

**Exposure Draft**

**July 2021**

*Comments due: January 31, 2022*

*International Standard on Auditing*

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**Proposed International Standard  
on Auditing for Audits of  
Financial Statements of Less  
Complex Entities (ISA for LCE)**

**IAASB**

**International Auditing  
and Assurance  
Standards Board**

## **About the IAASB**

This Exposure Draft was developed and approved by the International Auditing and Assurance Standards Board (IAASB).

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

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## REQUEST FOR COMMENTS

This Exposure Draft, proposed ISA for LCE, *Proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities*, was developed and approved by the International Auditing and Assurance Standards Board® (IAASB®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by January 31, 2022.**

Respondents are asked to submit their comments electronically through the IAASB website, using the "[Submit a Comment](#)" link. Please submit comments in both a PDF and Word file. First-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website.

This publication may be downloaded from the IAASB website: [www.iaasb.org](http://www.iaasb.org). The approved text is published in the English language.

# EXPLANATORY MEMORANDUM

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## Executive Summary

Smaller, less complex entities (LCEs) make a critical contribution to the world economy and account for the great majority of audits globally. At the same time increasingly complex structures and transactions need to be addressed through the development and revision of the International Standards on Auditing (ISAs). The IAASB recognizes that reflecting this complexity in the ISAs could pose challenges for audits of less complex entities.

Based on the feedback from the IAASB's 2019 Discussion Paper, [Audits of Less Complex Entities: Exploring Options to Address the Challenges in Applying the ISAs](#) and other input from outreach, the IAASB committed to addressing complexity, understandability, scalability and proportionality in the ISAs, and the specific needs of LCEs and the users of their financial statements, and agreed that:

- A global solution is preferred to increasingly fragmented solutions.
- A standard that has been designed to be proportionate to the typical nature and circumstance of an audit of an LCE would be responsive to those stakeholders who have identified challenges with applying the ISAs in audits of LCEs.
- There is an urgent need for action.

For this reason, the IAASB developed the Exposure Draft of proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ED-ISA for LCE) on an accelerated basis. The IAASB approved ED-ISA for LCE in June 2021.

This explanatory memorandum (EM) provides background to, and an explanation of, ED-ISA for LCE. This EM sets out the background to the development of the proposed standard, the Board's direction on the scoping of the proposed standard (in the Authority of the proposed standard), the broad principles used to develop a new standard that provides reasonable assurance and an explanation of the content of the standard, which is presented in Parts and follows the flow of an audit.

The Board's consideration of issues, deliberations and position with respect to key areas in developing the proposed standard are addressed in Sections 4 and 5, with specific questions to respondents included at the end of each of sections 4A through 4G, and at the end of section 5 in relation to Group Audits. Appendix 2 includes a full list of all questions for respondents to ED-ISA for LCE.

## Section 1 Background

### *Background to the Development of a Separate Standard*

1. It is estimated that more than 90% of entities across the world are small and medium-sized entities (SME),<sup>1</sup> with some regions estimating that the percentage could be higher,<sup>2</sup> such as in the European Union where it is estimated that over 99% of entities are SMEs.<sup>3</sup>
2. Audits are undertaken for a variety of reasons. Some jurisdictions mandate an audit through law or regulation (i.e., a statutory audit), which may be done for example by setting audit exemption thresholds (often on a size characteristic) to limit those entities to which statutory audit requirements apply, with changes to these thresholds regularly being reconsidered.<sup>4,5</sup> Even when there is not a statutory requirement for an audit, many SMEs are either required to have an audit for another reason or may choose to have an audit for management purposes.
3. At present, approximately 130 jurisdictions<sup>6</sup> have adopted or partially adopted the International Standards on Auditing (ISAs). The ISAs are designed to be applied to a wide variety of entities with differing circumstances and sizes, ranging from those whose nature and circumstances are simpler and more straightforward (i.e., LCEs), to those entities whose nature and circumstances are more complex (for example, entities with more complex structures, more complex information systems or controls, or more complex transactions).

<sup>1</sup> There is no global definition for a 'small- or medium-sized entity,' and the use and meaning of the term may differ in different jurisdictions. As the discussions about the challenges of applying the ISAs has historically been around the difficulties experienced in SMEs, this term is used in the introduction to the project to explain the background to the project. However, the IAASB is of the view that it is appropriate to focus on the complexity of the entity rather than its size, and therefore uses the term "less complex entities" (LCE).

<sup>2</sup> Reference: [Edinburgh Group: Growing the global economy through SMEs](#) & [World Trade Report 2016: Levelling the trading field for SMEs \(wto.org\)](#)

<sup>3</sup> Reference: [Europa: Statistics on Small and Medium Enterprises](#)

<sup>4</sup> For example, in Europe, member states can impose an exemption for audit for entities that are not public interest entities, medium or large entities (and the thresholds for exemption vary across the various member states). In India, there is a statutory requirement for all public and private limited companies to have an audit under their Companies Act annually. In Canada, business corporations that are privately owned are exempted from an audit if all shareholders consent in writing to the exemption in respect of that year. In Australia, there is a size threshold that exempts certain entities from a mandatory audit. In New Zealand, companies with under 10 shareholders may 'opt out' of an audit if they meet other size and regulatory provisions. In the US private companies (with some limited exceptions) are not subject to a statutory audit.

<sup>5</sup> In 2010 in Sweden, the regulatory requirement for an audit was abolished for small limited liability companies. However, in 2017, the Swedish National Audit Office published a report, Abolition of audit obligation of small limited companies – a reform where costs outweigh the benefits, where it cites numerous downsides to abolishing the SME audit obligation.

<sup>6</sup> Reference: [Global Impact Map | IFAC](#)

4. The IAASB has always been mindful of the need for the ISAs to be scalable in order to be used for audits of all entities, regardless of size or complexity. However, the operating and reporting environment is becoming more complex and is continually evolving. In addition, there has been a spotlight on the quality of audits through the results of audit inspections and recent high profile corporate failures, more commonly associated with more complex entities. This has contributed to the recent revision of ISAs such as ISA 540 (Revised)<sup>7</sup> and ISA 315 (Revised 2019),<sup>8</sup> as well as revisions to the IAASB's quality control standards, ISQM 1<sup>9</sup> and ISA 220 (Revised)<sup>10</sup>, and the development of new ISQM 2,<sup>11</sup> These revisions had the objective of making the International Standards more relevant in the evolving environment, and are intended to support the consistent performance of quality audits. However, with these revisions there has been growing concern about the length, complexity, and understandability of these standard and their application to audits of LCEs. Some stakeholders have therefore questioned whether the ISAs remain relevant and can be applied in a cost-effective manner to all audits.
5. In response to these and other similar concerns, various jurisdictions or regions have undertaken initiatives targeted at audits of less complex (or smaller) entities.<sup>12</sup> Furthermore, some jurisdictions have announced the intention to develop a standard(s) or solutions for audits of LCEs within their jurisdictions, or have already developed a pronouncement. These developments increase the probability of fragmentation in standards for a large section of the audit market. A summary of relevant initiatives or the development of separate standards is provided in Appendix 1.

*The Path to the IAASB's Project to Develop a Separate Standard for Auditing LCEs*

6. The widespread and continually growing international use of the ISAs underscores the importance the global community attaches to the ISAs, and therefore the importance of the IAASB continuing to focus its efforts on maintaining the quality and operability of these standards for audits of entities of all sizes and complexity. Alternative standards in different jurisdictions for the same type of engagement (i.e., an audit of an LCE) may lead to inconsistencies in quality and cause confusion for users. It is therefore in the public interest that the IAASB take action to establish a high-quality standard that has global relevance.

<sup>7</sup> ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>8</sup> ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*

<sup>9</sup> International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*

<sup>10</sup> ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*

<sup>11</sup> ISQM 2, *Engagement Quality Reviews*

<sup>12</sup> Some of the initiatives are targeted at statutory audits, others are initiatives targeted at other engagements for SMEs. Appendix 1 sets out examples of these initiatives.

7. Since the IAASB finalized the clarified ISAs in 2009, the IAASB has increasingly focused on the challenges and needs of stakeholders representing the LCE community:



8. The ISAs were clarified and revised in 2005–2009 (the ‘Clarity Project’) with a view to being applied to audits of entities of all sizes and complexity. As part of the finalization of the Clarity Project, the IAASB agreed to undertake a post-implementation review to determine whether its objectives in revising the ISAs had been achieved.
9. The post-implementation review of the Clarified ISAs was carried out in two phases. One of the key findings from Phase One of the review was that there was some concern about the application of the ISAs to smaller entities, notably whether they can be applied in a cost-effective manner. Accordingly, it was agreed that specific consideration would be given to this issue in Phase Two of the post-implementation review.
10. The IAASB completed its post-implementation review (PIR) of the clarified ISAs in 2013. As part of Phase Two of the PIR in 2011 and 2012, the IAASB conducted an annual survey of small- and medium-sized practices (SMPs) on audits of SMEs from a range of countries that had implemented the clarified ISAs, over two years once the clarified standards had been implemented (i.e., after they became effective in 2009). The findings from the surveys included:
- A call from respondents to further demonstrate the scalability of the requirements within the ISAs.
  - Concern about the documentation requirements, with some respondents calling for more guidance about the nature and extent of documentation required.
  - Issues around implementing certain standards in an SME environment.
11. In considering the findings from the post-implementation review, the IAASB acknowledged that the volume and complexity of the standards may result in challenges for audits of entities that are less complex. Accordingly, the IAASB recognized in its Strategy for 2015–2019, that in order to achieve effective implementation globally its standards need to be, and be seen to be, proportionate and scalable for audits of all sizes and complexity.



12. Further efforts to explore the challenges being experienced by auditors of LCEs and identify an appropriate solution included:
- (a) **January 2017** – The IAASB, together with the Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC), held a two-day working conference in Paris, focused on understanding the needs of SMPs when applying audit and non-audit IAASB standards to SMEs.
  - (b) **March 2017** – The IAASB discussed a paper setting out possible actions for how scalability and proportionality could be incorporated into the IAASB's standards, in particular in the ISAs.
  - (c) **June 2017** – The challenge of auditing SMEs and LCEs was discussed at the annual National Standards Setters (NSS) meeting hosted by the IAASB. NSS outlined developments in their jurisdictions emphasizing efforts to modify thresholds for audit exemptions.
  - (d) **June 2017** – An informal working group was established by the IAASB to consider the issues raised with a view to advising the Board on an appropriate way forward in response to the views expressed by stakeholders at both the Paris conference and the NSS meeting.
  - (e) **March 2018** – The IAASB discussed, in an executive session, a paper highlighting the challenges of auditing LCEs that were identified, and agreed with the recommendation that a global consultation on these matters was appropriate. To this end, the IAASB agreed that a discussion paper (DP) would help the IAASB consolidate the work that had been undertaken to date, better understand the issues that had been identified, and obtain stakeholder views on the most appropriate possible actions to address these issues with an open mind. The Board supported the Working Group continuing its work to develop the DP and make recommendations for possible IAASB actions after consideration of the feedback from the planned consultation.
  - (f) **September 2018** – The IAASB discussed an initial draft of a proposal for the activities of the LCE Working Group in developing a DP for IAASB discussion.
  - (g) **March 2019** – The DP was approved for issue at the March 2019 IAASB meeting.
  - (h) **April 2019** – The DP on issues and challenges related to audits of LCEs was published.
  - (i) **May 2019** – The second Paris conference was held, this time focusing on matters set out in the DP (again held jointly with the Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC)).
13. The Board also consulted extensively on the issues and challenges related to audits of LCEs:
- (a) Regular updates to, and input from, IFAC SMP Advisory Group.
  - (b) Specific outreach targeted at stakeholder groups representing the interests of SMP's, such as the Nordic Federation, Accountancy Europe, the Edinburgh Group, the European Federation of Accountants and Auditors for SMEs and other relevant professional accountancy organizations.
  - (c) Ongoing outreach to and discussions with NSS, regulators and audit oversight bodies.
  - (d) Discussions with representatives from the Forum of Firms and with auditors who serve LCEs.
  - (e) Focused discussion on the fraud aspects of an audit relevant to LCEs in a roundtable held in 2020.

*Discussion Paper – Possible Actions Explored*

14. The DP was a culmination of the IAASB's efforts to understand the many issues and challenges being faced relating to audits of LCEs. As well as exploring the identified issues and challenges in auditing LCEs, the DP proposed various actions that the IAASB could undertake and on which stakeholder views on a preferred action was sought:
- (a) Revise the ISAs to address scalability more explicitly and make the auditors work effort clearer.
  - (b) Develop a separate auditing standard for audits of LCEs that provides the same level of assurance as the ISAs (i.e., reasonable assurance).
  - (c) Develop guidance for auditors of LCEs or other related actions on how the ISA requirements apply in the circumstances of LCEs.
15. Ninety-three written responses were received to the DP. The more substantial, overarching matters heard from outreach and noted in the responses to the DP included that:
- (a) There is an urgent need to have an international solution to address issues related to audits of LCEs, as jurisdictions increasingly develop their own standards and commence other initiatives in this area (in particular, it was noted that this was not in the public interest to delay further as this may have long-term implications on the adoption and use of the IAASB's international standards).
  - (b) The IAASB should prioritize its efforts on developing a solution to address the challenges and issues related to audits of LCEs.
  - (c) The solution is not only one action, and likely involves a combination of the actions set out in the DP.
- In December 2019, the IAASB also published a [Feedback Statement](#) summarizing what was heard.
16. The responses to the DP also highlighted that many of the issues and challenges being experienced in audits of LCEs were not unique to LCEs, but could also apply more broadly to other audits. In particular, issues in applying the ISAs related to complexity, understandability, scalability and proportionality for all audits were highlighted. Therefore, in balancing the needs of all its stakeholders, as well as the time needed to develop changes to address the issues and challenges within the broader suite of ISAs, in June 2020 the IAASB agreed to two workstreams:
- (a) An 'ISA Focused Workstream' addressing the complexity, understandability, scalability and proportionality (CUSP) issues in relation to the ISAs more broadly, to address challenges that have been identified in applying the ISAs, for audits of all types of entities, including audits of LCEs; (more information with regard to the CUSP workstream can be found on the [project webpage](#)); and
  - (b) A 'Separate Standard Workstream' exploring the development of a separate standard to focus on audits of LCEs.

## Section 2 Introduction

### *The IAASB's Development of a Separate Standard for Audits of Financial Statements of LCEs*

17. From July 2020, the IAASB focused efforts on the development of a separate standard for audits of financial statements of LCEs (audits of LCEs).
18. In December 2020, the [Project Proposal](#) for the workstream to develop a separate standard was approved by the IAASB. The project is intended to serve the public interest by:
- Maintaining confidence in financial reporting of LCEs**—SMEs and other entities that are less complex are a critical source of employment and innovation and are embedded in local communities. Therefore, it is in the public interest to have high-quality audits that instill confidence and trust in this part of the economy.
  - Helping auditors of LCEs undertake consistent, effective, and high-quality audits**—Streamlined and targeted requirements that are appropriate to audits of LCEs result in the auditor obtaining reasonable assurance, performing an appropriately robust risk identification and assessment, and designing responses thereto, that are consistent and effective in the circumstances of the LCE, thereby maintaining audit quality.
  - Being responsive to stakeholder needs**—Considering the need for requirements targeted at, and appropriate for, the circumstance of the audit of an LCE, and maintaining a standard that is fit-for purpose, would be responsive to those stakeholders who have identified challenges with applying international standards in audits of LCEs.
  - Promoting a more consistent application of the auditing standards to audits of LCEs**—The development of a global standard for audits of LCEs is expected to fill a perceived gap that is currently filled by individual jurisdictions who are developing their own standards for audits of LCEs, which may result in inconsistency in practice within the LCE audit environment. Such fragmentation is not in the public interest. Developing a global solution would be in the public interest to ensure consistency of application of the standards in an audit of an LCE, as well as supporting a common understanding of the procedures undertaken in an audit of an LCE.
19. For its 2020–2023 Strategy period, the IAASB committed to a more agile approach to standard-setting (where appropriate). Using this ‘agile approach,’ and recognizing the urgent demand for a separate standard for auditing LCEs, the IAASB adopted an accelerated timeline for the development of the separate standard.



20. To receive real-time user feedback consistent with an agile approach to standard-setting, the IAASB leveraged a 15-member international 'Reference Group,' ([the LCE Reference Group](#)) comprised of representatives from the LCE community. This group assisted with the timely development of a proposed response relevant to the issues and challenges of auditing LCEs by:
  - (a) Providing views on the direction of proposals to facilitate effective development of the proposed standard. Initially this involved high-level discussions on strategic matters and principles used to develop the proposed standard and evolved to discussions on the content of the proposed standard once it had been developed.
  - (b) Offering perspectives on important technical matters arising from challenges being experienced in audits of LCEs, and how these should be reflected in the draft separate standard.
  - (c) Advising on other matters that should be taken into consideration as the proposed separate standard was being developed.
21. In accordance with the project timeline included in the Project Proposal, a separate standard has now been drafted and was approved for exposure by the IAASB in June 2021.
22. It is imperative to now obtain public feedback from those that would be directly affected by the standard (e.g., users of financial statements of LCEs, owners and management of LCEs, legislative or regulatory authorities or relevant local bodies with standard-setting authority, and auditors that serve LCEs). Feedback is sought on, in particular, the principles used to develop ED-ISA for LCE, the structure and content of the proposed standard as well as specific key issues, as outlined in the remainder of this memorandum.
23. The sections that follow describe the key issues considered by the IAASB in developing ED-ISA for LCE.

### Section 3 Guide for Respondents

The IAASB welcomes comments on all matters addressed in ED-ISA for LCE, but especially those identified in the **Request for Comments boxes** throughout this memorandum. A full list of all questions can also be found in Appendix 2 to this memorandum.

Respondents are asked to comment on the clarity, understandability and practicality of application of ED-ISA for LCE. In this regard, comments will be most helpful if specific aspects of ED-ISA for LCE are identified and the reasons for any concern about clarity, understandability and practicality of application, along with suggestions for improvement, are included. Specific suggestions for any proposed changes to wording in ED-ISA for LCE are also welcome.

Respondents are free to address only questions relevant to them, or all questions. When a respondent agrees with the proposals in ED-ISA for LCE, it will be helpful for the IAASB to be made aware of this view as support for the IAASB's proposals cannot always be inferred when not explicitly stated.

The IAASB recognizes that many audits today are audits of less complex entities, across a wide range of industries, jurisdictions, and entity types. Therefore, ED-ISA for LCE will likely be of particular interest for auditors and firms of all sizes and jurisdictions. Accordingly, the IAASB encourages field testing<sup>13</sup> of the proposals by auditors and firms, and welcomes the sharing of the results of any field testing performed with the IAASB as part of the responses to this ED.

<sup>13</sup> The IAASB did not believe that field testing or a roundtable was needed before approval of ED-ISA for LCE due to the extensive outreach and input from the LCE Reference Group. However, the IAASB recognizes that some firms may choose to undertake field testing to inform their response to ED-ISA for LCE. Field testing may take different forms and may focus on all or certain phases of an audit, or on specific requirements of ED-ISA for LCE, and may be executed at different levels. Field testing is not required in order to respond to ED-ISA for LCE but is recognized in terms of the additional information and different perspectives that may be obtained in this manner.

## Section 4 The Proposed Standard and Specific Matters for Comment

### Section 4A – Overarching Positioning of ED-ISA for LCE

24. ED-ISA for LCE has been developed as a separate, standalone standard, designed to be proportionate to the typical nature and circumstances of an LCE. The proposed standard contains requirements for the auditor to obtain sufficient appropriate audit evidence that is intended to enable the auditor to provide reasonable assurance in the circumstances of an audit of the financial statements of an LCE (i.e., an LCE as contemplated in the proposed standard (see Section 4B)).
25. ED-ISA for LCE is relevant for audits in the public sector if the criteria set out in the Authority of the proposed standard (Part A) have been met. Any additional responsibilities that are encompassed in the scope of a public sector engagement that is broader than the audit of financial statements, are not dealt with in ED-ISA for LCE. Where relevant, specific considerations for audits in the public sector have been presented as explanatory material.

#### *Separate Standalone Standard*

26. The IAASB developed ED-ISA for LCE as a standalone “self-contained” standard. The proposed standard is separate from the ISAs with no intended need to directly reference back to the requirements or application material in the ISAs in its application. This means that if there is a circumstance that has not been contemplated in the design of ED-ISA for LCE as addressed in the Authority of the proposed standard (Part A), relevant ISA requirements cannot be used to “top-up” ED-ISA for LCE in order to address the circumstance. Accordingly, the overall decision for the audit engagement is whether ED-ISA for LCE is appropriate for use given the nature and circumstances of the entity; the proposed standard does not address complex matters or circumstances, and is not permitted to be used for audits that are not audits of financial statements of LCEs.
27. For example, consider the circumstance where an entity has an accounting estimate calculated using a bespoke, complex model that is not contemplated by the proposed standard, but is otherwise an LCE. In this instance, an auditor may not use ED-ISA for LCE together with requirements from ISA 540 (Revised) to supplement what may not be addressed in ED-ISA for LCE when planning and performing the audit. Consequently, an auditor would then need to apply the ISAs or other appropriate auditing standards because ED-ISA for LCE, in its design, does not address complex matters or circumstances.<sup>14</sup>
28. In the initial development of ED-ISA for LCE, the IAASB extensively debated whether the proposed standard should be truly standalone or whether it should be used in conjunction with the ISAs in certain (appropriate) circumstances. Although there are benefits to both, the IAASB agreed that on balance giving auditors the ability to refer to the ISAs may create further challenges and issues, or other unintentional consequences, such as:
  - (a) Inappropriate use of ED-ISA for LCE when the ISAs were appropriate given the nature and circumstances of the entity and the needs of the users of that entity; or

<sup>14</sup> The Authority of the proposed standard (Part A) describes the specific prohibitions and qualitative characteristics of complexity for which the standard does not include requirements.

- (b) Explaining which standard(s) have been complied with in the auditor's report<sup>15</sup> (for example, it is inappropriate to refer to the ISAs in the auditor's report if the auditor has not fully complied with all ISAs relevant to the audit).
29. The IAASB also considered the future consequences of using the standalone standard if it were not more intricately linked to the ISAs. The proposed standard is based on the core requirements for an audit within the ISAs, which makes the proposed standard 'easier' to understand and use for those already using the ISAs. In the future, if an auditor did not use the ISAs and only used the proposed standard, concerns have been expressed about the effective application of the requirements (without the accumulated knowledge about the ISAs and the experience in applying them).
30. However, based on outreach and feedback, and further consideration of this matter, the IAASB has the view that the possible challenges of using the proposed standard in the future did not outweigh the benefits of a standalone standard. Furthermore, the proposed standard has been developed to help auditors understand the flow of an audit with clear and understandable requirements. The IAASB does, however, recognize that supporting guidance for implementation of the standard will be needed, both initially and on an ongoing basis (see Section 4G below).

*Level of Assurance for an Audit of an LCE Using ED-ISA for LCE*

31. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements of an entity. The auditor achieves this by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level in the circumstances of the engagement, and expressing an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The ISAs are designed to provide the basis for a reasonable assurance opinion in an audit. Reasonable assurance, in the context of an audit, provides a high, but not absolute, level of assurance.
32. When developing the separate standard for auditing LCE's, the Board consulted on and discussed the appropriate level of assurance that would be appropriate for the intended users of the financial statements of an LCE, including whether another kind of engagement, or a different level of assurance, should be considered.
33. There was strong encouragement from the IAASB's stakeholders that a separate standard should contain requirements that will result in a reasonable assurance opinion, and that this opinion should be in the form of an audit opinion. Accordingly, the Board's intentions have been to develop a separate auditing standard that will provide a reasonable assurance opinion, using the concepts and principles already used in an ISA audit (as the ISAs are already designed for the auditor to obtain a reasonable level of assurance).
34. It was also agreed that it needed to clear in the auditor's report which standard(s) have been used so that users of the financial statements have transparency as to which standards have been applied in conducting the audit.

*Title of the Standard*

35. The IAASB's Terms of Reference set out the types of pronouncements developed and issued by the IAASB (i.e., it notes that the "IAASB develops and issues International Standards on Auditing and International Standards on Review Engagements (ISREs) to be applied in audit and review

<sup>15</sup> Paragraphs 119-124 explain the requirements for reporting in the auditor's report.

engagements on historical financial information).” The Terms of Reference also states that the IAASB publishes other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers. Therefore, the development of a new auditing standard is within the IAASB’s Terms of Reference.

36. The IAASB considered options for the title and classification of the standard within its suite of International Standards, in light of concerns around possible confusion that may result from a new auditing standard with a similar name to the ISAs. The IAASB considered whether to add ED-ISA for LCE to the existing ISAs (for example by creating a 900-series). However, to avoid confusion about the standalone nature of the standard and ISAs being incorrectly used in conjunction with the standard, the IAASB opted against the placement of ED-ISA for LCE within the existing ISA series.
37. The proposed new auditing standard for audits of LCEs is an international standard, and addresses audits of historical financial information. The IAASB therefore considered how the title could be distinguished from the ISAs so as not to create confusion about which standards have been used for a particular audit. In the IAASB’s view, the title should reflect a new category of international standard that effectively describes the proposed standard, while also making it recognizable as an IAASB standard.
38. Therefore, it is proposed that the new standard be titled “International Standard on Auditing (ISA) for Audits of Financial Statements of Less Complex Entities (ISA for LCE),” which would distinguish the standard from the ISAs by referring specifically to audits of LCEs, while also maintaining identification as a global IAASB standard. This approach to ‘titling’ is also consistent with the approach used by the International Accounting Standards Board (IASB) in distinguishing its International Financial Reporting Standard for Small- and Medium-Sized Entities (IFRS for SME) from the ‘full’ International Financial Reporting Standards (IFRS).

