

12 September 2019

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Dear Willie,

IAASB Discussion Paper – Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs

Thank you for the opportunity to comment on this Discussion Paper. We submit the feedback from the New Zealand Auditing and Assurance Standards Board (NZAuASB) to the specific questions raised in the attachment.

The External Reporting Board (XRB) is a Crown Entity responsible for developing and issuing accounting and auditing and assurance standards in New Zealand. The XRB's outcome goal is to contribute to the creation of dynamic and trusted markets through the establishment of an accounting and assurance framework that engenders confidence in New Zealand financial reporting, assists entities to compete internationally and enhances entities' accountability to stakeholders. The NZAuASB has been delegated responsibility by the XRB for developing and issuing auditing and assurance standards.

The NZAuASB undertook various outreach activities to obtain feedback from its constituents on the Discussion Paper, including a webinar, online survey and one-on-one interviews with practitioners from both small and large firms. Their feedback helped inform the Board in developing its response.

The NZAuASB strongly supports the IAASB's initiative to explore an appropriate response to the challenges in applying the ISAs in audits of Less Complex Entities (LCEs). This is a topic of increasing relevance to all assurance practitioners in New Zealand, not only the Small and Medium Practices (SMPs), but also larger firms who regularly undertake audits of LCEs in New Zealand.

The NZAuASB agrees with the IAASB that the entity size is not the best proxy for the scalability and proportionality challenges faced by auditors in applying ISAs. The NZAuASB therefore supports the IAASB's shift from the existing smaller entities approach in the ISAs to the proposed approach addressing audits of LCEs. Consequently, the NZAuASB does not believe the adoption of the existing definition of a smaller entity in the ISAs provides the most appropriate perspective for the audit of LCEs.

Furthermore, while the challenge of the value of audit is excluded from the scope of this project, the NZAuASB encourages the IAASB to pursue this challenge as a matter of priority. The value of an audit is the existential reason for the ISAs, and it is vital to ensure that audit engagements continue to be relevant to LCEs.

Finally, the NZAuASB considers that the proposed actions to be explored in the discussion paper provide an appropriate basis for the IAASB to go forward in addressing the challenge of auditing LCEs. In particular, the

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NZAuASB strongly supports the proposed action to investigate the feasibility of a separate auditing standard for the audit of LCEs.

We are very interested in this project and are happy to offer our assistance to the task force if needed. Should you have any queries concerning our submission please contact either myself at the address details provided below or Sylvia van Dyk (sylvia.vandyk@xrb.govt.nz).

Yours sincerely,

Robert Buchanan

Chairman

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Submission of the New Zealand Auditing and Assurance Standards Board

IAASB Discussion Paper – Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs.

I Schedule of Responses to the IAASB's Specific Questions

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

Response:

The NZAuASB agrees with the Working Group's observation that complexity is not only about size. However, the NZAuASB notes the discussion paper uses the existing definition of a small entity (i.e. applying a size criteria) that is contrary to this observation. The NZAuASB's consultation with its New Zealand stakeholders also indicates that some of the characteristics of a smaller entity may be less relevant in today's evolving corporate governance than a decade ago.

For example, there is an increased level of independent directors' involvement in the governance of closely held entities with one or few shareholders. This may indicate the concentration of management and governance may not be a very accurate proxy for size, except for very small entities (e.g. micro entities).

Another concern raised by New Zealand constituents is that certain types of smaller entities may use certain types of transactions that are particularly complex to account for, because of their small size. For example, startup entities use share-based payments to remunerate their employees. Such payments are required to be measured in accordance with IFRS 2 *Share-based Payment*. Amongst other things this would require determining the fair value of the entity's shares. While this is rather a straightforward matter for a listed company with an active share market, a small entity without an active market for its shares may find it very difficult to determine the fair value of its shares. The entity has no in-house expertise to deal with this matter and engaging an external expert to undertake the valuation is very expensive.

The NZAuASB believes that instead of using size oriented qualitative characteristics, it may be more useful to consider what constitutes the main attributes of a Less Complex Entity, by establishing how those attributes impact the risks of material misstatements in the entity's financial statements. Such characteristics can be divided in the following two categories.

