with little differentiation in the end product (i.e. a true and fair view/reasonable assurance under ISA 700), this approach may not be effective in narrowing the expectation gap which exists with the wider public. It would be unlikely that the wider public would readily appreciate or empathise with the differing levels of requirements within the ISAs when the end product appears to be largely similar between audits of LCEs and non-LCEs.

## **Developing a Separate Auditing Standard for Audits of LCEs**

There are many challenges which can be foreseen with this course of action – it would be a time-consuming exercise for the standard-setters, it may lead to an audit of lower perceived quality and it may cause confusion in the market, particularly where the standard is developed based on a different auditing framework.

While we are cognisant of the challenges and potential confusion which may come with a separate auditing standard based on a different framework, we find merits in this course of action. For one, this would lead to product differentiation and this may spur awareness and appreciation of the differences between audits of different complexities. Users are able to make a choice based on their needs and this may help in narrowing the expectation gap.

At the moment, there appears to be only two possibilities for LCEs in many jurisdictions; either audit exemption or audit in accordance with the ISA framework (or its local equivalent). There may be a need in the market for a separate auditing framework which falls in between these two. There are small businesses which are exempted from audit but

which see the value of getting an audit performed (or some form of independent check). An audit under the ISA framework which is intended to give a high level of assurance, however, may not be seen as always necessary in the case of certain LCEs. There have been questions over the cost-benefits of an audit in accordance with the ISA framework for LCEs. Perhaps more can be understood on whether audits in accordance with the ISA framework are really necessary for all entities. The existence of two tiers of audits may even encourage certain LCEs to strive to improve in order to be ready for an audit in accordance with the ISA framework.

Another merit of this option is that auditors will be able to refer to a concise set of standards under a separate auditing framework which is tailored to be applicable for LCE audits. This improves the distinction between audits of LCEs and non-LCEs and leads to better audit efficiency.

We also hear concerns that the introduction of a 'second-grade' audit may lead to two tiers of auditors as there may be audit firms which focus largely on these audits. While this may not appear desirable at first glance, we think that this course of action may be worth exploring in the longer horizon. In the current environment, resource constraint is an issue/challenge leading to concerns over audit quality. A separate auditing framework with tailored and scaled-down requirements for LCE audits may help lighten this burden. Auditors may also find themselves assuming relatively lesser liability under such framework.

As we head into the next industrial wave, challenges faced by the audit profession in attracting and retaining talents are unlikely to go away. Public expectations of the audit profession are also unlikely to reduce over time. As such, this option should not be ignored.

Should you require any further clarification, please feel free to contact Mr Terence Lam, Senior Manager, Technical: Audit & Assurance, at ISCA via email at [terence.lam@isca.org.sg](mailto:terence.lam@isca.org.sg).

Yours faithfully,



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