#### *Conforming Amendments to the IAASB Preface*

39. The *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* (the IAASB Preface) within the IAASB Handbook describes the scope and authority of the pronouncements that the IAASB issues. With the introduction of a new category of international standard for the proposed standard, conforming amendments to the IAASB Preface will therefore be required.
40. The proposed conforming amendments to the IAASB Preface within this document set out the changes to facilitate this new category of international standard within the IAASB’s International Pronouncements and present the proposed conforming amendments to the IAASB Preface.

#### ***Request for Comments – Specific Questions***

1. Views are sought on:
  - (a) The standalone nature of the proposed standard, including detailing any areas of concern in applying the proposed standard, or possible obstacles that may impair this approach?
  - (b) The title of the proposed standard.
  - (c) Any other matters related to ED-ISA for LCE as discussed in this section (Section 4A).



2. Do you agree with the proposed conforming amendments to the IAASB Preface (see paragraphs 39-40)? If not, why not, and what further changes may be needed?

*Please note: there is an overarching question at the end of Section 4F (question 17) to share their views about whether, overall, ED-ISA for LCE meet the needs of users and other stakeholders, and whether the proposed standard can, and will, be used. It is best to answer that question after having considered all relevant matters explained in this memorandum and the content of the proposed standard.*

#### **Section 4B – Authority of the Standard**

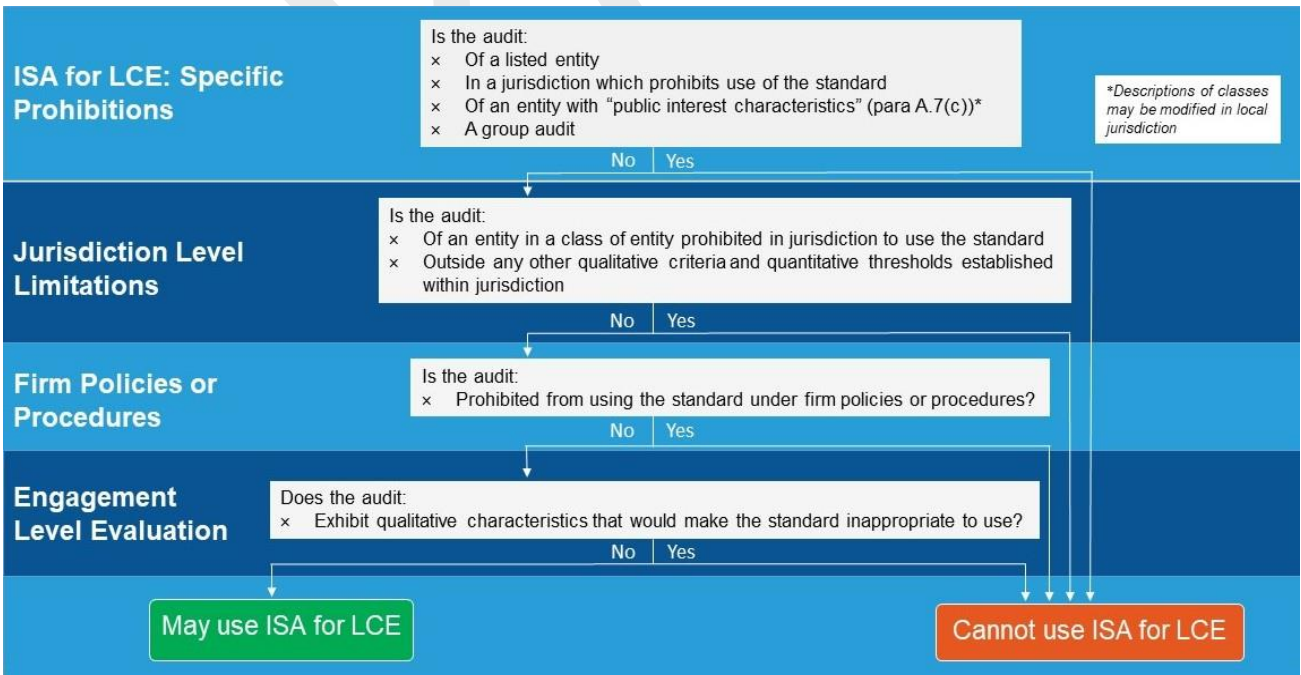
41. The Authority, described in Part A, sets out the scope of the proposed standard. To assist in the application of the Authority by legislative or regulatory authorities or relevant local bodies with standard-setting authority (such as regulators or oversight bodies, NSS, professional accountancy organizations or others as appropriate), firms and auditors, the IAASB has developed *Supplementary Guidance for the Authority of the Standard* (the Authority Supplemental Guide) that can be found on the [ISA for LCE Exposure Draft webpage](#). This supporting material sets out further considerations when determining or evaluating use of the proposed standard.
42. The IAASB extensively deliberated the approach to the scope and applicability of ED-ISA for LCE, including for which types of entities the proposed standard is intended to be used for, and how this would be best described and presented.
43. Explaining the scope of the proposed standard as clearly as possible is an important objective in the development and application of the proposed standard because it is intrinsically linked to the content of the standard.
44. The proposed standard has not been designed for obtaining sufficient appropriate audit evidence for complex matters or circumstances. If ED-ISA for LCE is used for engagements for which it has not been designed the requirements of the proposed standard will not be sufficient for the auditor to obtain sufficient appropriate audit evidence to support a reasonable assurance opinion. Therefore, a clear description of the types of entities for which the ISA for LCE is not intended—as set out in the Authority of the Standard and described in paragraph 50—is essential so that:
- (a) The IAASB could decide on the requirements that are appropriate for an audit of an LCE based on the typical nature and circumstances of such entities.
  - (b) Legislative or regulatory authorities or relevant local bodies with standard-setting authority, firms and auditors will be informed of the intended scope of the proposed standard.
45. During the development of ED-ISA for LCE, there have been mixed views on how prescriptive the language in the Authority should be, and how much judgment should be involved in making related determinations about the applicability of the standard. Initially, the IAASB took an approach to define a ‘less complex’ entity for the purpose of the proposed standard, but the IAASB had the view that this approach did not clearly capture all the circumstances that may make an entity less complex. The IAASB also explored an approach that required a significant level of judgment in determining the applicability of the standard, but that was not deemed appropriate from a consistency perspective.
46. The IAASB also considered the IASB’s approach to the applicability of the IFRS for SMEs, in particular, using the concept of “public accountability” to describe the scope for which entities the standard is not appropriate. The IAASB decided against the introduction of the concept of public accountability into the IAASB’s literature because this may cause further confusion with the concepts

already used to describe those entities exhibiting public interest characteristics.<sup>16</sup> Furthermore, further consideration would need to be given with how this new concept would apply to audits in the public sector.

47. Therefore, to obtain a balance between being too prescriptive and allowing too much judgment in determining whether the proposed standard is appropriate to use, the IAASB has explained the scope through prohibiting the use of the proposed standard for certain classes of entities , and further describing those qualitative characteristics that would make the standard inappropriate to use (i.e., collectively describing when the proposed standard is inappropriate for use because the audit would not be considered an audit of an LCE).
48. Although there would inevitably still be a level of judgment involved, it was considered that this approach would achieve a better balance between prescription and judgement. Some Board members remain of the view that the required level of judgment for those circumstances is too high and that a higher level of prescription is desirable. This is an area where the IAASB is seeking specific input.
49. In describing the basis for the determination of the appropriate use of the proposed standard, it is the IAASB’s view that the relevant limitations be designated into two categories:
  - (a) Specific classes of entities for which the use of the standard is prohibited.
  - (b) Qualitative characteristics that, if exhibited by an entity, preclude the use of the standard for the audit of the financial statements of that entity because they are indicators of, or proxies for, matters or circumstances for which the standard has not been designed.

Where an entity is not restricted by the limitations as described in (a) and (b) above, ED-ISA for LCE is appropriate to use for an audit engagement.

50. The following diagram explains the limitations for an individual engagement (paragraphs A.5. – A.9. in ED-ISA for LCE):



<sup>16</sup> The IAASB also remains mindful of the work being undertaken by the International Ethics Standards Board for Accountants (IESBA) on the definition of public interest entities (PIEs) and the impact those changes may have on the IAASB’s standards.

*Limiting Use through Specific Prohibitions*

51. As outlined in paragraph A.7. of ED-ISA for LCE, the specific classes of entities for which the proposed standard is prohibited include where:
- (a) Law or regulation: (see paragraph 52 below)
    - (i) Explicitly prohibits the use of the proposed ISA for LCE (i.e., the standard is not authorized for use in a particular jurisdiction); or
    - (ii) Specifies the use of auditing standards, other than the proposed ISA for LCE, for an audit of financial statements in that jurisdiction.
  - (b) The entity is a listed entity (see paragraphs 53–54 below).
  - (c) An entity meets one of the following criteria: (see paragraphs 53 and 55–61)
    - (i) An entity one of whose main functions is to take deposits from the public;
    - (ii) An entity one of whose main functions is to provide insurance to the public;
    - (iii) An entity whose function is to provide post-employment benefits;
    - (iv) An entity whose function is to act as a collective investment vehicle and which issues redeemable financial instruments to the public; or
    - (v) A class of entities where use of the proposed ISA for LCE is prohibited for that specific class of entity by a legislative or regulatory authority or relevant local body with standard-setting authority in the jurisdiction (see paragraphs 56 and 59 below).
  - (d) The audit is an audit of group financial statements (see paragraphs 62–63 and Section 5).

**Outright Prohibition by Law or Regulation**

52. Paragraph A.7.(a) of ED-ISA for LCE is intended to apply to all classes of entities in a particular jurisdiction where a jurisdiction either does not want to adopt the ED-ISA for LCE, or the jurisdiction specifies other standard(s) instead.

**Classes of Entities with Public Interest Characteristics – Listed Entities**

53. Classes of entities that have public interest characteristics that could embody a level of complexity in fact or appearance have mostly been excluded from the scope of ED-ISA for LCE. For some entities, where the public interest is so significant, such as listed entities, the IAASB believes ED-ISA for LCE is not appropriate and so can never be used for audits of these entities. Listed entities are defined as:

*Entities, whose shares, stocks or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.*

54. The decision to prohibit the use of the proposed standard for listed entities was broadly supported by many stakeholders with whom outreach has been performed, including securities regulators having a specific remit in this area. However, some stakeholders had the view that the decision about whether the standard is appropriate to use for an audit should be made based on complexity only, and therefore that smaller, ‘straightforward’ listed entities should be included within the scope of the proposed standard. However, the IAASB continued to have the view that because of the significance of the public interest in these entities, regardless of complexity, that they continue to be excluded

from the scope of the proposed standard. Therefore, there are currently no procedures within ED-ISA for LCE specific to listed entities (for example in relation to key audit matters or segment information).

#### Classes of Entities with Public Interest Characteristics – Other Entities

55. For other entities exhibiting public interest characteristics (that are not listed entities), describing these types of entities for a global audience is multifaceted. Some jurisdictions have defined PIEs for that jurisdiction, while others have not.
56. In the absence of a global definition of PIEs, the IAASB has described the classes of entities in paragraph A.7.(c)(i)-(iv) of ED-ISA for LCE that would typically exhibit public interest characteristics for the purpose of determining the appropriate use of ED-ISA for LCE (with the ability to make limited modifications to these classes of entities). There is also the ability for a jurisdiction to further prohibit specified classes of entities from using the proposed standard in that jurisdiction (paragraph A.7.(v)).
57. The classes of entities outlined in Paragraph A.7.(c)(i)-(iv) of ED-ISA for LCE broadly align with the proposals<sup>17</sup> by the IESBA to describe a PIE in its project to develop a definition of PIE. Notwithstanding the IESBA's consultation and any further changes that may be made to these descriptions for the purpose of the *International Code of Ethics for Professional Accountants (including International Independence Standards)* (IESBA Code), the IAASB is of the view that these are the same classes of entities that the IAASB would consider exhibit public interest characteristics for the purpose of the proposed standard and therefore would continue to use these descriptions.<sup>18</sup>
58. In allowing jurisdictions (i.e., legislative or regulatory authorities or relevant local bodies with standing-setting authority) to modify those classes of entities described in paragraph A.7.(i)-(iv) or the ability to further prohibit entities from using the standard under paragraph A.7.(v), the IAASB recognizes that there may be different circumstances in some jurisdictions that need to be taken into account. For example, there may be entities within a local context that are scoped into the prohibitions (because the broad class is prohibited) when they, in fact, do not exhibit public interest characteristics (they may be a 'sub-set' within the broad class described). There may also be additional classes of entities within a jurisdiction that also exhibits public interest characteristics. Therefore, the proposed standard allows for the ability to 'modify' these classes of prohibited entities through:
  - (a) Explicitly permitting a specific sub-set within a class to be able to use the proposed standard (however, still having regard to the qualitative characteristics relevant to the appropriate use of the standard (see paragraphs 67–71 below)).
  - (b) Introducing further classes of entities prohibited from using the proposed standard (through the use of paragraph A.7.(v)).

Such changes can only be made at a jurisdictional level and modifications can only be made within a specific class – a whole class cannot be removed. Paragraphs 18–20 of the Authority Supplemental Guide provides examples of when such modifications may be appropriate.

<sup>17</sup> <https://www.ethicsboard.org/publications/proposed-revisions-definitions-listed-entity-and-public-interest-entity-code>

<sup>18</sup> The IAASB has a project to consider the impact of the IESBA PIE project on the IAASB standards more broadly, including any changes made in relation to the definition of PIEs. Although the IAASB considers the classes of entities in the Authority appropriate, any further changes by the IESBA to its proposed definition of PIE will be further considered for consistency as the IESBA finalizes its project.

59. Despite similarities between Paragraph A.7. and the IESBA proposed PIE definition, paragraph A.7.(c)(v) of ED-ISA for LCE is different from how the IESBA describes the corresponding category for the purpose of its PIE project. For the purpose of determining which entities should be prohibited from using ED-ISA for LCE, and in light of the different approaches to defining PIEs across jurisdictions, the IAASB accept that jurisdictions should be able to further prohibit certain classes of entities from using the proposed standard if they so wish., (i.e., this is a category that can be modified by a jurisdiction to suit their individual circumstances) (also see paragraph 58 above). This change would also accommodate those jurisdictions that do not use the IESBA Code or that have a definition of PIE.
60. The IAASB also considered whether the full list of prohibited entities would adequately capture those entities intended to be excluded if a jurisdiction made no further changes to the Authority and concluded that this list was adequate.
61. Paragraph 23 of the Authority Supplemental Guide describes what is meant by an “entity’s main function” when applying paragraph A.7.(c)(i)-(ii) of ED-ISA for LCE. The consideration of whether the “main function” of an entity is as described is a matter of judgment. For example, if an entity sells goods or services and receives deposits for the purpose of securing the goods or service in advance of delivery of the good or service, the main function of the entity is unlikely to be taking deposits from the public. Each situation would be judged on the facts and circumstances as to what the entity’s main function is deemed to be for the purpose of using ED-ISA for LCE.

#### Exclusion of Audits of Group Financial Statements

62. Audits of group financial statements (group audits) have also been excluded from the scope of the proposed standard. This is because, on balance, the IAASB has the view that group audits inherently exhibit characteristics of complexity within an entity and, consistent with other areas of complexity, have not been contemplated in the design of the proposed standard. Therefore, the proposal of an outright prohibition on group audits is an area where the IAASB is seeking specific input – see Section 5.
63. The Authority describes the scope of a group audit based on the definition of group financial statements in the exposure draft of proposed ISA 600 (Revised).<sup>19</sup> The IAASB is in the process of discussing the comments received on proposed ISA 600 (Revised), and if further changes are made to the description of the scope of a group audit, the impact of those changes, if any, will be considered as ED-ISA for LCE is finalized.

#### Other Considerations

64. In considering how to describe the scope of ED-ISA for LCE, the IAASB debated the use of quantitative or other exemption thresholds or more specific criteria to scope the standard. However, it was agreed that it would not be practicable for the IAASB to define exemption thresholds or other criteria about what may constitute an audit of an LCE that would be capable of consistent global application because of, for example, the varying sizes of economies and sophistication of jurisdictions. However, the IAASB recognized that specific thresholds or criteria could be used by individual jurisdictions when evaluating the use of ED-ISA for LCE for that jurisdiction. Such exemptions may therefore be added as described in paragraph A.6. of the proposed standard.

<sup>19</sup> Proposed ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

65. The specific prohibitions are targeted at legislative or regulatory authorities or relevant local bodies with standard-setting authority, as they have the mandate and authority to permit use of ED-ISA for LCE in a specific jurisdiction. Firms and auditors will only be able to use the proposed standard if not prohibited from doing so in a specific jurisdiction and may not modify the classes of entities that are prohibited by the jurisdiction within which they are operating. However, firms, in setting policies or procedures for use of ED-ISA for LCE, may be able to further limit use of the standard within the firm to more classes of entities based on, for example, quality risks as a result of the nature and circumstances of the engagements performed by the firm.
66. In conjunction with the issuance of the proposed standard in a jurisdiction, legislative or regulatory authorities or relevant local bodies with standard-setting authority are expected to issue provisions and accompanying guidance for adoption and implementation of the standard, as appropriate. This may include a description of which audits are permitted to be conducted using the proposed standard in accordance with Part A of ED-ISA for LCE, taking into account, among other matters, the purpose of limiting the use of the standard and other relevant information in the Authority Supplemental Guide. Legislative or regulatory authorities or relevant local bodies with standard-setting authority may also include additional information for firms and auditors arising from local law, regulation or governmental authority that may be relevant to their decisions.

*Limiting Use through Qualitative Characteristics*

67. In addition to the specific prohibitions explained above, the use of the proposed standard is limited through qualitative characteristics. It is inappropriate for an audit of the financial statements of an entity to be undertaken using ED-ISA for LCE if the entity exhibits the following:
- Complex matters or circumstances relating to the nature and extent of the entity’s business activities, operations and related transactions and events relevant to the preparation of the financial statements.
  - Topics, themes and matters that increase, or indicate the presence of, complexity, such as those relating to ownership, corporate governance arrangements, policies, procedures or processes established by the entity.
- These are intended to be indicators of, or proxies for, matters or circumstances that are deemed complex for the purpose of the proposed standard (i.e., ED-ISA for LCE does not include requirements to address such matters or circumstances).
68. The qualitative characteristics are further described in paragraphs A.8.–A.9. in Part A of ED-ISA for LCE, as well as the Authority Supplemental Guide. For example, the presence of an accounting estimate with a higher degree of estimation uncertainty is likely an indicator of complexity, and therefore requirements in relation to the use of complex modelling and to address situations where there is higher estimation uncertainty have not been included in ED-ISA for LCE.
69. In evaluating whether ED-ISA for LCE is appropriate to use for a specific engagement, auditors will still need to exercise professional judgment, as it is not possible to create prohibitions and limitations that could “scope out” at a global level every audit of an entity that exhibits an indicator(s) of complexity.
70. Firms are responsible for establishing policies or procedures in relation to the permitted use of ED-ISA for LCE by the firm’s audit engagement teams.<sup>20</sup> In doing so, the firm takes into account the

<sup>20</sup> ISQM 1, paragraphs 24-27 and 30

specific prohibitions for use of the proposed standard, any further modifications or limitations by the applicable jurisdiction, as well as the qualitative characteristics described in paragraphs A.8.–A.9 of ED-ISA for LCE.

71. For individual audit engagements, as part of the firm’s acceptance or continuance procedures and the engagement partner’s responsibilities related thereto, the engagement partner is required to determine that the audit engagement is an audit of an LCE, taking into account specific prohibitions, jurisdictional determinations, qualitative characteristics and any firm policies or procedures.

***Request for Comments – Specific Questions***

3. Views are sought on the Authority (or scope) of ED-ISA for LCE (Part A of the proposed standard). In particular:
- (a) Is the Authority as presented implementable? If not, why not?
  - (b) Are there unintended consequences that could arise that the IAASB has not yet considered?
  - (c) Are there specific areas within the Authority that are not clear?
  - (d) Will the Authority, as set out, achieve the intended objective of appropriately informing stakeholders about the scoping of the proposed standard?
  - (e) Is the proposed role of legislative or regulatory authorities or relevant local bodies with standard setting authority in individual jurisdictions clear and appropriate?
4. Do you agree with the proposed limitations relating to the use of ED-ISA for LCE? If not, why and what changes (clarifications, additions or other amendments) need to be made? Please distinguish your response between the:
- (a) Specific prohibitions; and
  - (b) Qualitative characteristics.
- If you provide comments in relation to the specific prohibitions or qualitative characteristics, it will be helpful to clearly indicate the specific item(s) which your comments relate to and, in the case of additions (completeness), be specific about the item(s) that you believe should be added and your reasons.
5. Regarding the Authority Supplemental Guide:
- (a) Is the guide helpful in understanding the Authority? If not, why not?
  - (b) Are there other matters that should be included in the guide?
6. Are there any other matters related to the Authority that the IAASB should consider as it progresses ED-ISA for LCE to finalization?

**Section 4C – Key Principles Used in Developing ED-ISA for LCE**

72. Consistent with an audit conducted in accordance with the ISAs, the intended outcome from using ED-ISA for LCE is an audit opinion resulting for a quality audit engagement that would enhance the credibility of the financial statements for the users thereof. The basis for the design of ED-ISA for LCE to achieve this outcome is a separate standard for an audit of the financial statements of an LCE that:

- (a) Is proportionate to the nature and circumstances that would be typical of an audit of a less complex entity (as contemplated in the Authority).
  - (b) Can be used effectively and efficiently in those typical circumstances to obtain sufficient appropriate audit evidence to support a reasonable assurance audit opinion.
  - (c) Utilizes a risk-based approach to an audit, with requirements that are principles-based, so that the proposed standard can be applied to less complex entities with a wide range of circumstances and across sectors or industries.
73. Accordingly, many of the basic concepts used in the ISAs to support a risk-based approach have also been incorporated in ED-ISA for LCE, including:
- The use of objectives (see paragraphs 78–80 below);
  - Using the core ISA requirements and concepts (such as professional skepticism and professional judgment) as a base for establishing the work effort of the auditor when performing an audit of an LCE;
  - The need to obtain sufficient appropriate audit evidence to support the audit opinion;
  - The use of materiality to focus the auditor's efforts and to evaluate misstatements; and
  - Using the audit risk model, i.e., applying the concepts of inherent risk, control risk and detection risk.

As such, ED-ISA for LCE would have the same overall objectives of an audit for the auditor (described in Part 1), as well as the same inherent limitations as an ISA audit, which are explained within the Preface to the proposed standard.

#### *The Requirements in ED-ISA for LCE*

74. Similar to the ISAs, ED-ISA for LCE sets out requirements that, taken together, would fulfill the overall objective of the auditor (i.e., to express an opinion based on the audit evidence obtained). Compliance with these requirements is intended to support how the auditor obtains sufficient appropriate audit evidence as the basis for the auditor's reasonable assurance opinion.
75. Therefore, to develop a standard that will achieve reasonable assurance, the IAASB has used the requirements in the ISAs as the basis for the requirements within ED-ISA for LCE. This was accomplished by replicating and adapting requirements from the ISAs that are considered core to an audit, for the nature and circumstances of less complex entities as contemplated by the proposed standard. Audit procedures that are not relevant to an LCE, as contemplated by the proposed standard (e.g., procedures specific to listed entities), are not included within ED-ISA for LCE. Paragraph 104 further explains how the ISAs have been included within ED-ISA for LCE.
76. The auditor is required to comply with all relevant requirements in ED-ISA for LCE unless it is judged to be necessary to depart (and only in exceptional circumstances)<sup>21</sup> to be able to achieve reasonable assurance.
77. The IAASB has undertaken an analysis of how the requirements in ED-ISA for LCE 'map' against the equivalent ISA requirements. This mapping, which includes commentary to explain any differences, can be accessed on the [LCE Focus Area webpage](#) and is provided for reference only (i.e., it does

<sup>21</sup> See ED-ISA for LCE, paragraphs 1.4.2. and 1.4.3.



not form part of the consultation but is provided to help respondents understand the differences between ED-ISA for LCE and the ISAs). The use of the ISA requirements is also discussed further in Section 4E below.

#### *Objectives of Each Part*

78. Because the proposed standard is principles-based, similar to the ISAs, each Part of the ED-ISA for LCE contains objective(s) to be achieved by performing procedures to comply with the requirements within that Part. The objectives focus the auditor on:
- Understanding what needs to be accomplished; and
  - Deciding whether more needs to be done in the particular circumstances of the audit.
79. The objectives in ED-ISA for LCE align, where appropriate, to the equivalent ISA objectives. However, recognizing the structure and flow of ED-ISA for LCE, in some Parts there may be numerous topics addressed for which the equivalent ISAs for these individual topics would each have their own objective(s)). Therefore, some of the objectives in ED-ISA for LCE may be more broadly stated than would be found in the ISAs.
80. The IAASB also considered the intended outcomes of the objectives of all the Parts combined and debated whether the individual objectives would achieve the overall objectives of the auditor (see ED-ISA for LCE paragraph 1.3.1)<sup>22</sup> when combined, and agreed that the overall objectives could be achieved.

#### *Professional Skepticism and Professional Judgment*

81. The underlying concept of professional skepticism applies in the same way as it would in an ISA audit. Some of the changes to enhance the auditor's exercise of professional skepticism that were introduced in ISA 540 (Revised) and ISA 315 (Revised 2019), for example around corroborative or contradictory audit evidence, have also been incorporated within ED-ISA for LCE.
82. Using a risk-based approach also necessitates the exercise of professional judgment in planning and performing the audit and would be applied in the same way in ED-ISA for LCE that it would in an ISA audit.

#### *Relevant Ethical Requirements*

83. Using the same approach as the ISAs, ED-ISA for LCE has been developed requiring that the auditor comply with relevant ethical requirements, including those pertaining to independence, for financial statement audit engagements.