- 1) The qualitative characteristics that affect the complexity of the risks of material misstatements in an audit engagement. These may include:
 - a. The applicable financial reporting framework and its impact on risk of material misstatements (e.g. a primarily fair value measurement based financial reporting framework vs a financial reporting framework with a historical cost basis of measurement).
 - b. Whether the entity is publicly accountable.
 - c. The nature of the entity's business, its transactions, assets and liabilities.
 - d. Applicable legal and regulatory requirements.
 - e. The extent and importance of transactions with related parties.
- 2) The characteristics that underline the nature, quality and type of audit evidence to address the risk of material misstatements. These may include:
 - a. Whether an entity requires a sophisticated and highly integrated information system to

be able to meet its financial reporting obligations (including disclosures and information required for various tests such as impairment, going concern, fair value measurements etc.).

- b. The competency of key individuals responsible for the preparation of the entity financial statements.
- c. The extent of the availability of relevant and reliable evidence from external sources other than the entity's information system or other forms of evidence generated by the entity to support the entity's key assertions in the financial statements.
- d. The extent of assertions in the financial statements that cannot be adequately addressed without using information produced by the entity.
- e. The required timing of the entity's financial reporting.
- f. The quantity or volume of the entity's transactions and other information relevant to the entity's financial statements.

Furthermore, some of the NZAuASB's constituents questions the feasibility of conducting an audit of a very small entity in accordance with the ISAs from an economic perspective (in the New Zealand context a common example of a very small entity is a Registered Charity with annual expenditure less than NZD 250,000). The feedback indicates there may be a need to distinguish between an LCE and what some refer to as a micro entity.

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

Response:

In the NZAuASB outreach to its constituency the following examples were noted:

- Lack of clarity how a requirement may apply in the audit of an LCE. For example, paragraph A57 of ISA 315 (Revised) explains that a more effective oversight by an owner-manager may compensate for the generally more limited opportunities for segregation of duties in a smaller entity. Paragraph A58 adds that the owner-manager may be more able to override controls because the system of internal control is less structured. It is unclear how these two characteristics with opposing impacts on reliability of an entity's system of internal controls should inform auditors' risk assessment and work effort. Also, it is very hard to objectively evaluate management's effective oversight (especially given the often informal and undocumented nature of such oversight), which means it is unlikely auditors would place reliance on this feature when considering whether internal controls can reduce the risk of material misstatements. At the same time, given paragraph A58, the auditor of an LCE can reasonably be expected to elevate the management risk of override of controls.
- It is often impractical or inefficient to use substantive analytical procedures as a method to obtain audit evidence. For example, there is often very limited information that can be obtained from independent sources outside of the entity. Consequently, auditors of LCEs may be restricted to use information prepared by the entity. To evaluate reliability of the data used in a substantive analytical procedure under these circumstances, the auditor's primary source of evidence is obtained from testing the operating effectiveness of controls over preparation of the information by the entity. However, the entity's control environment may have significant deficiencies (e.g. domination of management by a single individual increasing risk of management override of controls (Para A28 of ISA 240), the extent to which controls are

documented by an entity in a verifiable manner may be limited (Para A18 ISA 330).

- The auditor's responsibilities relating to fraud in an audit of financial statements are disproportionately difficult to apply for audits of LCEs. For example, ISA 240 (Revised) includes examples of incentives for financial reporting fraud by an owner-manager because their personal financial situation may be threatened by the entity's adverse financial performance (e.g. when the owner-manager has provided a personal guarantee for a bank loan). The standard also describes opportunities for an owner-manager to commit fraud, including that there is no monitoring of the owner-manager (as there is no one to monitor them), and that there are internal controls deficiencies (e.g. heightened risk of management override of controls in an owner-managed entity).
 - In audits of LCEs the auditor may have an overall expectation of a primarily substantive approach to reduce audit risk to an acceptable level. This is due to impracticability of use of substantive analytical procedures and reliance on internal controls (either due to fundamental deficiencies in the internal controls or lack of documentation of controls in a retrospectively assessable manner). Under such circumstances, it is not always clear what controls are relevant to the audit and why the auditor is still required to evaluate their design and test their implementation. The outcome of such evaluation does not affect auditors' risk assessment (as they will need to test their operating effectiveness to be able to reduce risk to a lower level if controls are found to be effective), does not impact their procedures to obtain evidence to reduce audit risk, etc.
 - Many practitioners questioned the value of testing general journals as a method to address risk of material misstatement due to fraud. This is especially the case in audits of LCEs where the auditor is likely to be able to fully scan the reconciliation of all material balance sheet balances and identify unusual or suspicious items when performing substantive tests of details on these material balances.
 - Documentation is another challenging area. There is a general view that in auditing LCEs, the auditor needs to go through a process of elimination to determine which requirements do not apply, and to document why they may not be applicable. This can be time consuming, depending on the audit tools available to the auditors. The expectations of monitoring bodies' inspectors are that the audit file clearly demonstrates that the auditor has gone through this process.
 - The business risk approach may not be an efficient way to conduct an LCE audit. The entity structure, management practices and systems are not a good match for a business risk approach. The auditor may need to increase their effort to somehow fit the entity into the business risk framework underlying ISA 315.
3. **With regard to the factors driving challenges that are not within our control, or have been scoped out of our exploratory information gathering activities (as set out in Section II), if the IAASB were to focus on encouraging others to act, where should this focus be, and why?**

Response:

While commercial viability of audit as a service is not a standard setting matter, it nevertheless underpins why the standards are needed in first place. If the market is unwilling to pay the fees needed to conduct an audit in full compliance with the ISAs, this may be a strong indication that the market considers that value delivered by an audit does not exceed its costs. The New Zealand constituents who participated in the NZAuASB online poll indicated they are often questioned about the value of an audit (e.g. about 88% of participants) and that the fee pressure in the LCE audit segment of the market is stronger than others (more than 88% of participants).

It is essential to understand what value is sought from an audit by smaller entities and why the existing arrangement is not addressing their needs. It is therefore important to engage with potential

and existing users of audits of LCEs to evaluate how better to address their needs. Without such an engagement, auditing standards may stop to be relevant to a very important segment of the world economy.

We therefore believe that, out of the factors driving challenges that are excluded from this project (either because they are not within the IAASB's control or scoped out of this project), the following factors should be a focus.

- Commercial considerations relating to an audit
- Value of an audit
- Engagements other than audits

The NZAuASB believes that there is considerable overlap between the above factors and that it might be appropriate to consider these factors using an integrated approach.

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

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

Response:

Possible action	Potential positive attributes	Potential negative attributes
Revising the ISAs	<ul style="list-style-type: none"> • Less confusion for the market. • Cross border harmonisation. • The public interest is likely to be best served if audit is undertaken to the highest standard possible • Adopting the "building block" approach as explored in the discussion paper can enhance scalability of the standards. • Auditors will continue to work on one suite of auditing standards that is beneficial for education and training of the work force. 	<ul style="list-style-type: none"> • May not address the identified challenges to the required extent. • Would take time.
Developing a Separate Auditing Standard for Audits of LCEs	<ul style="list-style-type: none"> • Have the potential to address the identified challenges 	<ul style="list-style-type: none"> • Difficult to define easy to apply criteria to determine LCEs • How different a separate standard based on the existing conceptual framework that underpins ISAs can be to the ISAs? • It will be a challenge to develop a conceptual

		<p>framework other than the existing one that can accommodate reasonable assurance.</p> <ul style="list-style-type: none"> • Creates additional burden for auditors' education and training. • May increase the expectation gap • Will it provide the same quality as an audit in accordance with ISAs? • Would take time.
Developing Guidance for Auditors of LCEs or Other Related Actions	<ul style="list-style-type: none"> • Would be quicker to do. 	<ul style="list-style-type: none"> • There is already an abundance of guidance available. It is unlikely that additional guidance on its own can be helpful

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?

Response:

The NZAuASB has not noted any other possible actions.

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.

Response:

The NZAuASB believes that the most promising option seems to be a separate standard(s) for LCE audits. The New Zealand constituents who participated in the NZAuASB outreach activities also indicated a strong preference for this option (about 65% of participants, in an online survey asking their opinions about the three proposed possible actions, selected this option).

If this separate standard is developed to be responsive to the characteristics of LCE audits, it may be a success. An effort to develop such a standard is likely to be useful even if it is ultimately determined that a separate standard is not a viable option. In that event, the prepared material for a separate standard may be useful for revising the ISAs in a way that is more helpful for audits of LCEs.

A separate standard has also a greater potential for innovation as it is not restricted to stay in line with the existing ISAs in their current form and shape.

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

The NZAuASB does not have any further comments.