#### *Quality Management*

84. ED-ISA for LCE has been developed on the basis that the auditor performing the engagement is a member of a firm that is subject to the IAASB's Quality Management Standards (ISQMs),<sup>23</sup> or national requirements that are at least as demanding.

<sup>22</sup> The overall objective of an audit using ED-ISA for LCE is the same as the overall objective for an audit using the ISAs.

<sup>23</sup> The International Standards on Quality Management (ISQMs) include: ISQM 1 and ISQM 2. In addition, ISA 220 (Revised) has been used in developing Part 3 of ED-ISA for LCE. The IAASB's new and revised series of quality management standards have been used for developing ED-ISA for LCE as these will be effective before this proposed standard becomes effective.

*Essential Explanatory Material*

85. A key objective of the design of the proposed standard was to keep the standard concise and succinct (as much as possible); therefore, the approach to application or explanatory material was extensively deliberated.
86. The IAASB explored both a 'shorter version' and a 'longer version' of the equivalent of "application material" to be presented at the back of the proposed standard (similar to how the application material is presented after the requirements in the ISAs). In the context of the structure and flow of ED-ISA for LCE, the IAASB concluded that this approach disconnected application material from the relevant requirements and seemed very judgmental as to what was included, particularly where the application material in the ISAs is more educational in nature. Therefore, it seemed more appropriate to include any such material in the body of the proposed standard together with the related requirements.
87. The IAASB also considered whether any application or explanatory material was needed, but on balance agreed that some guidance was needed for implementation of selected concepts and requirements. The IAASB agreed to limit this material to where it was essential to understanding or applying a requirement(s). Accordingly, ED-ISA for LCE includes "essential explanatory material" (EEM) where it has been considered that explanatory material is crucial to support the requirements or concepts used.
88. The EEM serves a similar purpose to application and other explanatory material in the ISAs, but is much more limited than what is presented within the ISAs, and is targeted at a higher level (i.e., a conceptual and contextual level), taking into account the typical nature and circumstances of audits for which the proposed standard has been designed.
89. To distinguish EEM from the requirements within ED-ISA for LCE, the EEM has been presented in italics (and highlighted in light blue). There are two 'types' of EEM included: general introductory EEM that explains the context of the section that follows and EEM specific to the requirement directly above it. However, there is no difference in the status of each 'type.'
90. EEM does not in itself impose a requirement or expand any requirement. Rather it is used when the explanation or guidance it provides is considered to be so important that including it in the proposed standard and positioning it alongside the requirement(s) is deemed necessary and informative for a proper understanding of the requirement(s). The following sets out the broad principles used for inclusion of EEM in ED-ISA for LCE:
- The EEM paragraphs do not create additional obligations for the auditor and do not include a "shall."
  - Not every concept or requirement is explained. EEM has only been provided when it is deemed to provide crucial support to the appropriate application of the concept or requirement(s).
  - EEM is not intended to provide detailed examples about "how" to apply a requirement – rather it contains descriptions of matters relevant to understanding and applying the concepts or requirements within the draft ISA for LCE. For example, it may explain more precisely what the requirement means or what the requirement is intended to cover.
  - If deemed necessary, the EEM may explain "why" a procedure is required to be undertaken. It may also be used to explain the iterative nature of the proposed standard where needed.
  - The EEM, where appropriate, may illustrate how a requirement could be applied for different circumstances. This illustrates scalability of the proposed standard to the spectrum of entities that would likely fall within its remit.

- The EEM does not include background information on matters addressed in ED-ISA for LCE.
91. Selecting EEM paragraphs for inclusion in ED-ISA for LCE has been based on the judgment of the IAASB, with input from the LCE Reference Group. Within the ISAs, all of the paragraphs with “considerations specific for small entities” have been contemplated and included as appropriate. EEM has also been included for considerations specific to public sector entities and the use of automated tools and techniques (ATT). As the volume of explanatory material included within the proposed standard is limited, the IAASB acknowledges the need for implementation support materials to help the effective implementation once the proposed standard has been finalized (see Section 4G below).

**Request for Comment – Specific Questions**

7. Views are sought on the key principles used in developing ED-ISA for LCE as set out in this Section 4C. Please structure your response as follows:
- (a) The approach to how the ISA requirements have been incorporated in the proposed standard (see paragraphs 74-77).
  - (b) The approach to the objectives of each Part of the proposed standard (see paragraphs 78-80).
  - (c) The principles in relation to professional skepticism and professional judgement, relevant ethical requirements and quality management (see paragraphs 81-84)
  - (d) The approach to EEM (see paragraphs 85–91) including:
    - (i) The content of the EEM, including whether it serves the purpose for which it is intended.
    - (ii) The sufficiency of EEM.
    - (iii) The way the EEM has been presented within the proposed standard.

*Please note that Section 4E below addresses the content of ED-ISA for LCE, including specific questions for respondents to provide their detailed comments on the content of the proposed standard.*

**Section 4D – Overall Design and Structure of ED-ISA for LCE**

*Structure*

92. The content (i.e., the requirements and related EEM) of ED-ISA for LCE have been grouped into nine “Parts” that follow the flow of an audit engagement (rather than by subject matter or topic like the ISAs). The Parts are preceded by a Preface to the standard, and the Authority (as explained above).



93. An overview of each Part, along with accompanying sections and appendices can be found below:

|                    |  |
|--------------------|--|
| Preface            | Explains the design, intended use and format of the proposed standard, the responsibilities of management and the approach to future maintenance of the standard, as well as other relevant matters that do not form part of the standard.   |
| Authority (Part A) | Sets out the circumstances for which the proposed standard is prohibited or otherwise limited (as explained above).  |
| Parts 1 – 3        | Sets out the broad concepts and overarching matters relevant to the audit performed using ED-ISA for LCE, including the overarching objective of the audit. Section 4E below further explains the detailed content of each individual Part.  |
| Parts 4 – 9        | Sets out the core requirements for an audit of an LCE following the typical flow of an audit. Section 4E below further explains the detailed content of each individual Part.  |
| Appendices         | <p>Appendices 1 – 6 set out certain specific considerations and matters for an audit of an LCE, and also illustrative documents. Appendices presented within the ED-ISA for LCE have the same status as the EEM.</p> <p>Section 4E below further explains the detailed content of each Appendix.</p> |

94. The same structure has been used within each Part (Parts 1–9), to help with consistency of application:

- (a) An introductory box—setting out a summary of the content and scope of that Part. The material in the introductory boxes is not intended to create any obligations for the auditor. The IAASB considered the balance of information to include in these introductory boxes, and has the view they would likely be helpful to quickly understand what is included in each Part.
- (b) Objective(s)—See paragraphs 78–80 above.
- (c) Requirements—detailing, in a straightforward manner, all of the requirements that need to be complied with, unless the requirements are conditional and the condition does not exist (these are clearly articulated as conditional, e.g., if the *xyz condition exists*, the auditor shall...). Requirements are expressed using “shall.”
- (d) Specific Communication Requirements (where applicable)—If there are any specific communication requirements related to the matters included in that Part, they have been grouped together so that it is clear what all the specific communications to management or those charged with governance are that need to be made.
- (e) Specific Documentation Requirements (where applicable)—All the documentation requirements related to specific matters within that Part are also grouped together so that the specific matters that need to be documented are clear.

95. In addition to specific communication and documentation requirements in each Part, the proposed standard also contains overarching principles that apply to communication and documentation throughout the audit (in Parts 1 and 2 respectively) (see Section 4E below).
96. Requirements from certain topic-specific ISAs relating to certain topics that may be grouped together in a topic-specific ISA, for example fraud, law or regulation, audit evidence, going concern and communications with those charged with governance, are instead placed throughout the proposed standard in the Parts where the specific requirement is relevant.
97. The IAASB is of the view that the structure and workflow proposed helps users to easily and practically understand the order in which the requirements are typically executed in the flow of the audit.

*Drafting Principles Used*

98. The IAASB aims to set high quality international standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. This includes presenting any required actions as clear, understandable and stated as simply and concisely as practical. The use of long or multiple layers of bullet lists is avoided as this may be perceived as a checklist rather than a principles-based approach. Material that is lengthy, educational or background in nature has not been included. In addition, the IAASB has focused on:
  - Simpler numbering.
  - Limiting the number of “sub-bullets” where appropriate.
  - One thought per paragraph.
  - Combining requirements from the ISAs where appropriate and avoiding repetition.
  - Articulating the requirements in a clearer and simpler way where feasible.
99. The proposed drafting principles and guidelines being developed under the CUSP Workstream have been used where appropriate in drafting ED-ISA for LCE.
100. In developing ED-ISA for LCE using the principles explained above, including making the standard easier to understand and apply, the IAASB expects that tailoring the standard to the nature and circumstances of the entity and the audit engagement will be more effective and efficient. For example, auditors of LCEs will not need to spend time identifying what is applicable and what is not (e.g., as they would need to do if they were using the ISAs), as it should be clearer what the core requirements are when the nature and circumstances of the entity and the audit are less complex. The auditor would therefore be able to invest more time executing appropriate procedures that more effectively targets the risks of material misstatement, when appropriately used for an audit of an LCE.
101. However, it is not envisioned that ED-ISA for LCE will necessarily reduce the core procedures the auditor is required to perform to support the overall quality of the audit. There has been a strong message from the IAASB’s stakeholders that the separate standard should be based on the ISAs, and retain the robustness of an audit using the ISAs. Accordingly, the separate standard would present the requirements for an audit of an LCE based on the core requirements of the ISAs but drafted and presented in a more understandable and straightforward way, including that the requirements follow the flow of an audit engagement (see Section 4E below).

**Request for Comment – Specific Question**

8. Please provide your views on the overall design and structure of ED-ISA for LCE, including where relevant, the application of the drafting principles (paragraph 98-101).

**Section 4E – Content of ED-ISA for LCE***Broad Principles for Requirements*

102. Although ED-ISA for LCE is based on the core requirements from the ISAs, it does not contain requirements relating to prohibited entities, or where there are matters or circumstances that would have been deemed more complex as described in the Authority of the proposed standard. Accordingly, for example, the proposed standard does not include any requirements:
- (a) Specific to listed entities, including procedures related to reporting on segment information (ISA 501)<sup>24</sup> or key audit matters (KAMs) (ISA 701).<sup>25</sup>
  - (b) When the auditor intends to use the work of internal auditors (ISA 610 (Revised 2013)).<sup>26</sup> Internal auditors are likely to be used to provide assurance or add value or improve an organization's operations related to risk management, controls and governance processes of entities with higher complexity (e.g., more complex entity structures, complex IT systems etc.). In describing what is, and what is not, complex for the purpose of using the proposed standard, organizations that have internal audit functions are typically more complex (e.g., they may have global operations, or divisions or business lines operating independently, or exhibit one or more of the other qualitative characteristics not typical of an LCE), and therefore requirements on using the work of internal auditors are not included within the proposed standard.
  - (c) With respect to group audits (the requirements of ISA 600<sup>27</sup> on group audits have been omitted) (see Section 5).
103. The IAASB deliberated whether excluding these requirements was appropriate, particularly in the instance of KAMs where auditors of a non-listed entity may voluntarily report these in their auditor' report. The IAASB agreed that including such requirements would be inconsistent with the principle of public interest currently used to scope the proposed standard. The IAASB also considered a reference to the ISAs for the relevant requirements but on balance agreed that this would undermine the standalone nature of the standard. It was therefore concluded that such requirements or a reference to the relevant ISA not be included.
104. With respect to the other ISAs that are not specifically excluded as discussed above, the requirements were incorporated in ED-ISA for LCE as follows:
- (a) The requirements have been included "as is."
  - (b) Wording of the requirements have been modified or adapted to the nature and circumstances of the audit of an LCE. Such requirements are expected to deliver a similar outcome as the ISA requirement in the context of an audit of an LCE.
  - (c) Specific requirements within an ISA have been omitted including:

<sup>24</sup> ISA 501, *Audit Evidence—Specific Considerations for Selected Items*

<sup>25</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

<sup>26</sup> ISA 610 (Revised 2013), *Using the Work of Internal Auditors*

<sup>27</sup> ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

- (i) Requirements that address matters or circumstances that would relate to entities that have been specifically excluded from the scope of the proposed standard (e.g., requirements relating to segment information in ISA 501).
- (ii) Requirements that address complex matters or circumstances (in line with how the relevant qualitative characteristics in paragraph A.9. in the Authority have been described).
- (iii) Requirements, generally, for circumstances which are explained as being “rare” or “exceptional” in the ISAs and, in the view of the IAASB, it is deemed likely not to be encountered given the typical nature and circumstances of an audit of an LCE.

The ‘mapping documents’ described in paragraph 77 illustrate how each of these approaches apply to the extant ISA requirements.

105. ED-ISA for LCE incorporates the relevant requirements from the most recently approved ISAs, including ISA 540 (Revised), ISA 315 (Revised 2019), and ISA 220 (Revised), and conforming and consequential amendments arising from the revisions to these ISAs.<sup>28</sup> With regard to quality management, reference has also been made to ISQM 1 and ISQM 2.<sup>29</sup>
106. There are many differences between the ISAs and ED-ISA for LCE, with the detail of these differences set out in the mapping documents (as noted in paragraph 77 above). However, there are three more significant areas where the requirements are broadly different and each of these is explained below:
- (a) *Accounting estimates*<sup>30</sup>—Specific procedures in relation to the use of complex modelling and detailed requirements to address situations where there is higher estimation uncertainty have not been included (e.g., the estimate is not calculated using recognized or common measurement techniques or there is a highly specialized entity-developed model for which there are no observable inputs) as they are not expected to be relevant for the types of accounting estimates in an audit of a typical LCE.
  - (b) *Where the entity uses a service organization* for processing transactions—Because the requirements in the proposed standard have been designed for the typical nature and circumstances of an LCE, basic requirements for circumstances where an entity uses a service organization for processing transactions have been included (because, for example, many LCEs may have payroll processed by a service organization). However, situations that are deemed more complex relating to the entity’s use of a service organization have not been addressed within the proposed standard. For example, requirements relating to an auditor’s ability to rely on reports on the operating effectiveness of controls from the entity providing the

<sup>28</sup> The requirements from the newly revised standards have been largely incorporated ‘as is’ (where appropriate to an audit of an LCE) – the IAASB is of the view that as these standards are not yet effective, and are intended to be proportionate and scalable, it would be premature to make too many changes in respect of a standard that has only been recently revised. Changes have been made, however, where appropriate for an audit of an LCE and have been explained as relevant in this explanatory memorandum.

<sup>29</sup> The IAASB is not seeking comments on the content of those standards as part of this exposure draft.

<sup>30</sup> Using an expert for accounting estimates is contemplated in the proposed standard. A decision about how to audit the underlying account balance, class of transactions or disclosure, should not be used when determining whether the standard is appropriate to use for a specific engagement. Although the need for an expert may be an indicator of complexity, it may also be because in many LCEs there may not be the expertise capable of making a reliable point estimate. Accordingly, it is the underlying accounting estimate and the complexity thereof that is taken into account when considering the Authority of the standard.

services (e.g., 'Type 1' and 'Type 2' reports) are not included as it is anticipated that where transactions are less complex, the auditor would be able to obtain the necessary audit evidence without difficulty from records available (including, if applicable, in relation to controls at the service organization).

- (c) *Management amendments to the financial statements after the date of the auditor's report*—Detailed requirements relating to the reporting on, and distribution of, previously issued financial statements when financial statements are amended are not included because in most jurisdictions this is expected to be rare.

*Content of the Parts in ED-ISA for LCE*

107. The table below sets out a description of the content of each Part (if the content is further explained the relevant paragraph numbers have been provided):

|   |  |
|---|--|
| <p>Part 1: Fundamental Concepts, General Principles and Overarching Requirements</p>          | <p>Sets out the fundamental concepts, general principles and overarching principles to be applied throughout the audit, including:</p> <ul style="list-style-type: none"> <li>• Relevant ethical requirement and firm-level quality management (see paragraphs 83 and 84).</li> <li>• The overall objectives of the auditor (see paragraph 80).</li> <li>• Use of professional judgment and the exercise of professional skepticism (see paragraphs 81–82).</li> <li>• Overarching requirements to be applied throughout the audit with regard to fraud, law or regulation and related parties.</li> <li>• General requirements for communications with those charged with governance and management. Specific communication requirements, where applicable, have been set out in each relevant Part.</li> </ul> |
| <p>Part 2: Audit Evidence and Documentation</p>   | <p>Sets out the general requirements for obtaining sufficient appropriate audit evidence and general documentation requirements (see paragraph 110).</p>   |
| <p>Part 3: Engagement Quality Management</p>  | <p>Sets out the auditor's and engagement partner's obligations and responsibilities for quality management in an audit of an LCE. The requirements in this Part are based on ISA 220 (Revised).</p>  |
| <p>Part 4: Acceptance or Continuance of an Audit Engagement and Initial Audit Engagements</p> | <p>Sets out the auditor's obligations for agreeing the terms of engagement, including establishing that the preconditions for an audit are present, and determining that the use of ED-ISA for LCE is appropriate. This Part also addresses requirements for opening balances in initial audit engagements.</p>  |



|   |   |
|---|---|
| Part 5: Planning  | Sets out responsibilities for planning the audit, including the engagement team discussion, and the concept of materiality when planning and performing the audit (see paragraph 112 below).  |
| Part 6: Risk Identification and Assessment  | Sets out requirements for understanding the entity and its environment, the applicable financial reporting framework and the entity's internal control system, identifying risks of material misstatement and assessing inherent risk and control risk. The requirements in this Part are based on ISA 315 (Revised 2019). (See paragraphs 113-118 below) |
| Part 7: Responding to Assessed Risks of Material Misstatement                         | Sets out requirements for the design and implementation of responses to assessed risks of material misstatement at the financial statement and assertion levels, including substantive procedures and tests of controls. This Part also sets out requirements for specific procedures on various topics within an audit.                                  |
| Part 8: Concluding  | Sets out requirements for the evaluation of misstatements, concluding activities and evaluations (including going concern, subsequent events and analytical procedures), and obtaining written representations. This Part also covers the engagement partner's conclusions relating to quality management.  |
| Part 9: Forming an Opinion and Reporting  | Sets out the requirements for forming an opinion (including the types of audit opinions), the content of the auditor's report, other information and comparative information (see paragraphs 119–124 below).  |
| Appendix 1: Glossary of Terms   | Describes the meanings attributed to certain terms for the purpose of ED-ISA for LCE (see paragraphs 125–129 below).  |
| Appendix 2: Flowchart for Identifying and Assessing the Risk of Material Misstatement | Graphical representation of the process to identify and assess the risks of material misstatement, described in Part 6 of ED-ISA for LCE. This flowchart illustrates the iterative nature of the process.   |
| Appendix 3: Fraud Risk Factors  | Examples of fraud risk factors that may be relevant in an audit of an LCE.  |
| Appendix 4: Assertions  | Describes the categories of assertions to be considered in an audit of an LCE. The assertions are the same as presented in the ISAs.  |
| Appendix 5: Illustrative Engagement Letter  | An illustrative engagement letter that may be used to document the terms of engagement when using ED-ISA for LCE.   |
| Appendix 6: Illustrative Representation Letter  | An illustrative representation letter that may be used when obtaining written representations from management when using ED-ISA for LCE.  |

108. The nature and circumstances of an audit of an LCE as contemplated by ED-ISA for LCE is such that it is less complicated (or more straightforward), and where appropriate this more straightforward nature has been taken into account when considering the ISA requirements that would be core to an audit of an LCE. The following highlights some of the more significant areas where it may be helpful for respondents to understand the specific approach applied in ED-ISA for LCE.

*Documentation Requirements*

109. The approach to documentation in ED-ISA for LCE is the same as the approach to documentation in the ISAs.
110. The documentation requirements include overarching principles in Part 2 on the basis that documentation should be sufficient to enable an experienced auditor, having no previous experience with the audit, to understand the nature, timing and extent of the audit procedures undertaken, the results of the audit procedures and the audit evidence obtained, significant matters arising during the audit and the conclusions thereon, including significant professional judgements made in reaching those conclusions.
111. The individual Parts contain relevant specific documentation requirements, in the same way as the ISAs contain more specific documentation requirements, which are to be complied with in addition to the general documentation requirements set out in Part 2.

*Planning the Audit – the Audit Plan*

112. The auditor is still required to plan the audit in the same manner as the ISAs require the audit to be planned. However, one of the areas where the IAASB has modulated the proposed standard is to not distinguish between the 'overall audit strategy' and the 'audit plan' as would be required by the ISAs. In doing so, however, the relevant outcomes of what the auditor would need to do with regard to establishing the overall audit strategy and audit plan have been incorporated (i.e., there is still a requirement to establish and plan the scope, timing and direction of the audit).

*Risk Identification and Assessment*

113. Part 6 of ED-ISA for LCE addresses the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control. This understanding broadly covers the requirements within ISA 315 (Revised 2019) and a flowchart to support the auditor's understanding has been presented in Appendix 2.
114. During the development of ED-ISA for LCE, views were heard that this was an area that could be significantly modified for the typical nature and circumstances of an LCE. The IAASB is of the view that risk identification and assessment is foundational to an audit and that the robust changes made in ISA 315 (Revised) 2019 should be largely retained given ISA 315 (Revised 2019) is not yet effective and it is premature to make too many changes in respect of a standard that has only been recently revised. However, some adaptations have been made (as explained further below), where appropriate, to take account of the more straightforward nature and circumstances of an LCE.
115. Although ED-ISA for LCE retains the core requirements of ISA 315 (Revised 2019), the document does not include other aspects of some requirements that would more likely apply in circumstances where an entity is more complex. Core requirements that have been incorporated include:
- (a) The new concepts introduced in ISA 315 (Revised 2019) such as spectrum of inherent risk, inherent risk factors, relevant assertions and significant classes of transactions, account

balances and disclosures. The IAASB has the view that these concepts assist the auditor in identifying and assessing the risks of material misstatement, and therefore should be retained.

- (b) The concept of significant risk, consistent with ISA 315 (Revised 2019). By retaining all of these concepts, the robustness of the risk identification and assessment introduced in ISA 315 (Revised 2019) has been maintained.
  - (c) The requirement to evaluate whether a control is ‘designed effectively and to determine whether the control has been implemented’ (D&I) on all controls identified that address risks of material misstatement (as set out in paragraph 6.3.14.).
116. Examples of requirements, or aspects of requirements, that have not been retained, because they are less likely to apply in the circumstances where an entity is less complex include:
- (a) Some of the specific matters within the understanding of the control components (e.g., aspects of the control environment) because they would likely not exist in an LCE environment.
  - (b) The ‘stand-back’ requirement to evaluate the completeness of significant classes of transactions, account balances and disclosures where they are material.
117. Because of the way that the proposed standard has been structured, i.e., following the flow of an audit and not topic specific, relevant requirements from other ISAs that explain how to apply ISA 315 (Revised 2019) in specific circumstances have also been included as appropriate, including:
- Fraud (from ISA 240<sup>31</sup>).
  - Laws and regulations (from ISA 250 (Revised)<sup>32</sup>).
  - Accounting estimates (from ISA 540 (Revised)).
  - Related parties (from ISA 550<sup>33</sup>).
  - Using service organizations (from ISA 402<sup>34</sup>).
118. A new section has also been added collating all of the various specific “inquiries” of management throughout the various standards to enable an easier understanding of the specific matters that need to be addressed.

#### *Requirements Relating to Reporting*

119. The auditor’s report is the key communication to the intended user. Consistent with the approach of using the ISAs as a base for developing ED-ISA for LCE, the IAASB has the view that the auditor’s report required by the proposed standard, as a communication tool with respect to various aspects of the audit, should provide the same information as an ISA auditor’s report, but with the transparency for users of those reports as to which standard(s) have been used. Balancing these needs with the need to keep the proposed standard understandable and succinct, the IAASB recognized that keeping the reporting requirements clear is a critical part in the development of the proposed standard.

<sup>31</sup> ISA 240, *The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements*

<sup>32</sup> ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statement*

<sup>33</sup> ISA 550, *Related Parties*

<sup>34</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

120. During the development of the proposed standard, a number of different approaches on how to present auditor reporting requirements were explored. Initially the reporting requirements were kept to a bare minimum. However, the IAASB had the view that this could result in inappropriate reporting if anything other than an unmodified report was issued. The IAASB also considered whether to reference to the ISA reporting standards for the relevant reporting requirements, being mindful of the volume that the many reporting requirements could add to ED-ISA for LCE. However, this would also not be consistent with the standalone nature of the standard and therefore the IAASB concluded that this was not an appropriate option.
121. The IAASB therefore further deliberated how the reporting requirements could be incorporated in a clear and concise manner, and to be consistent with the principles that have been applied for incorporating requirements from the rest of the ISAs. Part 9 of ED-ISA for LCE presents the reporting requirements using the following approach:
- (a) Providing a specified content and format for an unmodified auditor's report. Departures from the wording of the report are not permitted except where required for compliance with law or regulation, or when the opinion or report needs to be modified in response to the specific engagement circumstances.
  - (b) Using tables to present requirements related to the circumstances that may lead to the modification of reports, and the text that may be used in the report where modifications occur.
  - (c) Using tables to present the form and content when using emphasis of matter, other matter, material uncertainty related to going concern and other information paragraphs.
  - (d) Including requirements in a standard text format where the presentation is not specified above.
122. The IAASB is of the view that this presentation is consistent with the design of the proposed standard, appropriate for the circumstances of an audit of an LCE, and that all requirements that would be generally relevant to an audit of an LCE have been included. In addition, the IAASB has the view that having a specified format for the auditor's report would be easier for users of the proposed standard and improve consistency in application. However, it is acknowledged that the presentation of the requirements, including specifying the content and format of the auditor's report, is a different approach to the ISAs and therefore input regarding this approach is requested.
123. The key differences between an auditor's report in ED-ISA for LCE and an ISA auditor's (unmodified) report include:
- (a) Within the Basis for Opinion and the Auditor's Responsibilities sections: the auditor's report refers to the audit being conducted in accordance with the ISA for LCE.
  - (b) There is no ability to present the auditor's responsibilities elsewhere except in the body of the auditor's report. The ISAs also allow the auditor's responsibilities to be presented within an appendix to the auditor's report or by specific reference within the auditor's report to the location of such description on a website of an appropriate authority where expressly permitted by law, regulation or national auditing standards.
124. In addition to the requirements in Part 9, the IAASB has developed a non-authoritative guide (*Supplementary Guidance – Reporting* (the Reporting Supplemental Guide) that can be found on the [ISA for LCE Exposure Draft webpage](#)) to provide further guidance and examples on modifications to the auditor's report, including a number of full illustrative reports. This Reporting Supplemental Guide also addresses changes to the auditor's report for emphasis of matter paragraphs, other matter

paragraphs, as well as further guidance as to which reports may be appropriate in various circumstances.

*Definitions (Glossary of Terms)*

125. Consideration was given to how the relevant definitions could be incorporated into ED-ISA for LCE, being mindful of the length of the standard and taking into account the length that the definitions would add.
126. The IAASB considered whether the IAASB Handbook glossary could be referred to, but it was reinforced that the definitions needed to form part of ED-ISA for LCE and not be situated outside of the standard as that could lead to questions about the authority of the definitions within the proposed standard. Although the IAASB considers that adding the relevant ISA definitions to the standard would add length to the standard, it also recognizes that these definitions need to form part of the standard (as they need to be within the remit of its authority). The IAASB therefore resolved to include the definitions in an appendix to the proposed standard.
127. The definitions in Appendix 1 of ED-ISA for LCE can be accessed via a link in ED-ISA for LCE – these definitions are not subject to consultation (as they already are defined in the full ISAs and there is no intention to have any different meanings between the same terms in the two sets of standards).
128. Once ED-ISA for LCE is moved into an electronic format, this will become less of an issue as all definitions will be incorporated in the same way (i.e., a “pop-up” with the relevant definition will appear once a term that is defined is selected).
129. It has also been clarified in Part 1 of the proposed standard that the entire text of the ED-ISA for LCE (which would include the appendices (i.e., the definitions)), is relevant to an understanding of the objectives of the proposed standard and the proper application of the requirements. In this way the definitions have been incorporated into the authoritative text of the proposed standard.

***Request for Comment – Specific Questions***

9. Please provide your views on the content of each of **Parts 1 through 8** of ED-ISA for LCE, including the completeness of each part. In responding to this question, please distinguish your comments by using a subheading for each of the Parts of the proposed standard.
10. For **Part 9**, do you agree with the approach taken in ED-ISA for LCE with regard to auditor reporting requirements, including:
  - (a) The presentation, content and completeness of Part 9.
  - (b) The approach to include a specified format and content of an unmodified auditor’s report as a requirement?
  - (c) The approach to providing example auditor’s reports in the Reporting Supplemental Guide.
11. With regard to the Reporting Supplemental Guide:
  - (a) Is the support material helpful, and if not, why not?
  - (b) Are there any other matters that should be included in relation to reporting?
12. Are there any areas within Parts 1–9 of the proposed standard where, in your view, the standard can be improved? If so, provide your reasons and describe any such

improvements. It will be helpful if you clearly indicate the specific Part(s) which your comments relate to.

#### Section 4F – Other Matters

##### *Transitioning Between ED-ISA for LCE and the ISAs*

130. The auditor is required to consider whether the proposed standard is appropriate to use (in terms of the Authority set out in Part A):
- (a) *At engagement acceptance or continuance.* If it is determined that there is complexity present that has not been contemplated by ED-ISA for LCE, the use of ED-ISA for LCE is not appropriate for the audit engagement and:
    - (i) If an initial audit engagement (i.e., initial acceptance phase), ED-ISA for LCE cannot be used; or
    - (ii) If a recurring audit engagement (i.e., continuance phase) the audit will need to be transitioned to the ISAs or other applicable auditing standards.
  - (b) *Subsequent to engagement acceptance or continuance.* If a matter or circumstance is found during the audit that exhibits complexity that has not been contemplated by the proposed standard, a determination will need to be made whether ED-ISA for LCE is still appropriate or the audit will need to be transitioned to the ISAs or other applicable auditing standards.
131. It was anticipated or intended, when designing ED-ISA for LCE, that it should be relatively rare for an audit of an entity to need to transition after engagement acceptance or continuance from using ED-ISA for LCE to using the ISAs. The specific prohibitions or relevant qualitative characteristics (e.g., a listed entity, a group audit, or an entity whose function is to perform certain activities, or the characteristics of the entity such as a complex ownership structure, complex IT systems, complex regulatory oversight etc.) are likely to be known at the time of engagement acceptance or continuance. Therefore, unknown complexities that would require a change for using ED-ISA for LCE would likely be relatively infrequent.
132. However, the exception to this may be accounting estimates. The entity may have initiated transactions that have resulted in complex accounting estimates in the period under audit that are not known to the auditor at the time of client acceptance or continuance and are discovered during the course of the audit. Regardless, if there is an indicator that there may be complex matters or circumstances the auditor will need to determine whether the proposed standard is still appropriate to use, and transition if necessary.
133. While the presence of one ‘complexity’ characteristic exhibited by an entity does not necessarily exclude the use of ED-ISA for LCE for that entity, it would not be appropriate to continue performing the audit under the proposed standard if the complex matter or circumstance identified has not been contemplated in the design of ED-ISA for LCE (see Part A of ED-ISA for LCE, paragraphs A.8. and A.9.).
134. Paragraph A.9. in ED-ISA for LCE specifies that “notwithstanding that professional judgment is used in determining whether the [draft] standard is appropriate to use, if there is uncertainty about whether an audit is an audit of the financial statements of an LCE, the use of the [draft] ISA for LCE is not appropriate.” This concept of ‘if in doubt, you are out’ is relevant when an auditor is making the determination whether ED-ISA for LCE is appropriate for an audit engagement, including for recurring audits.

135. When determining whether ED-ISA for LCE is appropriate to use on a recurring audit, indicators of complexity that were present in the previous period are taken into account, including considering whether those indicators have changed or whether there are new indicators that would otherwise result in a determination that ED-ISA for LCE is not appropriate for use in the current period.

The Process for Transitioning to the ISAs or Other Applicable Auditing Standards

136. If it is found that ED-ISA for LCE is not appropriate at either the continuance phase or during the audit (because matters of complexity not contemplated by the proposed standard have arisen) the audit will need to be transitioned to use the ISAs or other applicable auditing standards.
137. The IAASB considered whether there were other options that may be provided to an auditor in the circumstance that complex matters or transactions were identified during an audit. As described in paragraph 26, the standalone nature of ED-ISA for LCE means that there is no ability to directly reference back to the ISAs to allow the auditor to use ISA requirements for matters or transactions that are not included in the proposed standard. For example, if a complex accounting estimate is discovered that involves complex modelling there is no ability to reference ISA 540 (Revised) in order to obtain sufficient appropriate audit evidence about the complex accounting estimate, while performing the rest of the audit using ED-ISA for LCE.
138. The IAASB also considered the use of additional “modules,” which may contain specific procedures for a more complex topic or area that could be “added on” where needed. However, this approach was not deemed to be appropriate as the premise of the design of ED-ISA for LCE is that all the requirements in the standard are designed to be proportionate to the typical nature and circumstances of an audit of an LCE. It would also be difficult to identify appropriate discrete modules of “incremental requirements” for each individual circumstance of complexity that may occur. The IAASB also had concerns that this would make the standard less understandable and would conflict with the intended drafting principles of including requirements in the standalone standard. There is also the potential that such modules are used inappropriately if it is not clear about when the modules are appropriate for use (i.e., used for complex matters or circumstances on an ongoing basis that is more than what was intended for purposes of determining that the audit an audit of an LCE overall).
139. If it is determined that ED-ISA for LCE is no longer appropriate for use in an audit engagement, to transition the auditor would broadly need to (as appropriate in the circumstances):
- (a) Re-establish the terms of engagement, for example through the issuance of an updated engagement letter.
  - (b) Reissue communications with those charged with governance, where relevant.
  - (c) Evaluate whether sufficient work has been performed with regard to planning the audit, including:
    - (i) Establishing an overall audit strategy.
    - (ii) Determining whether the audit plan is sufficient and appropriate.
    - (iii) Determining whether experts or others (e.g., internal audit) need to be involved, to address the complex circumstance(s).
    - (iv) Determining the work to be performed at a service organization (if applicable).
  - (d) Consider whether there are any additional procedures required on opening balances.

- (e) Evaluate the sufficiency and appropriateness of work already performed, including with respect to:
  - (i) Understanding the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, and risk identification and assessment.
  - (ii) Further audit procedures that have already been designed and performed.
  - (iii) Documentation.
- (f) Design and perform additional procedures necessary to comply with all applicable ISA requirements (or requirements of other applicable auditing standards), with additional documentation as appropriate.
- (g) Undertake other actions as considered necessary to meet the objectives of the ISAs (or requirements of other applicable auditing standards) or to meet the obligations in terms of the firm's policies or procedures.

Where transitioning to the ISAs is necessary during an audit, the auditor is required to comply with all ISA requirements relevant to the audit to be able to represent compliance with the ISAs in the auditor's report. The incremental procedures needed will vary and will also depend on the firm's methodologies and the circumstances of the audit engagement.

140. The auditor's report should also clearly indicate which auditing standards are used for the period under audit. Where the auditor's report refers to a previous period under audit, for example due to circumstances relevant under ISA 710,<sup>35</sup> the auditing standards used for the prior period should also be clearly stated. It is anticipated that illustrative reports demonstrating such circumstances will be included in implementation material provided alongside the release of the final ISA for LCE.
141. Firms and auditors that perform audits under both sets of standards will need to have an understanding of the "differences" between ED-ISA for LCE and the ISAs to navigate this situation in a practical manner, including when designing methodologies and tools. The detailed differences between ED-ISA for LCE and the ISAs are set out in the mapping documents discussed in paragraph 77. It is acknowledged that when the proposed standard is finalized, implementation material would be useful to further guide auditors through transitioning to the ISAs, and therefore the IAASB would like to further explore what may be needed at a global level.

***Request for Comments – Specific Question***

13. Please provide your views on transitioning:

- (a) Are there any aspects of the proposed standard, further to what has been described above, that may create challenges for transitioning to the ISAs?
- (b) What support materials would assist in addressing these challenges?

*Maintenance of ED-ISA for LCE*

142. The content of ED-ISA for LCE is intrinsically linked to the ISAs as it is based on the ISA requirements adapted as relevant for the nature and circumstances of an audit of an LCE. Questions have arisen

<sup>35</sup> ISA 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements*



regarding how the proposed standard will be updated when the IAASB makes changes to revise the broader suite of ISAs.

143. Throughout the project, the IAASB has deliberated the approach to maintaining the standard after issuance. The IAASB acknowledged feedback that a stable platform should be maintained where possible. This message is consistently heard in outreach with stakeholders representing SMPs and SMEs, and has been described as a significant factor that would be considered in the decision to adopt and use the standard.
144. It has also been highlighted by relevant stakeholders that the amendments to the ISAs are often targeted at issues identified through inspections or other mechanisms highlighting issues within entities with more significant public interest characteristics.
145. The IAASB acknowledges some stakeholders believe that, because of the nature and circumstances of the entities for which ED-ISA for LCE would be appropriate, there is less urgency to make immediate changes, because there would be lower imminent risk to audit quality. This would be consistent with the view that the extant ISAs provide high-quality audits even when there is a new or revised standard finalized but not yet effective or has not been adopted at the effective date.
146. However, the need for a stable platform is balanced by the IAASB's desire to ensure standards are up to date, consistent and that requirements relating to the same topic are not substantially different between ED-ISA for LCE and the ISAs. Not updating ED-ISA for LCE on the same timeline as revisions to ISAs will create a timing difference in the effective date of requirements applicable to the same topic under both sets of standards, which may cause confusion for auditors and implementation challenges for firms that perform audits using both the ISAs and ED-ISA for LCE (for example, with respect to relevant firm policies or procedures, or the firm's audit methodology).
147. Therefore, on balance the IAASB agreed to commit to propose that amendments to ED-ISA for LCE will be made periodically when projects to revise ISAs are undertaken. As part of each ISA project, it is intended that there will be explicit consideration of when the changes to ED-ISA for LCE will be made, and proposals for those changes that are needed to ED-ISA for LCE developed accordingly. In addition, when developing an exposure draft for revisions to ED-ISA for LCE, the IAASB would also consider any specific issues that have been brought to the attention of the IAASB regarding application of ED-ISA for LCE.
148. If there is an urgent matter(s) that would make ED-ISA for LCE inoperable in the circumstance if a change(s) is not made, there is also the ability to process a narrow scope amendment to make such a change. It is expected that updates to the supplemental guidance (Authority and Reporting) will be made using the same timescale as changes to the proposed standard.
149. The IAASB expects that there will be a period of at least eighteen months between when any final amendments to ED-ISA for LCE are issued and the effective date of the updated revised standard, with the option to adopt revisions early (in the same way that newly revised or issued ISAs may be adopted early).

*ISA 800-Series*

150. Requirements relating to the ISA 800-series<sup>36</sup> have not been included in ED-ISA for LCE as the IAASB agreed to focus on developing an auditing standard for audits of complete sets of general purpose financial statements of LCEs first. It is the view of the IAASB that consideration will be given at a later time to adding a Part(s) to address special considerations in the application of the requirements of Parts 1–9 to financial statements prepared in accordance with special purpose frameworks and audits of single financial statements and specific elements, accounts or items of a financial statement, as well as, if a need exists, to address summary financial statements.

**Request for Comment – Specific Questions**

14. Do you agree with the proposed approach to the future updates and maintenance of the Standard and related supplemental guidance?
15. For any subsequent revisions to the standard once effective, should early adoption be allowed? If not, why not?
16. Should a separate Part on the ISA-800 series be included within ED-ISA for LCE? Please provide reasons for your response.
17. In your view, would ED-ISA for LCE meet the needs of users and other stakeholders for an engagement that enables the auditor to obtain reasonable assurance to express an audit opinion and for which the proposed standard has been developed? If not, why not. Please structure your comments to this question as follows:
- (a) Whether the proposed standard can, and will, be used in your jurisdiction.
  - (b) Whether the proposed standard meets the needs of auditors, audited entities, users of audited financial statements and other stakeholders.
  - (c) Whether there are aspects of the proposed standard that may create challenges for implementation (if so, how such challenges may be addressed).
18. Are there any other matters related to ED-ISA for LCE that the IAASB should consider as it progresses the proposed standard to finalization?

**Section 4G - Approach to Consultation and Finalization**

151. This exposure draft and accompanying explanatory memorandum (and the supplemental materials) will be translated into Spanish and French. These translated documents are expected to be published by mid-September 2021).
152. The IAASB is also planning a program of outreach with the objective of encouraging feedback on the proposed standard from all of the IAASB's stakeholders with an interest in matters related to audits of less complex entities. These include:
- (a) Social Media, Videos, Press Releases, Articles and Communiques.
  - (b) Global and regional webinars, including roundtables where feasible.

<sup>36</sup> The ISA 800-series includes: ISA 800 (Revised), *Special Considerations – Audits of Financial Statements prepared in accordance with Special Purpose Frameworks*; ISA 805 (Revised), *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* and ISA 810 (Revised), *Engagements to Report on Summary Financial Statements*.

(c) Working with the IFAC to reach a broad stakeholder base.

An outline of the intended outreach will be posted on the IAASB's website before the end of August 2021.

153. The IAASB also recognizes the need for guidance and support for practitioners and local jurisdictions for implementing the new standard when it has been finalized, particularly given the limited EEM that is included within the proposed standard. Although not in its standard-setting mandate, the IAASB will further consider how it can work, as appropriate, with NSS, IFAC and others to develop such guidance and support materials needed. The IAASB welcomes comment on what support and guidance would be useful when implementing and using the proposed standard.

***Request for Comments – Specific Question***

19. What support and guidance would be useful when implementing the proposed standard?

***Request for Comments – General Questions***

In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

20. Translations—recognizing that many respondents may intend to translate the final ISA for LCE in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing ED-ISA for LCE.
21. Effective Date—Recognizing ISA for LCE is a new standard, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final standard. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA for LCE.

## Section 5 Group Audits

154. The Authority of ED-ISA for LCE specifically prohibits use of the proposed standard for group audits. Accordingly, if the audit is a group audit (as defined – see footnote 3 in Part A of ED-ISA for LCE), the proposed standard cannot be used and the auditor will need to use the ISAs or other applicable auditing standards.
155. As indicated in Section 4B (paragraphs 62-63), when deciding to exclude group audits, the IAASB had the view that group audits inherently exhibit characteristics of complexity, and consistent with other areas of complexity, have not been contemplated in the design of the proposed standard. The perceived complexity (as discussed below in paragraph 158) would drive special considerations that would expand the auditor’s requirements throughout the audit process.
156. However, some stakeholders have the view that group audits, that otherwise meet the requirements to use ED-ISA for LCE, should be included in the scope of the proposed standard. It was highlighted that this exclusion could potentially impact the uptake of the proposed standard once finalized. Therefore, the IAASB believes that this is a specific area where it would like further information in order to determine whether to include group audits in the proposed standard as it is finalized.
157. The remainder of Section 5 elaborates on the matters highlighted in paragraphs 154–156, above, in the context of whether a group audit could be an audit of an LCE and, therefore, should be included in the scope of ED-ISA for LCE. This should be distinguished from a situation where a single legal entity is a component of a group and that entity’s financial statements are audited for statutory or other reasons, and the auditor of such entity is also involved in performing audit work for the purposes of the group audit at the request of the group auditor (i.e., is also a component auditor). The decision whether ED-ISA for LCE is appropriate to use for the audit of that entity’s financial statements for statutory or other reasons will be taken in accordance with the Authority in Part A of the proposed standard. The group auditor is responsible for the group audit, including, among other matters, providing clear direction to the component auditor about the nature, timing and extent of the work to be performed for purposes of the group audit – the group auditor will need to determine whether the use of ED-ISA for LCE in that regard (i.e., at the component level) is sufficient for their purposes.

### *Complexity when Performing Group Audits*

158. In addition to the matters regarding complexity as set out in the Authority for non-group audits, there are matters specifically relating to group financial statements that could potentially make the audit more complex. This includes, for example:
- *The complexity of the group’s structure.* A group may be more complex than a single entity because a group may have several subsidiaries, equity- accounted investments, branches or divisions or other entities or business units, sometimes in multiple locations. Its legal structure may also be different from the operating structure (e.g., for tax purposes). The complexity of the group structure could also include consideration of accounting for goodwill, joint ventures or special purpose entities that may also increase the complexity of the audit.
  - *The geographic locations of the group’s operations.* Having a group that is located in multiple geographical locations may give rise to increased complexities arising from different laws or regulations, languages, cultures and business practices, and there may be more complexities with obtaining sufficient appropriate audit evidence, including because of cultural and language issues, or access issues.

- *The structure and complexity of the group's IT environment and IT systems.* For example, a group may have a complex IT environment and systems because the IT systems for different entities within the group are not integrated (e.g., because of recent acquisitions or mergers). A group may also use one or more external service providers for aspects of its IT.
- *Relevant regulatory factors, including the regulatory environment.* A group may have operations that are subject to law or regulation in multiple jurisdictions, or entities or business units in the group that operate in multiple industries that are subject to different types of laws or regulations.
- *The ownership, and relationships between owners and other people or entities, including related parties.* Understanding the ownership and relationships can be more complex in a group that involves many entities or business units or that operate over multiple jurisdictions. Complexities may also arise when there are changes in ownership through formation, acquisitions or joint ventures.
- *The consolidation process used by the group (e.g., sub-consolidations and consolidation adjustments).* The level of centralization versus decentralization of the group's activities or processes relevant to its financial reporting process, and the consistency of the accounting policies and practices applied across the group may also add complexity to the consolidation process.

*Including or Excluding Group Audits from the Scope of ED-ISA for LCE*

159. The IAASB is open to reconsidering the decision to exclude group audits based on stakeholder feedback. If group audits are to be included in the proposed standard, the IAASB would like to explore how this could be done.
160. Therefore, in the first instance, alternatives in relation to group audits are:
- (a) Group audits continue to be excluded from the scope of the proposed standard (consistent with ED-ISA for LCE); **OR**
  - (b) Group audits are included in the scope of the proposed standard. If group audits are to be included, there is further consideration needed about how this can be done, which is discussed further below.
161. If group audits continue to be excluded from ED-ISA for LCE, this retains the status quo and no further changes are needed to either the Authority or the broader content of the proposed standard.
162. If group audits are to be included in ED-ISA for LCE:
- This would result in additional requirements, which would make the proposed standard longer and potentially more complex.
  - More professional judgment may be needed in determining whether ED-ISA for LCE could be used (depending how any requirements for group audits are incorporated).
  - Some jurisdictions could potentially not adopt the standard.

*Alternatives for Including Group Audits in the Scope of ED-ISA for LCE*

163. If the decision is made subsequent to the exposure period, based on the responses received, to include group audits in the scope of ED-ISA for LCE, the IAASB will need to consider how this could be done. For example:

- (a) The IAASB could decide on 'proxies for complexity,' for example through specific prohibitions, that limits entities that are groups from using the proposed standard if they fall outside of the prescribed boundaries; **OR**
- (b) The proposed standard describes the qualitative characteristics of complexity in a group audit and leaves the decision about complexity to the users of the proposed standard (in a similar way that the qualitative characteristics are operationalized in the Authority of ED-ISA for LCE).

There are benefits and disadvantages to both alternatives, which are set out below.

164. Decisions about how to include group audits in the proposed standard will determine the content incorporated in ED-ISA for LCE if the decision is made to include group audits. Therefore, the IAASB would like to hear stakeholder views on this.

#### Broad Impact on ED-ISA for LCE

165. If the decision is made to include group audits within the scope of ED-ISA for LCE, the specific exclusion in paragraph A.7.(d) in ED-ISA for LCE will need to be removed. Further changes to the Authority will also need to be made depending on the decisions made as to how to incorporate group audits, including but not limited to the judgments that will need to be made in respect of the less complex nature of the group audit.
166. For example, professional judgment will need to be applied for the following at the engagement level:
- (a) Whether the group as a whole meets the attributes of complexity that are already embedded within the Authority of ED-ISA for LCE (i.e., whether the audit is an audit of an LCE).
  - (b) If the option to allow the auditor to determine complexity of the group, any additional matters that are relevant to the complexity of group audits as set out in the standard.
167. ISA 600 (Revised)<sup>37</sup> addresses the special considerations that apply to group audits, including requirements for when component auditors are involved. The requirements in ISA 600 build on the requirements in other ISAs as they relate to and include additional requirements for the special considerations in group audit circumstances. If group audits are included in the scope of ED-ISA for LCE, the core requirements for an audit of a group audit in ISA 600 (Revised) will be considered in the same way that the core requirements from the other applicable ISAs have been included (refer to the broad principles for requirements in the proposed standard as discussed in Section 4E).
168. In addition, any new or revised definitions in ISA 600 (Revised) would need to be added to the other definitions within Appendix 1 of ED-ISA for LCE. EEM may also be needed on the same basis as other EEM has been included in the proposed standard. Further consideration may also be needed for revisions to the objectives of the relevant Parts.

#### **Option 1: IAASB uses a proxy(ies) for complexity**

169. If the IAASB uses a proxy(ies) for complexity, the IAASB would establish a "cut-off" or threshold for when the proposed standard may be used (these proxies relate specifically to group audits as it is assumed that the group would not otherwise be excluded due to the other limitations set out in the Authority to use the standard). These 'indicators of complexity' could include, for example:
- (a) The involvement of component auditors.

<sup>37</sup> See paragraph 63 in Section 4B

- (b) When entities or business units included in the group financial statements are situated in multiple locations that are in different jurisdictions or subject to different regulatory requirements.
170. To illustrate, and using the involvement of component auditors as an example, although the involvement of component auditors in itself does not necessarily drive complexity, the reasons why component auditors would need to be involved are often indicative of complexity (e.g., there may be different jurisdictions, different languages, different laws or regulations, decentralized activities, including information systems and controls, greater experience and more in-depth knowledge of local requirements by the component auditors, etc.). Therefore, the use of component auditors could be seen as a 'proxy' for other matters that would increase complexity.
171. By making the decision upfront about complexity and creating a cut off or setting a threshold, some IAASB members had the view that this option is easier to apply in practice and will involve less significant judgments about the complexity of the group.
172. However, it was highlighted by some Board members that this approach also carries the risk that the ability to use the standard could drive other decisions about the audit, such as whether component auditors are used or not, when it would otherwise be appropriate to do so to achieve a quality audit. In addition, by having a restrictive proxy(ies) for complexity, there may still be group audits that are inadvertently excluded from the scope of the proposed standard when they would otherwise be able to use the standard.

#### Impact on ED-ISA for LCE

173. If the approach to incorporating group audits is to use a cut-off or threshold as a proxy for complexity (i.e., to prescribe the types of group audits where it is appropriate to use the standard), only certain requirements from ISA 600 (Revised) would need to be incorporated (for example, if the cut-off is the involvement of component auditors, then any requirements relating to the work of component auditors could be omitted).
174. However, requirements to address other considerations that are relevant in a group audit engagement would still need to be included from ISA 600 (Revised)<sup>38</sup> (on the same basis as the other 'core requirements' from the other ISAs have been incorporated in the proposed standard). This would include, for example, requirements related to the group audit plan, understanding the group and its environment, the applicable financial reporting framework for the group and the group's system of internal control (for all entities or business units within the group), the consolidation process, communications with management and those charged with governance relevant to the group audit, and evaluating whether sufficient appropriate audit evidence has been obtained on which to base the group audit opinion.
175. If the approach to incorporating group audits is to use a cut-off or threshold as a proxy for complexity (i.e., to prescribe the types of group audits where it is appropriate to use the standard), only certain requirements from ISA 600 (Revised) would need to be incorporated (for example, if the cut-off is the involvement of component auditors, then any requirements relating to the work of component auditors could be omitted).

<sup>38</sup> The finalization of the revisions to ISA 600 (Revised) is expected in December 2021, and therefore this version of the standard will be used should the decision be made to incorporate group audits in the scope of ED-ISA for LCE.

**Option 2: Qualitative characteristics are used to determine whether the proposed standard is appropriate to use for a group audit**

176. Alternatively, ED-ISA for LCE could set out qualitative characteristics (as described in paragraph 158) specific to groups to help users of the proposed standard determine themselves whether a group would meet the complexity threshold for the purpose of using ED-ISA for LCE.
177. The rationale for this option is consistent with the view that the characteristic used in any cut off or threshold may not in itself, or by itself, necessarily drive complexity of the group audit.
178. This option would allow the firm or the auditor to consider whether there are matters that give rise to complexity specific to the nature and circumstances of that (group) entity, and would therefore be more consistent with the basic premise of ED-ISA for LCE (i.e., it applies to entities that are less complex, whether or not it is an audit of group financial statements, or whether component auditors are involved, the audit is performed across multiple jurisdictions, etc.). However, in of itself this approach would increase the judgment needed about whether the standard is appropriate or not.
179. The use of more judgment may be of concern to some stakeholders who may see an increase in the risk that ED-ISA for LCE will be inappropriately used. The increased use of judgment would also require more documentation about the determination of the appropriateness of using ED-ISA for LCE.

Impact on ED-ISA for LCE

180. If group audits are incorporated based on qualitative characteristics of groups that are less complex, all core requirements in ISA 600 (Revised) would need to be included, as relevant and proportionate for an LCE engagement (i.e., requirements relevant to a group audit as described in paragraph 167 above, as well as those that may otherwise have been excluded had a threshold been used, such as those described in paragraph 174). This approach is likely to add substantial length to ED-ISA for LCE.

***Request for Comments – Specific Questions***

22. The IAASB is looking for views on whether group audits should be excluded from (or included in) the scope of ED-ISA for LCE? Please provide reasons for your answer.
23. Respondents in public practice are asked to share information about the impact of excluding group audits from the scope of ED-ISA for LCE on the use of the proposed standard. In particular:
- (a) Would you use the standard if group audits are excluded? If not, why not?
  - (b) Approximately what % of the audits within your firm or practice would be group audits that would likely be able to use ED-ISA for LCE (i.e., because it is likely that such group audits could be considered less complex entities for the purpose of the proposed standard) except for the specific exclusion?
  - (c) What common examples of group structures and circumstances within your practice would be considered a less complex group.
24. If group audits are to be included in the scope of ED-ISA for LCE, how should be done (please provide reasons for your preferred option):
- (a) The IAASB establishes a proxy(ies) for complexity for when the proposed standard may be used (“Option 1 - see paragraph 169); or



- (b) ED-ISA for LCE sets out qualitative characteristics for complexity specific to groups (Option 2 - see paragraph 176), to help users of the proposed standard to determine themselves whether a group would meet the complexity threshold.
25. Are there other ways that group audits could be incorporated into the scope of the proposed standard that is not reflected in the alternatives described above? For example, are there proxies for complexity other than what is presented in paragraph 169 that the IAASB should consider?

*Proposed Presentation of the Group Audits Requirements in the ISA for LCE*

181. The IAASB would also like to explore how group audit requirements can be presented within the standard if group audits are included in the scope of ED-ISA for LCE. Alternative presentations include:

- (a) *Presenting all requirements pertaining to group audits in a separate Part to ED-ISA for LCE (for example, in Part 10).*

This approach would have the benefit that all requirements relating to group audits would be comprehensively presented together in one Part of the proposed ISA for LCE (i.e., as special considerations for group audits). This approach would also allow for easy ‘carving out’ of the Part should some jurisdictions decide that this would not be appropriate to be applied in that jurisdiction, or can be ignored by auditors if the audit is not an audit of group financial statements. Because ED-ISA for LCE is written in the ‘flow of the audit’, under this option, it would likely be necessary to cross-reference to this separate Part so as to make a connection between the flow of the audit process and the auditor’s related considerations relevant to groups (i.e., this would be similar to how ISA 600 interacts with the other ISAs).

- (b) *Presenting the requirements pertaining to group audits within each Part of ED-ISA for LCE (where applicable)*

Under this option the requirements for group audits will be presented within each relevant Part. The requirements relevant to group audits could be presented in separate boxes, or as a subsection, in each Part to distinguish them and facilitate their easy reference. The benefit of this approach would be that if the audit is an audit of group financial statements, the auditor would have access to all relevant requirements organized in the flow of the audit which is consistent with how the proposed standard has been developed. In those circumstances when the requirements for group audits apply, the auditor would have easy access to the group audit procedures in the flow of the audit, and would not have to refer to another Part to determine the relevant requirements.

***Request for Comments – Specific Question***

26. If group audits are included in ED-ISA for LCE, how should the relevant requirements be presented within the proposed standard (please provide reasons for your preferred option):
- (a) Presenting all requirements pertaining to group audits in a separate Part; or
- (b) Presenting the requirements pertaining to group audits within each relevant Part.

## Appendix 1 – Summary of Relevant Local Initiatives

| Country/Region | Initiative Type                       | Summary   |
|----------------|---------------------------------------|---|
| Belgium        | Separate Standard<br>(In use)         | In March 2019, Belgium published a statutory standard for auditing SMEs and small not-for-profit entities. This standard on contractual audits of SMEs, can be performed by both the registered auditors and the external accountants. It does not apply to statutory audits (for which only the ISAs apply) and includes the possibility to apply the ISAs if agreed between the relevant parties. The definition of an SME is linked to the threshold for mandatory audits. However, when the SME is considered to be complex, the registered auditors apply the ISAs.  |
| France         | Separate Standard<br>(In use)         | In June 2019, the French Institutes issued two separate and standalone standards for the audit of small entities (SEs): NEP 911 and NEP 912 (the selection of which is based on if the auditor is engaged for a period of three or six years). The standards can be used where there is no legal requirement to appoint a statutory audit, amongst other criteria. The objective of such standards is to define a proportionate audit approach and to set only the basic, principles based, requirements which are necessary in an audit of a SE. The standards are short, i.e., only 10 pages and standalone, i.e., with no reference to other standards. They use the same notion and lead to the same final product as the “traditional” audit, i.e., reasonable assurance, sufficient appropriate audit evidence, professional skepticism, professional judgment, full compliance with the Code of Ethics). |
| Germany        | Separate Standard (in drafting stage) | The Institut der Wirtschaftsprüfer (IDW) is working towards exposing a draft of a separate standard for audits of financial statements of less complex entities other than PIEs, as defined in the EU, in the Autumn of 2021.   |
| India          | Separate Standard<br>(Exposure Draft) | In February 2021, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants in India released an exposure draft for a new standard for audits of smaller and less complex entities (which was open for comment until the end of March 2021). The proposed standard does not apply to companies, and other entities meeting specific criteria (quantitative and industry criteria). At the time of this publication, results from the exposure draft were not yet available.  |

|   |   |   |
|---|---|---|
| <p>Nordic Federation (Sweden, Denmark, Finland, Iceland and Norway)</p> | <p>Separate Standard (Exposure Draft)</p> | <p>In June 2015, a consultation on a “Nordic Standard for Audits of Small Entities” was published. The draft standard was developed by the Nordic Federation of Public Accountants for consultation in Sweden, Denmark, Finland, Iceland and Norway.</p> <p>Responses were received from all around the world, not only from the intended targeted countries. Respondents echoed the call for something to be done, but had mixed views about what this should be. One of the major messages from the responses was that, in order for this initiative to be successful, an international rather than a regional response was required. In light of this, the Nordic Federation of Public Accountants continued to encourage the IAASB to focus efforts in this area.</p> |
| <p>Sri Lanka</p>  | <p>Separate Standard (In use)</p>         | <p>In 2018, Sri Lanka issued “The Sri Lanka Auditing Standard for the Audits of Non-Specified Business Enterprises” (SLAuS). The SLAuS was developed at the Institute of Chartered Accountants of Sri Lanka with the draft Nordic Standard being used in its development. The Standard is applicable for audits of small and medium sized entities (that do not have public accountability and publish general purpose financial statements for external users).</p>  |
| <p>Switzerland</p>  | <p>Separate Standard (In use)</p>         | <p>Within the Swiss Company Law, large entities as well as listed entities are subject to a full scope audit (including an attestation on the design and implementation of internal controls over financial reporting), whereas SMEs are subject to a limited statutory examination, i.e., a negative assurance engagement.</p> <p>While a separate standard has been established for the limited statutory examination, the full scope audit is performed applying Swiss auditing standards. These standards represent the ISAs with certain add-ons for Swiss-specific issues.</p>  |

In addition to the development of separate standards, countries across the world have created national guidance on the proportionate application of the ISAs (e.g., Austria, Australia, Belgium, Bulgaria, Germany, Hungary, Italy, Slovak Republic, Switzerland) as well as creating nationally supported IT tools for audits of small entities or LCEs (e.g., USA, Belgium, Bulgaria, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Latvia, Netherlands, Norway, Switzerland).

## Appendix 2 – Request for Comments: Summary of Questions

### Guide for Respondents

Respondents are asked to comment on the clarity, understandability and practicality of application of ED-ISA for LCE. In this regard, comments will be most helpful if specific aspects of ED-ISA for LCE are identified and the reasons for any concern about clarity, understandability and practicality of application, along with suggestions for improvement, are included. Specific suggestions for any proposed changes to wording in ED-ISA for LCE are also welcome.

Respondents are free to address only questions relevant to them, or all questions. When a respondent agrees with the proposals in ED-ISA for LCE, it will be helpful for the IAASB to be made aware of this view as support for the IAASB's proposals cannot always be inferred when not explicitly stated.

### Section 4A – Overarching Positioning of ED-ISA for LCE

1. Views are sought on:<sup>39</sup>
  - (a) The standalone nature of the proposed standard, including detailing any areas of concern in applying the proposed standard, or possible obstacles that may impair this approach?
  - (b) The title of the proposed standard.
  - (c) Any other matters related to ED-ISA for LCE as discussed in this section (Section 4A).
2. Do you agree with the proposed conforming amendments to the IAASB Preface (see paragraphs 39-40)? If not, why not, and what further changes may be needed?

### Section 4B – Authority of the Standard

3. Views are sought on the Authority (or scope) of ED-ISA for LCE (Part A of the proposed standard). In particular:
  - (a) Is the Authority as presented implementable? If not, why not?
  - (b) Are there unintended consequences that could arise that the IAASB has not yet considered?
  - (c) Are there specific areas within the Authority that are not clear?
  - (d) Will the Authority, as set out, achieve the intended objective of appropriately informing stakeholders about the scoping of the proposed standard?
  - (e) Is the proposed role of legislative or regulatory authorities or relevant local bodies with standard setting authority in individual jurisdictions clear and appropriate?

<sup>39</sup> There is an overarching question at the end of Section 4F (question 17) to share their views about whether, overall, ED-ISA for LCE meet the needs of users and other stakeholders, and whether the proposed standard can, and will, be used. It is best to answer that question after having considered all relevant matters explained in this memorandum and the content of the proposed standard.

4. Do you agree with the proposed limitations relating to the use of ED-ISA for LCE? If not, why and what changes (clarifications, additions or other amendments) need to be made? Please distinguish your response between the:

- (a) Specific prohibitions; and
- (b) Qualitative characteristics.

If you provide comments in relation to the specific prohibitions or qualitative characteristics, it will be helpful to clearly indicate the specific item(s) which your comments relate to and, in the case of additions (completeness), be specific about the item(s) that you believe should be added and your reasons.

5. Regarding the Authority Supplemental Guide:
- (a) Is the guide helpful in understanding the Authority? If not, why not?
  - (b) Are there other matters that should be included in the guide?
6. Are there any other matters related to the Authority that the IAASB should consider as it progresses ED-ISA for LCE to finalization?

#### **Section 4C – Key Principles Used in Developing ED-ISA for LCE**

7. Views are sought on the key principles used in developing ED-ISA for LCE as set out in this Section 4C.<sup>40</sup> Please structure your response as follows:
- (a) The approach to how the ISA requirements have been incorporated in the proposed standard (see paragraphs 74-77).
  - (b) The approach to the objectives of each Part of the proposed standard (see paragraphs 78-80).
  - (c) The principles in relation to professional skepticism and professional judgement, relevant ethical requirements and quality management (see paragraphs 81-84)
  - (d) The approach to EEM (see paragraphs 85–91) including:
    - (i) The content of the EEM, including whether it serves the purpose for which it is intended.
    - (ii) The sufficiency of EEM.
    - (iii) The way the EEM has been presented within the proposed standard.

#### **Section 4D – Overall Design and Structure of ED-ISA for LCE**

8. Please provide your views on the overall design and structure of ED-ISA for LCE., including where relevant, on the application of the drafting principles (paragraph 98-101).

#### **Section 4E – Content of ED-ISA for LCE**

9. Please provide your views on the content of each of **Parts 1 through 8** of ED-ISA for LCE, including the completeness of each part. In responding to this question, please distinguish your comments by using a subheading for each of the Parts of the proposed standard.

<sup>40</sup> Section 4E below addresses the content of ED-ISA for LCE, including specific questions for respondents to provide their detailed comments on the content of the proposed standard.

10. For **Part 9**, do you agree with the approach taken in ED-ISA for LCE with regard to auditor reporting requirements, including:
  - (a) The presentation, content and completeness of Part 9.
  - (b) The approach to include a specified format and content of an unmodified auditor's report as a requirement?
  - (c) The approach to providing example auditor's reports in the Reporting Supplemental Guide.
11. With regard to the Reporting Supplemental Guide:
  - (a) Is the support material helpful, and if not, why not?
  - (b) Are there any other matters that should be included in relation to reporting?
12. Are there any areas within Parts 1–9 of the proposed standard where, in your view, the standard can be improved? If so, provide your reasons and describe any such improvements. It will be helpful if you clearly indicate the specific Part(s) which your comments relate to.

#### **Section 4F – Other Matters**

13. Please provide your views on transitioning:
  - (a) Are there any aspects of the proposed standard, further to what has been described above, that may create challenges for transitioning to the ISAs?
  - (b) What support materials would assist in addressing these challenges?
14. Do you agree with the proposed approach to the future updates and maintenance of the Standard and related supplemental guidance?
15. For any subsequent revisions to the standard once effective, should early adoption be allowed? If not, why not?
16. Should a separate Part on the ISA-800 series be included within ED-ISA for LCE? Please provide reasons for your response.
17. In your view, would ED-ISA for LCE meet the needs of users and other stakeholders for an engagement that enables the auditor to obtain reasonable assurance to express an audit opinion and for which the proposed standard has been developed? If not, why not. Please structure your comments to this question as follows:
  - (a) Whether the proposed standard can, and will, be used in your jurisdiction.
  - (b) Whether the proposed standard meets the needs of auditors, audited entities, users of audited financial statements and other stakeholders.
  - (c) Whether there are aspects of the proposed standard that may create challenges for implementation (if so, how such challenges may be addressed).
18. Are there any other matters related to ED-ISA for LCE that the IAASB should consider as it progresses the proposed standard to finalization?

#### **Section 4G - Approach to Consultation and Finalization**

19. What support and guidance would be useful when implementing the proposed standard?

20. Translations—recognizing that many respondents may intend to translate the final ISA for LCE in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing ED-ISA for LCE.
21. Effective Date—Recognizing ISA for LCE is a new standard, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods beginning at least 18 months after the approval of a final standard. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA for LCE.

### **Section 5 – Group Audits**

22. The IAASB is looking for views on whether group audits should be excluded from (or included in) the scope of ED-ISA for LCE. Please provide reasons for your answer.
23. Respondents in public practice are asked to share information about the impact of excluding group audits from the scope of ED-ISA for LCE on the use of the proposed standard. In particular:
  - (a) Would you use the standard if group audits are excluded? If not, why not?
  - (b) Approximately what % of the audits within your firm or practice would be group audits that would likely be able to use ED-ISA for LCE (i.e., because it is likely that such group audits could be considered less complex entities for the purpose of the proposed standard) except for the specific exclusion?
  - (c) What common examples of group structures and circumstances within your practice would be considered a less complex group.
24. If group audits are to be included in the scope of ED-ISA for LCE, the IAASB is looking for views about how should be done (please provide reasons for your preferred option):
  - (a) The IAASB establishes a proxy(ies) for complexity for when the proposed standard may be used (“Option 1 - see paragraph 169); or
  - (b) ED-ISA for LCE sets out qualitative characteristics for complexity specific to groups (Option 2 - see paragraph 176), to help users of the proposed standard to determine themselves whether a group would meet the complexity threshold.
25. Are there other ways that group audits could be incorporated into the scope of the proposed standard that is not reflected in the alternatives described above? For example, are there proxies for complexity other than what is presented in paragraph 169 that the IAASB should consider?
26. If group audits are included in ED-ISA for LCE, how should the relevant requirements be presented within the proposed standard (please provide reasons for your preferred option):
  - (a) Presenting all requirements pertaining to group audits in a separate Part; or
  - (b) Presenting the requirements pertaining to group audits within each relevant Part.

# PROPOSED INTERNATIONAL STANDARD ON AUDITING FOR AUDITS OF FINANCIAL STATEMENTS OF LESS COMPLEX ENTITIES

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## Preface—[Draft] ISA for LCE

- P.1. This [draft] standard (i.e., the ISA for LCE) has been designed to achieve reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, for audits of financial statements of less complex entities (LCEs) in the private and public sectors. The [draft] standard has been developed to reflect the nature and circumstances of an audit of the financial statements of an LCE and result in the consistent performance of a quality audit engagement. A quality audit engagement is achieved by planning and performing the engagement and reporting on it in accordance with professional standards and applicable legal and regulatory requirements. Achieving the objective of this [draft] standard involves exercising professional judgment and professional skepticism.
- P.2. Part A sets out the authority for this [draft] standard. A clear description of the types of entities for which an audit in accordance with this [draft] standard has been designed - as set out in Part A - is essential so that:
- The IAASB can decide on objectives and requirements for inclusion within the ISA for LCE that are appropriate for an audit of an LCE; and
  - Legislative or regulatory authorities or relevant local bodies with standard setting authority (such as national standard setters or professional accountancy organizations), firms, auditors, and others will be informed of the intended scope of the [draft] standard.
- P.3. Descriptions of the type of entities for which an audit in accordance with this [draft] standard is permitted rest with legislative and regulatory authorities or relevant local bodies. Such descriptions may or may not align with the limitations for use as set out in Part A. The intended scope of this [draft] standard corresponds to the matters describing an audit of the financial statements of an LCE as set out in Part A and does not contemplate jurisdictional descriptions.
- P.4. This [draft] standard does not override local law or regulation that governs audits of financial statements in a particular jurisdiction.
- P.5. If this [draft] standard is used for audit engagements other than those contemplated in Part A, the auditor is not permitted to represent compliance with the [draft] ISA for LCE in the auditor's report.

### The Applicable Financial Reporting Framework

- P.6. The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. Law or regulation may establish the responsibilities of management, and those charged with governance, in relation to financial reporting. This [draft] standard does not impose responsibilities on management or those charged with governance and does not override law or regulation that govern their responsibilities. However, an audit in accordance with this [draft] standard is conducted on the premise that management, and where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

*Those Charged with Governance and Management's Responsibilities for Preparation of the Financial Statements*

*The extent of management's responsibilities, or the way that they are described, may differ across jurisdictions. While there may be differences in the extent of those responsibilities or how they are*

*described, an audit in accordance with this [draft] standard is conducted on the premise that management, and where appropriate, those charged with governance, have acknowledged and understood that they have responsibility:*

- *For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant, their fair presentation;*
- *For such internal control as management, and where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and*
- *To provide the auditor with unrestricted access to all information of which they are aware that is relevant to the preparation of the financial statements, additional information the auditor may request, and unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.*

- P.7. The applicable financial reporting framework often encompasses financial reporting standards established by an authorized or recognized standard setting organization, or may also encompass legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorized or recognized standard-setting organization and legislative or regulatory requirements.
- P.8. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, the framework ordinarily embodies sufficiently broad principles that can serve as a basis for developing and applying accounting policies consistent with the framework's concepts underlying the requirements.
- P.9. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. This [draft] standard covers both frameworks. The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:
- (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
  - (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

### **An Audit of Financial Statements**

- P.10. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. As the basis for the auditor's opinion, this [draft] standard requires the auditor to obtain

reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

- P.11. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

#### *Inherent Limitations of an Audit*

*Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks of material misstatement is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks of material misstatement is a matter of professional judgment, rather than a matter capable of precise measurement.*

*Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with this [draft] standard. Accordingly, the subsequent discovery of a material misstatement resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with this [draft] standard. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence.*

#### **Format of the [Draft] ISA for LCE**

P.12. The [draft] ISA for LCE includes:

- The Authority (Part A), which sets out the circumstances for which the [draft] ISA for LCE is prohibited or not appropriate to use.
- Part 1, which sets out the fundamental concepts and overarching principles to be applied throughout the audit.
- Part 2, which sets out the general requirements for audit evidence and documentation, as well as the overall objective of the audit.
- Part 3, which sets out the auditor's and engagement partner's obligations and responsibilities for quality management in an audit of an LCE.
- Parts 4 to 9, which follow the flow of an audit engagement, and set out the detailed requirements for the audit. Each of these Parts also includes specific communication and documentation requirements as necessary.
- Appendices, which include the glossary of terms used in this [draft] standard, assertions, an illustrative engagement letter and an illustrative representation letter, as well as other relevant supporting materials for implementation of the requirements within this [draft] standard.

P.13. The content of each Part includes:

- Introductory material in a separate box setting out the content and scope of that Part (but does not create any additional obligations for the auditor).

- Objective(s), which link the requirements of that Part and the overall objective of the audit.
- Requirements to be met, except where the requirement is conditional and the condition does not exist. All requirements are numbered relating to the relevant Part, for example A.1., A.2., or 1.1.1., 1.1.2., etc. Requirements are expressed using “shall.”
- Essential explanatory material (EEM), designed to provide further explanation relevant to a sub-section or a specific requirement. All EEM is presented in italics within separate blue boxes. There are two types of EEM: general introductory EEM that explains the context of the section that follows and EEM specific to the requirement directly above it.

P.14. Definitions, describing the meanings attributed to certain terms for the purpose of this [draft] standard, can be found in the Glossary of Terms in Appendix 1.<sup>41</sup> The definitions assist in the consistent application and interpretation of the requirements, and are not intended to override definitions that may be established for other purposes, whether in law or regulation. Unless otherwise indicated, the definitions carry the same meanings throughout this [draft] standard.

#### *Non-Authoritative Support Materials*

P.15. The IAASB may issue Staff publications or other non-authoritative material to support the implementation of the [draft] ISA for LCE.

#### **Public Sector Entities**

P.16. This [draft] standard is relevant to engagements in the public sector if the criteria set out in the Authority in Part A have been met. The public sector auditor’s responsibilities, however, may be affected by the audit mandate, or by obligations on public sector entities arising from law, regulation or other authority (such as ministerial directives, government policy requirements, or resolutions of the legislature), which may encompass a broader scope than an audit of financial statements in accordance with this [draft] standard. These additional responsibilities are not dealt with in this [draft] standard. They may be dealt with in the pronouncements of the International Organization of Supreme Audit Institutions or national standard setters, or in guidance developed by public sector audit agencies.

P.17. The applicable financial reporting framework in a public sector entity is determined by the legislative and regulatory frameworks relevant to each jurisdiction or within each geographical area. Matters that may be considered in the entity’s application of the applicable financial reporting requirements, and how it applies in the context of the nature and circumstances of the entity and its environment, include whether the entity applies a full accrual basis of accounting or a cash basis of accounting in accordance with the International Public Sector Accounting Standards, or a hybrid.

P.18. Ownership of a public sector entity may not have the same relevance as in the private sector because decisions related to the entity may be made outside of the entity as a result of political processes. Therefore, management may not have control over certain decisions that are made. Matters that may be relevant include understanding the ability of the entity to make unilateral decisions, and the ability of other public sector entities to control or influence the entity’s mandate and strategic direction.

<sup>41</sup> The definitions in this [draft] standard are consistent with the definitions in the International Standards on Auditing (ISAs) (i.e., contained in the IAASB’s Glossary of Terms within the IAASB’s Handbook Volume 1). The Glossary of Terms in Appendix 1 also includes other relevant terms in the IAASB Handbook Glossary of Terms that are not defined but are used in the ISAs.

P.19. Where relevant, considerations specific to public sector entities have been included in EEM.

**Maintenance of the [draft] ISA for LCE**

P.20. The IAASB expects to propose amendments to the ISA for LCE periodically. The IAASB will consider the impact on the [draft] ISA for LCE as part of a project to revise or develop a new ISA, and a determination made as to the urgency for the need for a change to this [draft] standard. In developing the exposure draft of the changes for the [draft] ISA for LCE, the IAASB will consider any specific issues that have been brought to the attention of the IAASB regarding application of the ISA for LCE. The IAASB expects that there will be a period of at least eighteen months between when amendments to the ISA for LCE are issued and the effective date of those amendments.

DRAFT

## A. Authority of the [Draft] ISA for Audits of Financial Statements of Less Complex Entities

- A.1. Part A sets out the authority of the [draft] ISA for LCE by describing the specific prohibitions and qualitative characteristics that will make the [draft] standard inappropriate for use in an audit of the financial statements of an LCE. The requirements in this [draft] ISA for LCE have been designed to be proportionate to the typical nature and circumstance of an audit of an LCE (i.e., they do not address complex matters or circumstances).
- A.2. This [draft] ISA for LCE is not permitted to be used for audits that are not audits of financial statements of LCEs. If the [draft] ISA for LCE is used for an audit outside the intended scope of this [draft] standard, compliance with the requirements of the [draft] ISA for LCE will not be sufficient for the auditor to obtain sufficient appropriate audit evidence to support a reasonable assurance opinion.

### Limitations for Using the [Draft] ISA for LCE

- A.3. Limitations for using the [draft] ISA for LCE are designated into two categories:
- Specific classes of entities for which the use of the [draft] ISA for LCE is prohibited (i.e., specific prohibitions); and
  - Qualitative characteristics that if exhibited by an entity preclude the use of the [draft] ISA for LCE for the audit of the financial statements of that entity.
- A.4. This section explains these limitations for use of the [draft] ISA for LCE. The *Supplemental Guidance for the Authority of the Standard* (the Authority Supplemental Guide) which can be found on the [ISA for LCE Exposure Draft webpage](#), further explains matters that may be relevant in the determination of use of the [draft] ISA for LCE.

### *Specific Prohibitions*

- A.5. Entities that have public interest characteristics could embody a level of complexity in fact or appearance and are specifically prohibited from using the [draft] ISA for LCE.
- A.6. Paragraph A.7. sets out the classes of entities for which the use of this [draft] standard is specifically prohibited. The classes in paragraph A.7.(a), (b) and (d) are outright prohibitions and cannot be modified. Legislative or regulatory authorities or relevant local bodies with standard-setting authority can modify each class described in paragraph A.7.(c) but a class cannot be removed. Modifications can be made by adding a class of entities to the list of prohibited entities, permitting specific sub-sets within a class to be able to use the [draft] standard or using quantitative thresholds to prohibit use of the [draft] standard. Legislative or regulatory authorities or relevant local bodies with standard-setting authority may subsequently remove or amend modifications that they have made.
- A.7. The [draft] ISA for LCE shall not be used if:
- (a) Law or regulation:
    - (i) Explicitly prohibits the use of the [draft] ISA for LCE (i.e., the [draft] standard is not authorized for use in a particular jurisdiction); or
    - (ii) Specifies the use of auditing standards, other than the [draft] ISA for LCE, for an audit of financial statements in that jurisdiction.
  - (b) The entity is a listed entity.



- (c) An entity meets one of the following criteria:<sup>42</sup>
- (i) An entity one of whose main functions is to take deposits from the public;
  - (ii) An entity one of whose main functions is to provide insurance to the public;
  - (iii) An entity whose function is to provide post-employment benefits;
  - (iv) An entity whose function is to act as a collective investment vehicle and that issues redeemable financial instruments to the public; or
  - (v) A class of entities where use of the [draft] ISA for LCE is prohibited for that specific class of entity by a legislative or regulatory authority or relevant local body with standard-setting authority in the jurisdiction.
- (d) The audit is an audit of group financial statements.<sup>43</sup>

#### *Qualitative Characteristics*

A.8. If an audit engagement is not prohibited from use of the [draft] ISA for LCE as set out in paragraph A.7., it would be inappropriate for an audit of the financial statements of the entity to be undertaken using the [draft] ISA for LCE if the entity exhibits the following:

- Complex matters or circumstances relating to the nature and extent of the entity's business activities, operations and related transactions and events relevant to the preparation of the financial statements.
- Topics, themes and matters that increase, or indicate the presence of, complexity, such as those relating to ownership, corporate governance arrangements, policies, procedures or processes established by the entity.

These are indicators of, or proxies for, matters or circumstances for which the [draft] ISA for LCE has not been designed to address.

A.9. In accordance with paragraph A.8., the [draft] ISA for LCE is inappropriate for the audit of the financial statements if an entity exhibits one or more of the following characteristics:

- The entity's business activities, business model or the industry in which the entity operates results in pervasive risks that increase the complexity of the audit, such as when the entity operates in new or emerging markets, or entities in the development stage.
- The organizational structure is not relatively straightforward or simple, such as
  - Multiple levels and reporting lines, with many individuals involved in financial reporting, to accommodate the entity's business activities; or

<sup>42</sup> See paragraphs 51-63 of the accompanying Explanatory Memorandum.

<sup>43</sup> Consistent with the proposed ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, group financial statements are financial statements that include the financial information of more than one entity or business unit through a consolidation process. The term consolidation process refers not only to the preparation of consolidated financial statements in accordance with the applicable financial reporting framework, but also to the presentation of combined financial statements, and to the aggregation of the financial information of entities or business units such as branches or divisions. This definition may change as ISA 600 (Revised) is finalized. See Paragraphs 62–63 and Section 5 of the accompanying Explanatory Memorandum for further discussion related to group audits.

- Including unusual entities or arrangements, such as special-purpose entities, complex joint ventures, off-balance sheet financing arrangements, or other complex financing arrangements.
- Ownership or oversight structures are complex.
- The entity's operations are subject to a higher degree of regulation or to significant regulatory oversight, such as being subject to prudential regulations.
- Transactions are complex or the information system and related processes relevant to the entity's financial statements are complex such that the data collection and processing involves complex accounting or calculations.
- The entity's IT environment or IT systems are complex, such as when the IT environment and processes involve highly-customized or highly-integrated IT applications, with internal resources or external service providers that have software development and IT environment maintenance skills to support the IT environment and processes.
- The entity's accounting estimates are subject to a higher degree of estimation uncertainty or the measurement basis requires complex methods that may involve multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them.

This list is not exhaustive and other relevant matters may also need to be considered. Each of the qualitative characteristics may on its own not be sufficient to determine whether the [draft] ISA for LCE is appropriate or not in the circumstances, therefore the matters described in the list are intended to be considered both individually and in combination. The presence of one characteristic exhibited by an entity does not necessarily exclude the use of the [draft] ISA for LCE for that entity. Notwithstanding that professional judgment is used in determining whether the [draft] standard is appropriate to use, if there is uncertainty about whether an audit is an audit of the financial statements of an LCE, the use of the [draft] ISA for LCE is not appropriate.

### **Responsibilities of Legislative or Regulatory Authorities or Relevant Local Bodies**

- A10. Decisions about the required or permitted use of the IAASB's International Standards rest with legislative or regulatory authorities or relevant local bodies with standard-setting authority (such as regulators or oversight bodies, national standard setters, professional accountancy organizations or others as appropriate) in individual jurisdictions. This applies to the International Standards on Auditing (ISAs) and the [draft] ISA for LCE.
- A.11. As part of the local adoption and implementation process, legislative or regulatory authorities or relevant local bodies with standard-setting authority may:
- (a) Modify, but not remove, the classes of entities in paragraph A.7.(c)(i)-(iv) by, for example, applying quantitative criteria to a class or otherwise modifying as set out in paragraph A.6.; or
  - (b) Further limit use of the [draft] standard in paragraph A.7.(c)(v) by inclusion of an additional class(es) of entity or through setting specific size criteria (such as using revenue, assets or employee number limits).

In doing so, the specific prohibitions and the qualitative characteristics should be considered, as well as other specific needs that may be relevant in the jurisdiction. The Supplemental Guide may be helpful when determining the permitted use of the [draft] standard for a jurisdiction.

## Firms and Auditors

- A.12. Firms are responsible for establishing policies or procedures in relation to the permitted use of the [draft] ISA for LCE by the firm's engagement teams.<sup>44</sup> In doing so, the firm takes into account the specific prohibitions for use of the [draft] standard in paragraph A.7., including any further modifications or limitations for the applicable jurisdiction, as well as the qualitative characteristics described in paragraphs A.8.–A.9. The firm may also further limit the classes of entities for which the firm's engagement teams can use the [draft] ISA for LCE.
- A.13. For individual audit engagements, as part of the firm's acceptance or continuance procedures and the engagement partner's responsibilities related thereto, the engagement partner is required to determine that the audit engagement is an audit of an LCE in accordance with this Part (i.e., Part A) in order to use the [draft] ISA for LCE (see Part 4, paragraph 4.2.1.). For this purpose, the engagement partner takes into account:
- The list of entities for which the use of the [draft] standard is specifically prohibited as set out in the local jurisdiction.
  - The qualitative characteristics (see paragraphs A.8.–A.9.).
  - Firm policies or procedures.
- A.14. The Supplemental Guide may also be helpful to firms in developing policies or procedures in relation to the use of the [draft] ISA for LCE. At the engagement level, the engagement partner may also find the guidance helpful in understanding when the [draft] standard would be appropriate for a particular audit engagement.

<sup>44</sup> International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraphs 24-27 and 30

## **1. Fundamental Concepts, General Principles and Overarching Requirements**

### *Content of this Part*

Part 1 sets out the:

- Effective date of this [draft] standard.
- The relevant ethical requirements and obligations for firm-level quality management.
- Overall objectives of the auditor. Each Part within this [draft] standard contains an objective for planning and performing the audit and provides a link between the requirements within that Part and the overall objectives of the auditor. The objectives within each Part assist the auditor to understand the intended outcomes of the procedures contained in that Part.
- Fundamental concepts, general principles and overarching requirements applicable to the engagement, including professional skepticism and professional judgment.
- Overarching requirements in relation to fraud, law or regulation, related parties and communications with management and, where appropriate, those charged with governance.
- General communication requirements that apply to all Parts. Within individual Parts there may be additional specific communication requirements.

### *Scope of this Part*

The concepts, principles and overarching requirements in this Part apply throughout the audit engagement.

### **1.1. Effective Date**

1.1.1. This [draft] standard is effective for audits of financial statements for periods beginning on or after [XXX].

*The auditor is permitted to apply this [draft] standard, if not prohibited by law or regulation, before the effective date specified.*

### **1.2. Relevant Ethical Requirements and Firm-Level Quality Management**

#### *Relevant Ethical Requirements for an Audit of Financial Statements*

1.2.1. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, for financial statement audit engagements.

#### *Firm-Level Quality Management*

*Systems of quality management, including the policies or procedures, are the responsibility of the firm. ISQM 1,<sup>45</sup> applies to all firms that perform audits. This [draft] standard is premised on the basis that the firm is subject to ISQM 1 or to national requirements that are at least as demanding.*

<sup>45</sup> International Standards on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews for Financial Statements, or Other Assurance or Related Services Engagements*

*If an engagement quality review is required by the firm's policies or procedures established in accordance with ISQM 1, then ISQM 2,<sup>46</sup> applies. ISQM 2 deals with the appointment and eligibility of the engagement quality reviewer, and the performance and documentation of the engagement quality review.*

### 1.3. Overall Objectives of the Auditor

1.3.1. The overall objectives of the auditor when conducting an audit of financial statements using the [draft] ISA for LCE are to:

- (a) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects in accordance with an applicable financial reporting framework; and
- (b) Report on the financial statements, and communicate as required by this [draft] ISA for LCE, in accordance with the auditor's findings.

1.3.2. The entire text of this [draft] ISA for LCE is relevant to an understanding of the objectives of this [draft] standard and the proper application of the requirements.

1.3.3. To achieve the overall objectives, the auditor shall use the objectives stated in the relevant Parts in planning and performing the audit, to:

- (a) Determine whether any audit procedures in addition to those required by the relevant Part are necessary to achieve the objectives stated in this [draft] standard; and
- (b) Evaluate whether sufficient appropriate audit evidence has been obtained.

*The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches:*

- *Evaluate whether further relevant audit evidence has been, or will be, obtained;*
- *Extend the work performed in applying one or more requirements; or*
- *Perform other procedures judged by the auditor to be necessary in the circumstances.*

1.3.4. If an objective in a Part cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor to:

- (a) Modify the terms of engagement and perform the audit and report in accordance with the International Standards on Auditing; or
- (b) Modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation).

Failure to achieve an objective represents a significant matter requiring documentation.

<sup>46</sup> ISQM 2, *Engagement Quality Reviews*

#### 1.4. Fundamental Concepts and General Principles for Performing the Audit

- 1.4.1. The auditor shall comply with all relevant requirements unless paragraph 1.4.3. applies. A requirement is relevant when the circumstances of the audit addressed by the requirement exist.
- 1.4.2. The auditor shall not represent compliance with the [draft] ISA for LCE in the auditor's report unless all relevant requirements in this [draft] standard have been met or the circumstances in paragraph 1.4.3. apply.
- 1.4.3. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement. In such circumstances, the auditor shall perform alternative procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement.

##### *Professional Judgment*

- 1.4.4. The auditor shall exercise professional judgment in planning and performing the audit.

*Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and this [draft] standard and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances.*

*The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have been sufficiently developed to achieve the necessary competencies for reasonable judgments.*

*The exercise of professional judgment in any particular case is based on the facts and circumstances that are known to the auditor.*

*Significant professional judgments made in reaching conclusions on significant matters arising during the audit are required to be documented in accordance with the requirements of Part 2 of this [draft] standard.*

##### *Professional Skepticism*

- 1.4.5. The auditor shall plan and perform the audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
- 1.4.6. The auditor shall design and perform procedures in a way that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

*Professional skepticism includes being alert to, for example:*

- *Audit evidence that contradicts other audit evidence obtained.*
- *Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.*
- *Conditions that may indicate possible fraud.*
- *Circumstances that suggest the need for audit procedures in addition to those required by this [draft] standard.*

*Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management, and where appropriate, those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.*

*The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management, and where appropriate, those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.*

## **1.5. Fraud**

*The primary responsibility for the prevention and detection of fraud rests with both management, and where appropriate, those charged with governance of the entity. Although fraud is a broad legal concept, for the purposes of this [draft] standard, the auditor is concerned with fraud that causes a material misstatement in the financial statements.*

*An auditor conducting an audit in accordance with this [draft] standard is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error even though the audit is properly planned and performed in accordance with this [draft] standard. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.*

*Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.*

*When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this [draft] standard are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.*

### **1.5.1. The auditor shall address the risk of fraud when:**

- (a) Identifying and assessing risks of material misstatement, whether due to fraud or error. In doing so, the auditor shall evaluate whether information obtained from the procedures to identify and assess risks and related activities indicates that one or more fraud risk factors are present;<sup>47</sup>

<sup>47</sup> Appendix 3 sets out fraud risk factors relevant to less complex entities.

- (b) Obtaining sufficient appropriate audit evidence through designing and implementing appropriate responses to assessed risks of material misstatement, including risks of material misstatement due to fraud; and
- (c) Responding appropriately to fraud or suspected fraud identified during the audit.

*Considerations Specific to Public Sector Entities*

*The public sector auditor's responsibilities relating to fraud may be a result of law, regulation or other authority applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.*

*Auditor Unable to Continue the Engagement*

- 1.5.2. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall determine the legal and professional responsibilities applicable in the circumstances or consider whether it is appropriate to withdraw, where withdrawal is possible under law or regulation.

*Considerations Specific to Public Sector Entities*

*In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.*

**1.6. Law or Regulation**

*It is the responsibility of management, with the oversight of those charged with governance where appropriate, to ensure that the entity's operations are conducted in accordance with the provisions of law or regulation, including compliance with the provisions of law or regulation that determine the reported amounts and disclosures in an entity's financial statements.*

*The requirements in this [draft] standard are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with law or regulation. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all law or regulation. The auditor's focus in an audit of the financial statements is on circumstances when non-compliance with law or regulation results in a material misstatement of the financial statements. In this regard, the auditor's responsibilities are in relation to compliance with two different categories of law or regulation and are distinguished as follows:*

- (a) *The provisions of those laws or regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements (e.g., tax and pension law or regulation); and*
- (b) *Other law or regulation that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (e.g., compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations), i.e., non-*



*compliance with such law or regulation may therefore have a material effect on the financial statements.*

- 1.6.1. During the audit, the auditor shall remain alert to the possibility that performing audit procedures may bring instances of non-compliance or suspected non-compliance with law or regulation to the auditor's attention.
- 1.6.2. In the absence of identified or suspected non-compliance with law or regulation, the auditor is not required to perform audit procedures regarding the entity's compliance with law or regulations, other than what is required by this [draft] standard.

#### *Considerations Specific to Public Sector Entities*

*In the public sector, there may be additional audit responsibilities with respect to the consideration of law or and regulation which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.*

#### *Reporting to an Appropriate Authority Outside the Entity*

- 1.6.3. If the auditor has identified or suspects non-compliance with law or regulation, or fraud, the auditor shall determine whether law, regulation or relevant ethical requirements:
- (a) Require the auditor to report to an appropriate authority outside the entity.
  - (b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

*Reporting identified or suspected non-compliance with law or regulation, or fraud, to an appropriate authority outside the entity may be required or appropriate in the circumstances because:*

- *The auditor has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements; or*
- *Law, regulation or relevant ethical requirements provide the auditor with the right to do so.*

### **1.7. Related Parties**

- 1.7.1. During the audit, the auditor shall remain alert for:
- (a) Information about the entity's related parties, including circumstances involving a related party with dominant influence; and
  - (b) Arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, and significant transactions outside the entity's normal course of business.

*Many related party transactions occur in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud.*

*Many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the financial reporting framework has established such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework. Even if the applicable financial reporting framework has not established such requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions to be able to conclude whether the financial statements achieve fair presentation and are not misleading.*

## **1.8. General Communications with Management and Those Charged with Governance**

1.8.1. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

1.8.2. The auditor shall communicate, on a timely basis, with management and, if separate, those charged with governance.

*Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. Governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees or equivalent.*

*If those charged with governance are separate from management, the communication requirements to those charged with governance also apply to management, and therefore communication with both would be appropriate.*

*There may be other cases where it is not clear with whom to communicate, for example in some family-owned businesses, some not-for-profit organizations and some government entities (e.g., the governance structure may not be defined). In such cases the auditor may need to discuss and agree with management or the engaging party with whom communications should be made.*

1.8.3. Specific matters to be communicated are required throughout this [draft] standard. The auditor shall use professional judgment in determining the appropriate form, timing and general content of the communications with management, and when appropriate, those charged with governance. When determining the form of communication, the auditor shall consider:

- (a) Legal requirements for communication; and
- (b) The significance of the matters to be communicated.

*The appropriate timing for communications will vary with the circumstances of the audit, and may be affected by the significance and nature of the matter, and the actions expected to be taken by those charged with governance.*

1.8.4. In some cases, all of those charged with governance are involved in managing the entity, for example, an LCE where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this [draft] standard are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities

adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

- 1.8.5. Where the responses to inquiries of management, and where appropriate, those charged with governance about a particular matter are inconsistent, the auditor shall investigate the inconsistency.
- 1.8.6. If the auditor has identified fraud or has obtained information that indicates that fraud may exist, the auditor shall communicate these matters, unless prohibited by law or regulation, on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

*Considerations Specific to Public Sector Entities*

*In the public sector, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related law, regulation or other authority.*

*Specific Communications to Those Charged with Governance in Relation to Fraud*

- 1.8.7. Unless prohibited by law or regulation, the auditor shall communicate to those charged with governance, on a timely basis, if the auditor has identified or suspects fraud involving:
- (a) Management, unless those charged with governance are involved in managing the entity;
  - (b) Employees who have significant roles in the entity's internal control system; or
  - (c) Others where the fraud results in a material misstatement in the financial statements.
- 1.8.8. If the auditor suspects fraud involving management, the auditor shall discuss with those charged with governance the nature, timing and extent of audit procedures necessary to complete the audit.

## **2. Audit Evidence and Documentation**

### *Content of this Part*

Part 2 sets out the requirements to be applied throughout the audit for:

- Audit evidence.
- Documentation. Within individual Parts there may also be additional specific documentation requirements.

### *Scope of this Part*

The requirements in this Part apply throughout the audit engagement.

### **2.1. Objectives**

2.1.1. The objectives of the auditor are to:

- (a) Design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion; and
- (b) Prepare documentation that provides a sufficient and appropriate record of the basis for the auditor's report and provides evidence that the audit was planned and performed in accordance with the [draft] ISA for LCE and applicable law or regulation.

### **2.2. Sufficient Appropriate Audit Evidence**

2.2.1. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level thereby enabling the auditor to draw reasonable conclusions on which to base the auditor's opinion.

2.2.2. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

*Sufficiency is the measure of the quantity of audit evidence, and is affected by the auditor's assessment of the risks of material misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also the quality of the audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate if it is of poor quality.*

*Appropriateness is the measure of the quality of the audit evidence, that is its relevance and reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of audit evidence is influenced by its source and by its nature, and dependent on the individual circumstances under which it is obtained.*

*Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.*

### 2.3. Information to be Used as Audit Evidence

*Audit evidence is cumulative in nature and is primarily obtained from audit procedures performed during the audit, but may also include information from other sources, such as:*

- *Previous audits (provided that the auditor has confirmed there are no changes);*
- *Other engagements performed for the client; and*
- *The firm's quality management procedures for acceptance and continuance.*

*Audit evidence may come from inside or outside the entity (the entity's accounting records are an important source of audit evidence), the work of management's expert, and includes information that both supports and corroborates management's assertions, as well as contradicts such assertions.*

*Automated Tools and Techniques (ATT)*

*ATT, for the purpose of this [draft] standard, are IT-enabled processes that involve the automation of methods and procedures, for example the analysis of data using modelling and visualization, or drone technology to observe or inspect assets.*

*In applying this [draft] standard, an auditor may design and perform audit procedures manually or through the use of ATT, and either technique can be effective. Regardless of the tools and techniques used, the auditor is required to comply with the requirements in this [draft] standard.*

- 2.3.1. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence, including information from external information sources.

*Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of the information may be affected by the direction of testing.*

*The reliability of information to be used as audit evidence is influenced by its source and nature, as well as the circumstances under which it was obtained, including the controls over its preparation and maintenance where relevant. Generally, the reliability of information is increased when it is obtained from independent sources outside of the entity, by the auditor directly, is an original document rather than a copy and written rather than oral information. However, circumstances may exist that could affect these generalizations.*

- 2.3.2. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes including, as necessary in the circumstances:

- (a) Obtaining evidence about the accuracy and completeness of the information; and
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

*Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.*

- 2.3.3. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further and determine the effect on the rest of the audit evidence obtained.
- 2.3.4 The auditor shall determine what modifications or additions to procedures are necessary if:
- (a) Audit evidence obtained from one source is inconsistent with that obtained from another; or
  - (b) The auditor has doubts about the reliability of information to be used as audit evidence.

## 2.4. Procedures for Obtaining Audit Evidence

*Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by designing and performing procedures to identify and assess risks of material misstatement (see Part 6) and further audit procedures (see Part 7).*

*Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.*

### *Automated Tools and Techniques*

*Using ATT can supplement or replace manual or repetitive tasks. In certain circumstances, when obtaining audit evidence, an auditor may determine that the use of ATT to perform certain audit procedures may result in more persuasive audit evidence relative to the assertion being tested. In other circumstances, performing audit procedures may be effective without the use of ATT.*

*The use of ATT may potentially create biases or a general risk of overreliance on the information or output of the audit procedure performed. As powerful as these tools may be, they are not a substitute for the auditor's knowledge and professional judgment. Further, although the auditor may have access to a wide array of data, including from varying sources (i.e., increased quantity), the exercise of professional skepticism remains necessary to critically assess audit evidence arising from the use of data and from the outputs from using ATT.*

## 2.5 General Documentation Requirements

*The form, content and extent of audit documentation depends on the nature and circumstances of the entity and the procedures being performed. Audit documentation may be in paper or electronic format. It is not necessary to include superseded drafts of working papers or financial statements in the audit documentation.*

*Oral explanations, by the auditor on their own, do not adequately support the work performed by the auditor or the conclusions reached.*

### *Automated Tools and Techniques*

*This [draft] standard does not differentiate between different tools and techniques that the auditor may use to design and perform audit procedures, for example using manual or automated audit procedures with respect to what is required to be documented. Regardless of the tools and techniques used, the auditor is required to comply with relevant documentation requirements.*



2.5.1. Specific matters to be documented are set out throughout this [draft] standard. The auditor shall prepare audit documentation on a timely basis that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) The nature, timing and extent of the audit procedures performed in accordance with this [draft] standard and applicable legal and regulatory requirements, including recording:
  - (i) The identifying characteristics of the specific items or matters tested;
  - (ii) Who performed the work and the date such work was completed;
  - (iii) Who reviewed the audit work performed and the date and extent of such review, including what was reviewed;

*In the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (e.g., there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.*

- (b) The results of the audit procedures performed, and the audit evidence obtained; and
- (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

*Judging the significance of a matter requires professional judgment and the analysis of the facts and circumstances. Examples of significant matters include matters giving rise to significant risks, areas where the financial statements could be materially misstated, circumstances where the auditor has had difficulty in applying the necessary audit procedures, or any findings that could result in a modified opinion.*

2.5.2. The auditor shall document identified or suspected non-compliance with law or regulation and the results of discussion with management, and where appropriate, those charged with governance and parties outside the entity.

2.5.3. If the auditor identified information that is inconsistent with the auditor's conclusion regarding a significant matter, the auditor shall document how the inconsistency was addressed.

2.5.4. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement of this [draft] standard, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure.

#### *Documentation of Communications*

2.5.5. The auditor shall include in the audit documentation any:

- (a) Communications about fraud made to management, those charged with governance, regulators and others; and
- (b) Discussions of significant matters related to non-compliance with law or regulation, or fraud, with management, those charged with governance and others, including how the matter has been responded to.

- 2.5.6. The auditor shall document discussions of significant matters with management, and where appropriate, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.
- 2.5.7. Where matters required to be communicated by this [draft] standard are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated.
- 2.5.8. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. Written communications need not include all matters that arose during the audit.

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### **3. Engagement Quality Management**

#### *Content of this Part*

Part 3 sets out the responsibilities for managing and achieving quality for the audit engagement.

#### *Scope of this Part*

In accordance with ISQM 1, the firm is responsible for designing, implementing and operating a system of quality management for audits of financial statements, that provides the firm with reasonable assurance that the firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements, and that engagement reports issued are appropriate in the circumstances. The engagement team, led by the engagement partner, is responsible within the context of the firm's system of quality management for:

- Implementing the firm's responses to quality risks that are applicable to the audit engagement using information communicated by, or obtained from, the firm;
- Determining whether additional responses are needed at the engagement level beyond those in the firm's policies or procedures given the nature and circumstances of the engagement; and
- Communicating to the firm information from the audit engagement that is required to be communicated by the firm's policies or procedures to support the design, implementation and operation of the firm's system of quality management.

The requirements in this Part apply throughout the audit engagement.

#### **3.1 Objective**

3.1.1. The objective of the auditor is to manage quality at the engagement level to obtain reasonable assurance that quality has been achieved such that:

- (a) The auditor has fulfilled the auditor's responsibilities in accordance with this [draft] ISA for LCE, relevant ethical standards and the applicable legal and regulatory requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

#### **3.2. The Engagement Partner's Responsibilities**

##### *Leadership Responsibilities for Managing and Achieving Quality*

*The requirements for direction, supervision and review of the work of other members of the engagement team are only relevant if there are members of the engagement team other than the engagement partner.*

3.2.1. The engagement partner shall take overall responsibility for managing and achieving quality on the audit engagement. In doing so, the engagement partner shall be sufficiently and appropriately involved throughout the audit engagement such that the engagement partner has the basis for determining whether the significant judgments made, and conclusions reached are appropriate in the circumstances.

*Being sufficiently and appropriately involved throughout the audit engagement when procedures, tasks or actions have been assigned to other members of the engagement team may be demonstrated by the engagement partner in different ways, including:*

- *Informing assignees about the nature of their responsibilities and authority, the scope of the work being assigned and the objectives thereof; and to provide any other necessary instructions and relevant information.*
- *Direction and supervision of the assignees.*
- *Review of the assignees' work to evaluate the conclusions reached.*

3.2.2. The engagement partner shall take responsibility for clear, consistent and effective actions being taken that reflect the firm's commitment to quality, and establish and communicate the expected behavior of the engagement team members, including emphasizing:

- (a) That all engagement team members are responsible for contributing to the management and achievement of quality at the engagement level;
- (b) The importance of professional ethics, values and attitudes to the members of the engagement team;
- (c) The importance of open and robust communication within the engagement team, and supporting the ability of engagement team members to raise concerns without fear of reprisal; and
- (d) The importance of each engagement team member exercising professional skepticism throughout the audit engagement.

*The engagement partner's responsibility for managing and achieving quality is supported by a firm culture that demonstrates a commitment to quality. In addressing the requirements in paragraphs 3.2.1. and 3.2.2. above, the engagement partner may communicate directly to other members of the engagement team and reinforce this communication through conduct and actions (e.g., leading by example). The nature and extent of the actions of the engagement partner to demonstrate the firm's commitment to quality may depend on a variety of factors including the size, structure, and complexity of the firm and the engagement team, and the nature and circumstances of the audit engagement. For an engagement team with few engagement team members, influencing the desired culture through direct interaction and conduct may be sufficient.*

3.2.3. If the engagement partner assigns the design or performance of procedures, tasks or actions to other members of the engagement team, the engagement partner shall continue to take overall responsibility for managing and achieving quality through direction and supervision of those members of the engagement team, and review of their work.

3.2.4. In taking overall responsibility for managing and achieving quality through direction, supervision and review of the work, the engagement partner shall determine that the nature, timing and extent of direction, supervision and review is responsive to the nature and circumstances of the engagement and the resources assigned, in compliance with the firm's related policies or procedures, this [draft] standard, relevant ethical requirements and regulatory requirements.

*The approach to direction, supervision and review may be tailored depending on, for example:*

- *The engagement team member's previous experience with the entity and the area to be audited.*

- *The assessed risks of material misstatement. A higher assessed risk of material misstatement may require a corresponding increase in the extent and frequency of the direction and supervision of engagement team members and a more detailed review of their work.*
- *The competence and capabilities of the individual engagement team members performing the audit work. For example, less experienced engagement team members may require more detailed instructions and more frequent, or in-person, interactions as the work is performed.*
- *The manner in which the reviews of the work performed are expected to take place.*

### *Relevant Ethical Requirements*

3.2.5. Throughout the audit engagement, the engagement partner shall:

- (a) Take responsibility for other members of the engagement team having been made aware of relevant ethical requirements that are applicable given the nature and circumstances of the audit engagement and the firm's related policies or procedures for identifying, evaluating and addressing threats to compliance with relevant ethical requirements; and
- (b) Remain alert through observation, inspection of audit documentation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.

3.2.6. If matters come to the engagement partner's attention that indicate that a threat to compliance with relevant ethical requirements exists or relevant ethical requirements have not been fulfilled, the engagement partner shall take action, as appropriate in the circumstances, including:

- (a) Following the firm's policies or procedures to evaluate the threat; and
- (b) Consulting with others in the firm.

### *Other Engagement Partner Responsibilities*

3.2.7. Taking into account the nature and circumstances of the audit and the firm's related policies or procedures, the engagement partner shall determine that:

- (a) Sufficient and appropriate resources are assigned or made available to the engagement team in a timely manner; and
- (b) Members of the engagement team, and any auditor's external experts, collectively have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement.

3.2.8. If the conditions in paragraph 3.2.7. are not met, the engagement partner shall take appropriate action including, if relevant, communicating with appropriate individuals about the need to assign or make available additional or alternative resources to the engagement.

3.2.9. The engagement partner shall take responsibility for using the resources assigned or made available to the engagement team appropriately.

3.2.10. The engagement partner shall:

- (a) Understand the information from the firm's monitoring and remediation process that has been communicated, and if applicable, information for the monitoring and remediation process of

other network firms that has been communicated, and determine the relevance and effect of that information on the audit engagement, and take appropriate action; and

- (b) Remain alert for matters that may be relevant to the firm's monitoring and remediation process, and communicate that information as appropriate.

3.2.11. The engagement partner shall review audit documentation at appropriate points in time during the audit, including documentation of significant matters, significant judgments (including those relating to difficult or contentious matters) and the conclusions reached, and other matters that, in the engagement partner's professional judgment, are relevant to the engagement partner's responsibilities.

*The engagement partner exercises professional judgment in determining matters to review, for example, based on:*

- *The nature and circumstances of the audit engagement.*
- *Which engagement team member performed the work.*
- *Matters from recent inspection findings.*
- *The requirements of the firm's policies or procedures.*

3.2.12. The engagement partner shall:

- (a) Take responsibility for differences of opinion being addressed and resolved in accordance with the firm's policies or procedures;
- (b) Take responsibility for consultations being undertaken in accordance with the firm's related policies or procedures, or where deemed necessary on difficult or contentious matters;
- (c) Determine that conclusions reached with respect to differences of opinion and difficult or contentious matters are documented, agreed with the party consulted and implemented; and
- (d) Not date the auditor's report until any differences of opinion are resolved.

*Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. If unusual issues are involved, it may be desirable to consult with other suitably- experienced auditors or the auditor's professional body.*

*Consultation may be appropriate, or required by the firm's policies or procedures, when there are issues that are complex or unfamiliar, significant risks, significant transactions that are outside the normal course of business, or that otherwise appear to be unusual, limitations imposed by management or non-compliance with law or regulation.*

*Differences of opinion may arise within the engagement team, or between the engagement team and the engagement quality reviewer, or even with individuals performing activities within the firm's system of quality management such as those responsible for providing consultation.*

*In considering matters related to differences of opinion, or difficult or contentious matters, the engagement partner may also consider whether the use of the [draft] ISA for LCE continues to be appropriate.*

3.2.13. For audit engagements for which an engagement quality review is required, the engagement partner shall determine that an engagement quality reviewer has been appointed and:

- (a) Cooperate with the engagement quality reviewer;
- (b) Discuss significant matters and significant judgments arising during the audit with the engagement quality reviewer; and
- (c) Not date the auditor's report before the engagement quality review is complete.

*Review of Communications*

3.2.14. The engagement partner shall review, prior to their issuance, formal written communications to management, those charged with governance or regulatory authorities.

**3.3 Specific Documentation Requirements**

3.3.1. In addition to the general documentation requirements (Part 2.5.) for an audit engagement, the auditor shall include in the audit documentation matters identified, relevant discussions, and conclusions reached with respect to fulfillment of responsibilities for relevant ethical requirements, including applicable independence requirements.

## **4. Acceptance or Continuance of an Audit Engagement and Initial Audit Engagements**

### *Content of this Part*

Part 4 sets out the auditor's responsibilities for:

- Agreeing the terms of the audit engagement with management, and where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit are present.
- Determining that use of the [draft] ISA for LCE is appropriate for the audit engagement.

Part 4 also addresses activities related to initial audit engagements.

### *Scope of this Part*

Part A of this [draft] standard sets out the authority for appropriate use of this [draft] standard. This Part sets out the engagement partner's obligations for use of this [draft] standard as part of the firm's acceptance or continuance procedures for an audit engagement of an LCE.

The information and audit evidence gathered during client acceptance and continuance procedures is used to make the determination that the [draft] ISA for LCE is appropriate for the audit engagement and also informs the auditor's procedures when planning the audit and for risk identification and assessment.

Part 1.2. sets out that this [draft] standard is premised on the basis that the firm is subject to ISQM 1 or to national requirements that are at least as demanding. ISQM 1 requires the firm to establish quality objectives that address the acceptance and continuance of client relationships and specific engagements. In addition, compliance with ISQM 1 may require firms to have policies or procedures to address other matters of relevance to this Part.

Audit engagements may only be accepted when the auditor considers that relevant ethical requirements such as independence and professional competence and due care will be satisfied and the preconditions for an audit are present. In addition, the auditor considers the performance of non-assurance services for the audit client and whether these services are permissible.

If the audit is an initial engagement, this Part also sets out the auditor's responsibilities relating to opening balances.

### **4.1. Objectives**

4.1.1. The objectives of the auditor are:

- (a) To accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
  - (i) Establishing whether the preconditions for an audit are present; and
  - (ii) Confirming that there is a common understanding between the auditor and management, and where appropriate, those charged with governance, of the terms of the audit engagement.
- (b) For initial audit engagements, to obtain sufficient appropriate audit evidence about whether:
  - (i) Opening balances contain misstatements that materially affect the current period's financial statements, and

- (ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

#### **4.2. Determining that the [Draft] ISA for LCE is Appropriate for the Audit Engagement**

- 4.2.1. The engagement partner shall determine, in accordance with Part A of this [draft] standard, that the audit engagement can be undertaken using the [draft] ISA for LCE.

*Part A sets out the matters relevant to the engagement partner's determination of use of the [draft] ISA for LCE, in particular in relation to the limitations for using the [draft] standard. This determination is made when the engagement partner is determining that the firm's policies or procedures regarding acceptance and continuance have been followed (see paragraph 4.4.1.).*

*Information and audit evidence gathered during client acceptance and continuance procedures may be used to make the determination about use of the [draft] ISA for LCE. Further information may also be obtained when performing risk identification and assessment procedures that may change the engagement partner's initial determination about use of the [draft] ISA for LCE in accordance with this Part. Part 6 (see paragraph 6.5.10) requires the engagement partner to determine whether the [draft] ISA for LCE continues to be appropriate for the nature and circumstances of the entity being audited during the risk identification and assessment process. Consideration of further information throughout the audit may change the engagement partner's determination about the appropriateness of the use of the [draft] ISA for LCE.*

#### **4.3 Preconditions for an Audit**

- 4.3.1. In order to establish whether the preconditions for an audit are present, the auditor shall:
  - (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable;
  - (b) Obtain the agreement of management and where appropriate, those charged with governance, that it acknowledges and understands its responsibility:
    - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
    - (ii) For such controls as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
    - (iii) To provide the auditor with:
      - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
      - b. Additional information that the auditor may request from management for the purpose of the audit; and
      - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.



4.3.2. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable; or
- (b) If the agreement of management that it acknowledges and understands its responsibility has not been obtained.

4.3.3. If management or those charged with governance impose a limitation on the scope of the auditor's work such that the auditor believes that the limitation will result in the auditor disclaiming the opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

#### 4.4. Additional Considerations in Engagement Acceptance

4.4.1. The engagement partner shall determine that the firm's policies or procedures regarding acceptance and continuance of the audit engagement have been followed<sup>48</sup> and that conclusions reached in this regard are appropriate, including the appropriate use of the [draft] ISA for LCE.

4.4.2. In some cases, law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of this [draft] standard. In these circumstances, the auditor shall evaluate:

- (a) Whether users may misunderstand the assurance obtained from the audit of the financial statements, and, if so,
- (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

4.4.3. If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with the [draft] ISA for LCE. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with this [draft] ISA for LCE.

#### 4.5. Terms of the Audit Engagement

*Performing acceptance or continuance procedures before planning commences assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the current engagement.*

*This [draft] standard requires the auditor to ascertain certain matters, upon which it is necessary for the auditor and management or, where appropriate, those charged with governance to agree, and which are in the control of the entity, prior to the auditor accepting the audit engagement.*

4.5.1. The auditor shall agree the terms of the audit engagement with management, or where appropriate, those charged with governance.

<sup>48</sup> International Standard on Quality Management (ISQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, paragraph 30 sets out the firm's responsibilities for establishing quality objectives for the acceptance of specific engagements, including judgments relating to financial and operating priorities of the firm when deciding to accept or continue specific engagements.



*If law or regulation prescribes the responsibilities of management that are equivalent in effect to what this [draft] standard requires, the auditor may use the wording of the law or regulation to describe them in the written agreement.*

- 4.5.2. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.
- 4.5.3. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.
- 4.5.4. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.
- 4.5.5. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
- 4.5.6. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
- (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
  - (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

#### **4.6. Initial Audit Engagements**

- 4.6.1. If the engagement is an initial audit and there has been a change in auditor, the auditor shall communicate with the predecessor auditor, in compliance with relevant ethical requirements.
- 4.6.2. The auditor shall read the most recent financial statements, if any, and the auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
- 4.6.3. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.<sup>49</sup>
- 4.6.4. The auditor shall obtain sufficient appropriate audit evidence<sup>50</sup> about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
  - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

<sup>49</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.I.

<sup>50</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.F.

- (c) Performing one or more of the following:
- (i) Where the prior year financial statements were audited, inspecting the predecessor auditor's working papers to obtain evidence regarding the opening balances;
  - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

4.6.5. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.<sup>51</sup>

4.6.6. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether any changes in accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.<sup>52</sup>

#### **4.7. Specific Communication Requirements**

##### *Communications with Those Charged with Governance*

4.7.1. The auditor shall communicate with those charged with governance the auditor's responsibilities for forming and expressing an opinion on the financial statements prepared by management, and that the auditor's responsibilities do not relieve management or those charged with governance from their responsibilities for oversight of the preparation of the financial statements.

#### **4.8. Specific Documentation Requirements**

4.8.1. In addition to the general documentation requirements (Part 2.5.), the auditor shall include in the audit documentation matters identified, relevant discussions, and conclusions reached with respect to the acceptance and continuance of the client relationship and audit engagement.

4.8.2. The auditor shall document the determination made for using the [draft] ISA for LCE.

4.8.3. The auditor shall document changes, if any, to the determination of the use of the [draft] ISA for LCE if further information comes to the auditor's attention during the audit that may change the professional judgment made in this regard.

4.8.4. The auditor shall record in an audit engagement letter or other suitable form of written agreement:

- (a) That the audit will be undertaken using the [draft] ISA for LCE.
- (b) The objective and scope of the audit of the financial statements;
- (c) The respective responsibilities of the auditor and management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements;

<sup>51</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.G.

<sup>52</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.H.

- (e) Reference to the expected form and content of any reports to be issued by the auditor; and
- (f) A statement that there may be circumstances in which a report may differ from its expected form and content.

4.8.5. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in this [draft] standard, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies, and that management acknowledges and understands its responsibilities.

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## 5. Planning

### *Content of this Part*

Part 5 sets out the auditor's responsibility to plan the audit (including holding an engagement team discussion), and the concept of materiality when planning and performing the audit.

### *Scope of this Part*

Planning is continual and is not a discrete phase of the audit but is iterative, as necessary, throughout the audit. Part 6, identifying and assessing risks of material misstatement, and Part 7, responding to assessed risks of material misstatement, are also relevant to this Part.

Some requirements within this Part are linked to procedures in other Parts and may require the auditor to execute on those procedures in order to meet the requirements in this Part.

### 5.1. Objectives

5.1.1. The objectives of the auditor are to:

- (a) Plan the audit so that it will be performed in an effective manner; and
- (b) Apply the concept of materiality appropriately in planning and performing the audit.

### 5.2. Planning Activities

*The nature, timing and extent of planning activities will vary according to the nature and circumstances of the entity, the size and nature of the engagement team, the engagement team members' previous experience with the entity and any changes in circumstances that occur during the audit engagement. When an engagement is carried out by a single individual some of the requirements may not be relevant (e.g., the engagement team discussion), however consideration may still be given to the matters within the relevant paragraphs as they may still assist the auditor.*

*The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.*

5.2.1. The engagement partner and other key members of the engagement team shall be involved in planning the audit.

5.2.2. The auditor shall set the scope, timing and direction of the audit and:

- (a) Identify the characteristics of the engagement that define its scope;
- (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for this entity is relevant;

- (e) Ascertain the nature, timing and extent of procedures to be performed and the resources necessary to perform the audit, including determining whether experts are needed; and
- (f) Plan the nature, timing and extent of direction and supervision of engagement team members and review of their work.

*In the audit of an LCE, establishing the scope, timing and direction of the audit need not be a complicated or time-consuming exercise. For example, a suitable brief memorandum prepared at the completion of the previous audit, based on inspection of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented scope, timing and direction for the current audit engagement. Standard audit programs or checklists created based on the assumption of few identified controls, as is likely to be the case in a less complex entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.*

- 5.2.3. The engagement partner shall take into account information obtained in the acceptance and continuance process in planning and performing the audit.
- 5.2.4. When information used to plan and perform the audit has been obtained from the previous experience with the entity, or prior audits, the auditor shall evaluate whether such information remains relevant and reliable as audit evidence in the current period.
- 5.2.5. The auditor shall update and change the scope, timing and direction as necessary during the audit.

#### *Engagement Team Discussion*

- 5.2.6. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, including:
  - (a) The application of the applicable financial reporting framework to the entity's facts and circumstances.
  - (b) How and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud may occur, and how fraud or error could arise from related party relationships or transactions.

Discussions among the engagement team shall occur setting aside beliefs the engagement team may have that management, and where appropriate, those charged with governance are honest and have integrity.

*The engagement team discussion may also include other matters related to the audit such as the logistics, operational and other matters (such as when risks of material misstatement may have changed from prior years or matters related to relevant ethical requirement including independence) and the timing of the audit and communications that are required.*

- 5.2.7. When there are engagement team members not involved in the discussion, the engagement partner shall determine which matters are to be communicated to those members.

#### *Using the Work of Management's Expert*

- 5.2.8. If information to be used as audit evidence has been prepared using the work of management's expert, the auditor shall, having regard to the significance of that expert's work for the auditor's purpose:

- (a) Evaluate the competence, capabilities and objectivity of that expert;
- (b) Understand the work of that expert; and
- (c) Evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion.

*Determining Whether to Use the Work of an Auditor's Expert*

5.2.9. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.

*If the preparation of the financial statements involves the use of expertise in a field other than accounting, the auditor, who is skilled in accounting and auditing, may not possess the necessary expertise to audit those financial statements. The engagement partner is required to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement. Further, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the engagement. The auditor's determination of whether to use the work of an auditor's expert, and if so when and to what extent, assists the auditor in meeting these requirements. As the audit progresses, or as circumstances change, the auditor may need to revise earlier decisions about using the work of an auditor's expert.*

*The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert concludes, based on the audit procedures performed and the evidence obtained, that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.*

5.2.10. The auditor shall consider the following when determining the nature, timing and extent of procedures related to the auditor's expert:

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality management policies or procedures.

5.2.11. If the auditor is using the work of an auditor's expert, the auditor shall:

- (a) Evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity, including inquiry regarding interests and relationships that may create a threat to objectivity, for the auditor's purpose;
- (b) Obtain sufficient understanding of the field of expertise to enable the auditor to determine the nature, scope and objectives of the auditor's expert work and evaluate that work for the auditor's purpose; and
- (c) Agree in writing with the auditor's expert the nature, scope and objectives of the expert's work, the respective roles and responsibilities of the expert and the auditor in relation to that work,

the nature, timing and extent of communications and the need for the expert to observe confidentiality requirements.

### *Going Concern*

*Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.*

5.2.12. The auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern and:

- (a) If such an assessment has been performed, discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
- (b) If such an assessment has not yet been performed, discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

*The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.*

5.2.13. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

## **5.3. Materiality**

5.3.1. The auditor shall determine materiality for the financial statements as a whole.

*The concept of materiality is applied by the auditor in both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements if any, on the financial statements and in forming an opinion in the auditor's report.*

*The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial needs of users of the financial statements. The auditor's professional judgment about misstatements that will be considered material provides a basis for:*

- *Determining the nature, timing and extent of procedures to identify and assess risks of material misstatement;*
- *Identifying and assessing the risks of material misstatement; and*



- *Determining the nature, timing and extent of further audit procedures.*

*A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.*

- 5.3.2. The auditor shall also determine the materiality level or levels to be applied to particular classes of transactions, account balances or disclosures if, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

#### *Considerations Specific to Public Sector Entities*

*In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.*

- 5.3.3. The auditor shall determine performance materiality for the purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

*Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

- 5.3.4. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) if the auditor becomes aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.
- 5.3.5. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

#### **5.4. Specific Communication Requirements**

- 5.4.1. The auditor shall communicate to management, and where appropriate, those charged with governance an overview of the planned scope, timing and direction of the audit.



## 5.5. Specific Documentation Requirements

- 5.5.1. In addition to the general documentation requirements (Part 2.5.) for an audit engagement, the auditor shall include a description of the scope, timing and direction of the audit, and significant changes made during the audit, together with the reasons for such changes, in the audit documentation.
- 5.5.2. The auditor shall include in the audit documentation a description of:
- (a) The nature, timing and extent of planned risk identification and assessment procedures.
  - (b) The nature, timing and extent of planned further audit procedures at the financial statement and assertion level.
  - (c) Other planned audit procedures that are required to be carried out so that the engagement complies with the requirements of this [draft] standard.
- 5.5.3. The auditor shall document the discussion among the engagement team and significant decisions reached including significant decisions regarding the susceptibility of the entity's financial statements to material misstatement due to fraud or error.
- 5.5.4. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination of materiality (including any revisions as applicable):
- (a) Materiality for the financial statements as a whole;
  - (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures; and
  - (c) Performance materiality.

## **6. Risk Identification and Assessment**

### *Content of this Part*

Part 6 contains the requirements relevant to the auditor's responsibility to perform procedures and related activities to:

- Understand the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control (the entity's internal control system);
- Identify risks of material misstatement at the financial statement and assertion levels, whether due to fraud or error; and
- Assess inherent risk and control risk.

Appendix 2 illustrates the iterative nature of the auditor's risk identification and assessment.

### *Scope of this Part*

This Part deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, which provides the basis for the audit procedures undertaken to respond to assessed risks in Part 7. Part 5 sets out the auditor's obligations for planning activities, including the requirements for the engagement team discussion.

### **6.1 Objectives**

- 6.1.1. The objectives of the auditor are to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

*Understanding the entity and its environment, the applicable financial reporting framework and the entity's internal control system enables the auditor to identify and assess the risks of material misstatement. The auditor's risk identification and assessment process is iterative and dynamic. The auditor's understanding of the entity and its environment, the applicable financial reporting framework, and the entity's internal control system are interdependent with concepts within the requirements to identify and assess the risks of material misstatement.*

### **6.2. Procedures for Identifying and Assessing Risks and Related Activities**

- 6.2.1. The auditor shall design and perform procedures to obtain audit evidence that provides an appropriate basis for:

- (a) The identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels; and
- (b) The design of further audit procedures.

*The auditor uses professional judgment to determine the nature and extent of the procedures to be performed, which may vary with the formality of the entity's policies or procedures.*

*Some less complex entities, and particularly owner-managed entities, may not have established structured processes and systems (e.g., a risk assessment process or a process to monitor the entity's internal control system) or may have established processes or systems with limited*

*documentation or a lack of consistency in how they are undertaken. When such systems and processes lack formality, compliance with the procedures in this Part is still required. For example the auditor may still be able to perform the required procedures through observation and inquiry.*

*Designing and performing procedures to obtain audit evidence in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of evidence.*

6.2.2. The procedures to identify and assess risks of material misstatement shall include:

- (a) Inquiries of management, and other appropriate individuals within the entity;
- (b) Analytical procedures.; and
- (c) Observation and inspection.

*The auditor is not required to perform all of these procedures for each aspect of the auditor's understanding required.*

#### *Considerations Specific to Public Sector Entities*

*When making inquiries of those who may have information that is likely to assist in identifying risks of material misstatement, auditors of public sector entities may obtain information from additional sources such as from the auditors that are involved in performance or other audits related to the entity. Procedures performed by auditors of public sector entities to identify and assess risks of material misstatement may also include observation and inspection of documents prepared by management for the legislature, for example documents related to mandatory performance reporting.*

#### *Automated Tools and Techniques*

*If the auditor uses ATT, the auditor may design and perform procedures to identify and assess risks of material misstatement on relatively large volumes of data (from the general ledger, sub-ledgers or other operational data) including for analysis, observation or inspection.*

6.2.3. In designing and performing procedures to identify and assess risks of material misstatement, the auditor shall consider possible risks of material misstatement arising from:

- (a) Fraud or error;
- (b) Related parties; and
- (c) Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

#### *Fraud*

*Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively, such as recording fictitious journal entries close to the end of the financial reporting period.*

*Misappropriation of assets involves the theft of the entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.*

*Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.*

#### *Going Concern*

*Events or conditions that may cast significant doubt on the entity's ability to continue as a going concern of particular relevance to an LCE include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.*

- 6.2.4. When identifying risks of material misstatement, including those arising from fraud, the auditor shall consider information from all procedures designed and performed for risk identification to determine whether fraud risk factors are present, including:
- (a) The acceptance or continuance procedures; and
  - (b) When applicable, other engagements performed by the engagement partner for the entity.
- 6.2.5. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.
- 6.2.6. If the audit opinion on the prior period's financial statements was modified the auditor shall evaluate the effect on the current year's financial statements when identifying and assessing risks of material misstatement.

### **6.3. Understanding Relevant Aspects of the Entity**

*The auditor's understanding of the entity and its environment, and the applicable financial reporting framework, establishes a frame of reference in which the auditor identifies and assesses the risks of material misstatement, and also informs how the auditor plans and performs further audit procedures.*

#### *Understanding the Entity and Its Environment*

- 6.3.1. The auditor shall understand:
- (a) The entity's organizational structure, ownership and governance, business model (including how the entity uses IT in its business model).
  - (b) The industry and other external factors.
  - (c) How the entity's financial performance is measured internally and externally.
  - (d) The legal and regulatory framework applicable to the entity, and how the entity is complying with that framework.
  - (e) The entity's transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed.
  - (f) Agreements or relationships that may result in unrecognized liabilities, future commitments or changes to current asset valuations through inspecting minutes of meetings and correspondence with legal counsel and inspecting legal expense accounts.

*Understanding the entity's objectives, strategy and business model helps the auditor to understand the entity at a strategic level, and to understand the business risks the entity takes and faces. An understanding of the business risks that have an effect on the financial statements assists the auditor*

*in identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.*

#### *Considerations Specific to Public Sector Entities*

*Entities operating in the public sector may create and deliver value in different ways to those creating wealth for owners but will still have a 'business model' with a specific objective. Matters public sector auditors may obtain an understanding of that are relevant to the business model of the entity, include:*

- *Knowledge of relevant government activities, including related programs.*
- *Program objectives and strategies, including public policy elements.*

6.3.2. The auditor shall understand how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud or error in the entity and the controls that management has established to mitigate these risks.

#### *Understanding the Applicable Financial Reporting Framework*

6.3.3. The auditor shall understand:

- (a) The applicable financial reporting framework including, for accounting estimates, the recognition criteria, measurement bases, and the related presentation and disclosure requirements and how these apply in the context of the nature and circumstances of the entity and its environment.
- (b) The entity's accounting policies and reasons for any changes thereto.

6.3.4. The auditor shall evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.

#### *Inherent Risk Factors*

6.3.5. In understanding the entity and its environment and the applicable financial reporting framework in accordance with this Part, the auditor shall understand how inherent risk factors affect the susceptibility of assertions to misstatement, and the degree to which they do so.

*Inherent risk factors may be qualitative or quantitative and affect the susceptibility of assertions to misstatement. Qualitative inherent risk factors relating to the preparation of information required by the applicable financial reporting framework include:*

- *Complexity;*
- *Subjectivity;*
- *Change;*
- *Uncertainty (for accounting estimates this is estimation uncertainty); or*
- *Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.*

*The presence of inherent risk factors that give rise to higher inherent risk. related to accounting estimates may be indicators that the [draft] ISA for LCE is not appropriate for the audit.*

### *Understanding the Entity's Internal Control System*

*The auditor's understanding of the entity's internal control system influences the auditor's identification and assessment of the risks of material misstatement, and also assists the auditor in planning and designing further audit procedures. The entity's internal control system consists of the five components of internal control, for which an understanding is required for each:*

- *The control environment.*
- *The entity's risk assessment process.*
- *The entity's process to monitor the internal control system.*
- *The information system and communication.*
- *Control activities.*

*In less complex entities, and in particular owner-manager entities, the way in which the entity's internal control system is designed, implemented and maintained will vary with the entity's size and complexity. When there are no formal processes or documented policies or procedures, the auditor is still required to understand how management, or where appropriate, those charged with governance prevent and detect fraud and error, and use professional judgment to determine the nature and extent of the procedures to obtain the required understanding.*

#### *Considerations Specific to Public Sector Entities*

*Auditors of public sector entities often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice or reporting on spending against budget. Auditors of public sector entities may also have responsibilities to report on compliance with law, regulation or other authority. As a result, their considerations about the internal control system may be broader and more detailed.*

6.3.6. The auditor shall evaluate whether management (with the oversight of those charged with governance, if applicable) has created and maintained a control environment that provides an appropriate foundation for the other components of the entity's internal control system, including determining whether there are any deficiencies in the control environment that undermine the other components of the entity's internal control system. For this purpose, the auditor shall understand:

- (a) How management, and where appropriate, those charged with governance, oversee the entity, and demonstrate integrity and ethical values;
- (b) The entity's assignment of authority and responsibility;
- (c) The culture of the entity, including whether the culture supports honesty and ethical behavior; and
- (d) When applicable, how owner-managers have an active involvement and influence the risks arising from management override of controls due to lack of segregation of duties.

*The control environment provides an overall foundation for the operation of the other components of the entity's internal control system and deficiencies may undermine the rest of the entity's internal control system. Although it does not directly prevent or detect and correct misstatements, it may influence the effectiveness of other controls in the internal control system. The control environment includes the governance and management functions and the attitudes, awareness and actions of*

*those charged with governance and management concerning the entity's internal control system and its importance in the entity.*

*Because the control environment is foundational to the entity's internal control system, any deficiencies could have pervasive effects on the preparation of the financial statements. Therefore, the auditor's understanding and evaluations of this component affect the auditor's identification and assessment of risks of material misstatement at the financial statement level, and may also affect the identification and assessment of risks of material misstatement at the assertion level, as well as the auditor's responses to the identified risks.*

*In the case of an LCE, some or all aspects of the control environment may not be applicable or less relevant. For example, an LCE may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in an LCE does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.*

- 6.3.7. The auditor shall evaluate whether the entity's risk assessment process is appropriate to the entity's circumstances considering the nature and complexity of the entity. For this purpose, the auditor shall understand the entity's risk assessment process relevant to the preparation of the financial statements (i.e., how risks are identified, assessed and addressed), including how this process identifies and addresses risks related to accounting estimates.

*Understanding how the entity assesses its business risks and other risks can assist the auditor in understanding where there are identified risks, and whether the entity has responded to those risks. This may inform the auditor in understanding whether the risks faced by the entity have been identified, assessed and addressed as appropriate to the nature and circumstances of the entity, and help the auditor in identifying and assessing risks of material misstatement and responding to those risks.*

- 6.3.8. The auditor shall evaluate whether the entity's process for monitoring the internal control system is appropriate to the entity's circumstances considering the nature and complexity of the entity. For this purpose, the auditor shall understand the entity's process to monitor the entity's internal control system, including the sources of information and the basis upon which management considers the information to be sufficiently reliable, as well as how deficiencies are remediated.

*Understanding the entity's monitoring of the internal control system assists the auditor to understand whether the entity's internal control system is present and functioning. In less complex entities, and in particular owner-manager entities, the auditor's understanding of the entity's process to monitor the entity's internal control system is often focused on how management or the owner-manager is directly involved in operations, as there may not be any other formal monitoring activities.*



6.3.9. The auditor shall understand the information system relevant to the preparation of the financial statements, including:

- (a) For significant classes of transactions, account balances and disclosures, how those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements, as well as:
  - (i) How the information system captures, processes and discloses events and conditions, other than transactions;
  - (ii) The accounting records, specific accounts in the financial statements and other supporting records for the flows of information;
  - (iii) The entity's resources used in the financial reporting process;
  - (iv) The financial reporting process used to prepare the entity's financial statements, including disclosures; and
- (b) The IT environment relevant to (a)(i) to (iv) above.

6.3.10. The auditor shall understand how the entity communicates significant matters related to the preparation of the financial statements, and related reporting responsibilities, between people within the entity, between management and those charged with governance (if applicable) and with external parties (such as regulatory authorities or others as required).

6.3.11. The auditor shall evaluate whether the entity's information system and communication appropriately supports the preparation of the entity's financial statements in accordance with the applicable financial reporting framework.

*The auditor's understanding of the information system may be obtained in various ways and may include:*

- *Inquiries of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process;*
- *Inspection of policy or process manuals or other documentation of the entity's information system;*
- *Observation of the performance of the policies or procedures by entity's personnel; or*
- *Selecting transactions and tracing them through the applicable process in the information system (i.e., performing a walk-through).*

*The information system, and related business processes, in less complex entities are likely to involve a less complex IT environment; however, the role of the information system is just as important when identifying and assessing risks of material misstatement. Less complex entities with direct management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies.*

#### *Automated Tools and Techniques*

*The auditor may also use ATT to obtain direct access to, or a digital download from, the databases in the entity's information system that store accounting records of transactions. By applying ATT to this information, the auditor may confirm the understanding obtained about how transactions flow through the information system by tracing journal entries, or other digital records related to a particular*



*transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of risks of material misstatement.*

6.3.12. For accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures, the auditor's understanding of the information system and the flow of information relevant to the preparation of the financial statements shall include:

- (a) How management identifies, selects and applies relevant methods, assumptions and data that are appropriate in the context of the applicable financial reporting framework, including identification of significant assumptions;
- (b) How management understands the degree of estimation uncertainty and addresses such uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements;
- (c) Controls over management's process for making accounting estimates; and
- (d) How management reviews the outcomes of previous estimates and responds to the results of that review.

6.3.13. Based on the auditor's evaluations about whether the control environment, the entity's risk assessment process, the monitoring of the entity's internal control system and the information system are appropriate in context of the nature and circumstances of the entity, the auditor shall determine whether one or more control deficiencies have been identified.

6.3.14. The auditor shall identify controls that address risks of material misstatement at the assertion level as follows:

- (a) Controls that address risks determined to be significant risks;
- (b) Controls over journal entries including to record non-recurring, unusual transactions or adjustments;
- (c) Controls for which the auditor plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive testing, including those controls that address risks for which substantive procedures alone are not enough to obtain sufficient appropriate audit evidence;
- (d) Other controls, based on the auditor's professional judgment, where the auditor considers it appropriate to meet the objectives of identifying risks of material misstatement at the assertion level;
- (e) If applicable, controls that relate to information processed by a service organization; and
- (f) Controls, if any, to identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework, authorize and approve significant transactions and relationships with related parties, and authorize and approve significant transactions and arrangements outside the normal course of business.

For each control identified in (a)–(f) above, the auditor shall evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed

to support the operation of other controls, and determine whether the control has been implemented, by performing procedures more than inquiry.

*The auditor is required to identify specific controls, evaluate the design and determine whether the controls have been implemented. This assists the auditor's understanding of management's approach to addressing certain risks, and therefore provides a basis for the design and performance of further audit procedures responsive to these risks even when the auditor does not plan to test the operating effectiveness of identified controls.*

*Controls over journal entries are expected to be identified for all audits because the manner in which an entity incorporates information from transaction processing into the general ledger ordinarily involves the use of journal entries, whether standard or non-standard, or automated or manual. The extent to which other controls are identified may vary based on the nature of the entity and the auditor's planned approach to further audit procedures. For example, in an audit of an LCE, the entity's information system may not be complex and the auditor may not intend to test the operating effectiveness of controls. Further, the auditor may not have identified any significant risks or any other risks of material misstatement for which it is necessary for the auditor to evaluate the design of controls and determine that they have been implemented. In such an audit, the auditor may determine that there are no identified controls other than the entity's controls over journal entries.*

6.3.15. For the controls identified in paragraph 6.3.14, the auditor shall identify the IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT.

6.3.16. For the IT applications and other aspects of the IT environment identified in paragraph 6.3.15, the auditor shall identify the related risks arising from the use of IT and the entity's general IT controls that respond to those risks, and evaluate whether the general IT controls are effectively designed to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls, and determine whether the control has been implemented by performing procedures more than inquiry.

*The auditor's understanding of the information system (which may be done by performing walk-through procedures) includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system. This is because the entity's use of IT applications or other aspects of the IT environment may give rise to risks arising from IT (i.e., the susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information).*

*The extent of the auditor's understanding of the IT processes, including the extent to which the entity has general IT controls in place, will vary with the nature and the circumstances of the entity and its IT environment, as well as based on the nature and extent of controls identified by the auditor. The number of IT applications that are subject to risks arising from the use of IT also will vary based on these factors.*

6.3.17. If the entity uses the services of a service organization, the auditor's understanding of the information system shall include:

- (a) The nature of the services provided by the service organization and the significance of those services to the entity;
- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization;

- (c) The relevant contractual terms for the activities undertaken by the service organization;
- (d) Controls at the service organization relevant to the entity's transactions; and
- (e) The controls applied to transactions with the service organization.

*The auditor's understanding of the services of a service organization will inform the auditor about the significance of the controls of the service organization relative to those of the entity, which may also be demonstrated by the degree of interaction between its activities and those of the entity. For example, the service organization may process and account for transactions that are still required to be authorized by the entity, alternatively the entity may rely on such controls being affected at the service organization. The nature and extent of work to be performed by the auditor regarding the services provided by a service organization depend on the nature and significance of those services to the entity and the relevance of those services to the audit.*

#### *Deficiencies in the Entity's Internal Control System*

6.3.18. The auditor shall determine whether deficiencies identified in the entity's internal control system, individually or in combination, constitute significant deficiencies.

#### **6.4. Identifying Risks of Material Misstatement**

*Risks of material misstatement are identified and assessed by the auditor to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.*

6.4.1. The auditor shall identify the risks of material misstatement, due to fraud or error, at:

- (a) The financial statement level; and
- (b) The assertion level for classes of transactions, account balances, and disclosures.

*The identification of risks of material misstatement is performed before consideration of any related controls (i.e., the inherent risk), and is based on the auditor's consideration of misstatements that have a reasonable possibility of both occurring, and being material if they were to occur.*

*Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance or disclosure level (e.g., risk of management override of controls).*

*In identifying and assessing the risks of material misstatement, the auditor uses assertions to consider the different types of potential misstatements that may occur. Appendix 4 sets out assertions that may be used by the auditor in considering different types of misstatements at the assertion level.*

6.4.2. In identifying the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

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

6.4.3. The auditor shall determine the relevant assertions and the related significant classes of transactions, account balances and disclosures.

*Determining relevant assertions and the significant classes of transactions, account balances and disclosures provides the basis for the scope of the auditor's understanding of the entity's information system required to be obtained, and the identification and assessment of risks of material misstatement.*

## 6.5. Risk Assessment

### *Assessing Inherent Risk*

6.5.1. For identified risks of material misstatement, the auditor shall assess:

- (a) The risks of material misstatement at the financial statement level. In doing so, the auditor shall determine whether such risks affect risks at the assertion level, and evaluate the nature and extent of their pervasive effect on the financial statements; and
- (b) Inherent risk for identified risks of material misstatement at the assertion level by assessing the likelihood and magnitude of misstatement. In doing so, the auditor shall take into account how, and the degree to which inherent risk factors affect the susceptibility of relevant assertions to misstatement.

*The assessed inherent risk for a particular risk of material misstatement at the assertion level represents a judgment within a range, from lower to higher, on the spectrum of inherent risk.*

*In assessing inherent risk, the auditor uses professional judgment in determining the significance of the combination of the likelihood and magnitude of a misstatement on the spectrum of inherent risk. The judgment about where in the range inherent risk is assessed may vary based on the nature, size or circumstances of the entity, and takes into account the assessed likelihood and magnitude of the misstatement and inherent risk factors.*

*In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur, based on consideration of the inherent risk factors. In considering the magnitude of a misstatement, the auditor considers the qualitative and quantitative aspects of the possible misstatement (i.e., misstatements in assertions about classes of transactions, account balances or disclosures may be judged to be material due to nature, size or circumstances).*

#### *Considerations Specific to Public Sector Entities*

*In exercising professional judgment as to the assessment of the risk of material misstatement, public sector auditors may consider the complexity of the regulations and directives, and the risks of non-compliance with authorities.*

6.5.2. In identifying and assessing risks of material misstatement relating to an accounting estimate and related disclosure at the assertion level, the auditor shall take into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the following are affected by complexity, subjectivity or other inherent risk factors:

- (a) The selection and application of the method, the assumptions and data used; and
- (b) The selection of management's point estimate and related disclosures.

6.5.3. The auditor shall determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level.

*Where routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. This may be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form. In such cases:*

- *The sufficiency and appropriateness of audit evidence usually depend on the effectiveness of controls over its accuracy and completeness.*
- *The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.*

#### *Significant Risks*

6.5.4. The auditor shall determine whether any of the assessed risks of material misstatement are, in the auditor's professional judgment, a significant risk.

*The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk as set out in paragraphs 6.5.4.–6.5.5. Being close to the upper end of the spectrum of inherent risk will differ from entity to entity, and will not necessarily be the same for an entity period on period. It may depend on the nature and circumstances of the entity for which the risk is being assessed.*

6.5.5. In exercising professional judgment as to which assessed risks are significant risks, the auditor shall determine whether the assessed risks associated with related party relationships and transactions are significant risks.

6.5.6. The auditor shall determine whether risks of material misstatement assessed relating to accounting estimates are significant risks.

6.5.7. The auditor shall treat the following as significant risks:

- (a) Identified fraud risks including:
  - (i) Management override of controls. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur it is a risk of material misstatement due to fraud and therefore a significant risk; and
  - (ii) Risk of fraud in revenue recognition. Based on a presumption that there are risks of fraud in revenue recognition the auditor shall evaluate which types of revenue, revenue transactions or assertions give rise to such risks; and
- (b) Identified significant related party transactions outside the entity's normal course of business.

#### *Assessing Control Risk*

6.5.8. If the auditor plans to test the operating effectiveness of controls the auditor shall assess control risk, otherwise the risk of material misstatement is the same as the assessment of inherent risk.

*The auditor's plans to test the operating effectiveness of controls is based on the expectation that controls are operating effectively, and this will form the basis of the auditor's assessment of control risk.*

*The initial expectation of the operating effectiveness of controls is based on the auditor's evaluation of the design, and the determination of implementation, of the controls identified in paragraphs 6.3.14. and 6.3.16. Once the auditor has tested the operating effectiveness of the controls in accordance with Part 7, the auditor will be able to confirm the initial expectation about the operating effectiveness of controls. If the controls are not operating effectively as expected, then the auditor will need to revise the control risk assessment.*

*The auditor's assessment of control risk may be performed in different ways depending on preferred audit techniques or methodologies, and may be expressed in different ways. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.*

#### *Evaluation of the Procedures to Identify and Assess Risks of Material Misstatement and Revision of Risk Assessment*

- 6.5.9. The auditor shall evaluate whether the audit evidence obtained from procedures to identify and assess the risks of material misstatement provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor shall perform additional procedures until audit evidence has been obtained to provide such a basis. In identifying and assessing the risks of material misstatement, the auditor shall take into account all audit evidence obtained from the procedures to identify and assess the risks of material misstatement, whether corroborative or contradictory to assertions made by management.
- 6.5.10. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly.

#### *Evaluation of the Appropriateness of Using the [draft] ISA for LCE*

- 6.5.11. Based on the procedures performed to identify and assess the risks of material misstatement, the engagement partner shall evaluate whether the [draft] ISA for LCE continues to be appropriate for the nature and circumstances of the entity being audited.

*The auditor's original determination to use the [draft] ISA for LCE may change as new information or additional audit evidence is obtained when performing procedures to identify and assess risks of material misstatement. In circumstances where audit evidence, or new information, is obtained, which is inconsistent with the auditor's original determination for using the [draft] ISA for LCE, the auditor may need to change the original determination to use the [draft] ISA for LCE.*



## 6.6. Specific Inquiries of Management and Those Charged with Governance

6.6.1. In designing and performing procedures to identify and assess the risks of material misstatement due to fraud or error, the auditor shall make inquiries of management regarding:

- (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
- (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity;
- (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior;
- (e) The identity of the entity's related parties, including changes from the prior period; the nature of the relationships between the entity and these related parties; and whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions;
- (f) Non-compliance with law or regulation that may have a material effect on the financial statements, and inspecting correspondence, if any, with the relevant licensing or regulatory authorities; and
- (g) Events or conditions that exist that individually, or collectively, may affect the ability of the entity to continue as a going concern.

6.6.2. The auditor shall make inquiries of management, and as appropriate, those charged with governance, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

## 6.7. Specific Communication Requirements

6.7.1. The auditor shall communicate to management, and where appropriate, those charged with governance, the significant risks identified by the auditor.

## 6.8. Specific Documentation Requirements

*The form and extent of documentation for the identification and assessment of the risks of material misstatement may be simple and relatively brief, and is influenced by:*

- *The nature, size and complexity of the entity and its internal control system.*
- *Availability of information from the entity.*
- *The audit methodology and technology used in the course of the audit.*

*It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it, but rather apply the principles in Part 2.5 and the matters noted below.*

6.8.1. In addition to the general documentation requirements (Part 2.5.) for an audit of an LCE, the auditor shall include the following in the audit documentation:

- (a) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, the applicable financial reporting framework and the entity's internal control system;

*Key elements of understanding documented by the auditor include those on which the auditor based the assessment of risks of material misstatement.*

- (b) The names of the identified related parties (including changes from prior period) and the nature of the related party relationships;
- (c) The identified and assessed risks of material misstatement, including risks due to fraud, at the financial statement level and at the assertion level, including significant risks and risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence, and the rationale for the significant judgments made;

*The auditor is required to take into account the inherent risk factors when identifying and assessing the risks of material misstatement. However, the auditor is not required to document how every inherent risk factor was taken into account in relation to each class of transaction, account balance or disclosure.*

- (d) If applicable, the reasons for the conclusion that there is not a risk of material misstatement due to fraud related to revenue recognition;
- (e) The controls set out in paragraphs 6.3.14. and 6.3.16 and the evaluation whether the control is designed effectively and determination whether the control has been implemented; and
- (f) For accounting estimates, key elements of the auditor's understanding of the accounting estimates, including controls as appropriate, the linkage of the assessed risks of material misstatements to the auditor's further procedures, and any indicators of management bias and how those were addressed.

6.8.2. The auditor shall document the evaluation about whether the [draft] ISA for LCE continues to be appropriate for the nature and circumstances of the entity being audited.



## **7. Responding to Assessed Risks of Material Misstatement**

### *Content of this Part*

Part 7 contains content related to the:

- Design and implementation of overall responses to assessed risks of material misstatement at the financial statement level;
- Design and implementation of responses to the assessed risks of material misstatement at the assertion level (i.e., design and performance of further audit procedures). Further procedures include substantive procedures (tests of detail and substantive analytical procedures) and tests of controls (as appropriate), and is expanded on in this Part; and
- Procedures for specific topics when responding to assessed risks of material misstatement.

### *Scope of this Part*

This Part sets out the specific requirements for obtaining audit evidence through responding to assessed risks of material misstatement. Part 2 also sets out the broad requirements for audit evidence. In complying with the requirements in this Part, the auditor may find it useful to refer to the following that set out relevant matters:

- Fraud – see Part 1.5.
- Law or regulation – see Part 1.6.
- Related parties – see Part 1.7.
- Information to be used as audit evidence – see Part 2.3.
- Procedures for obtaining audit evidence – see Part 2.4.

### **7.1. Objectives**

7.1.2. The objectives of the auditor are to:

- (a) Obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement (the assessed risks), through designing and implementing responses to those risks;
- (b) Respond appropriately to risks of material misstatement arising from fraud or suspected fraud;
- (c) Obtain sufficient appropriate audit evidence regarding management's use of the going concern assumption and related disclosures; and
- (d) Respond appropriately to identified or suspected non-compliance with law or regulation that have been identified during the audit.

### **7.2. Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Financial Statement Level**

7.2.1. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, whether due to fraud or error.

*The auditor's overall responses at the financial statement level, for example, making general changes to the nature, timing or extent of audit procedures, or adjustments to resources assigned or using experts, are based on those risks that relate pervasively to the financial statements as a whole. These*

*may include, for example, risks arising from industry, regulatory and other external factors, or matters related broadly to the entity's basis of accounting or accounting policies.*

*In particular, the auditor's overall responses also are influenced by the auditor's understanding of the control environment. The control environment provides a foundation for the operation of the other components of the entity's internal control system. The control environment does not directly prevent, or detect and correct, misstatements. It may, however, influence the effectiveness of controls in the other components of the entity's internal control system. Therefore, an effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity.*

*Deficiencies that have been identified in the control environment when obtaining an understanding of the entity's internal control system, however, have the opposite effect and may result in the need for more extensive audit evidence from substantive procedures. A weak control environment also impacts the work that may be undertaken at an interim period.*

7.2.2. In determining overall responses to address assessed risks of material misstatement, due to fraud or error, at the financial statement level, the auditor shall:

- (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud or error for the engagement;
- (b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements, may be indicative of errors or fraudulent financial reporting resulting from management's effort to manage earnings; and
- (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

### **7.3. Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level**

7.3.1. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on, and responsive to, assessed risks, whether due to fraud or error, at the assertion level.

*Further audit procedures comprise tests of controls and substantive procedures. The auditor may choose to perform tests of controls or they may be required in specific circumstances (see paragraph 7.3.2.(d)). Substantive procedures include tests of details and substantive analytical procedures.*

*Further audit procedures are responsive to the assessed risk of material misstatement at the assertion level, and provide a clear linkage between the auditor's further procedures and the risk assessment. If the assessed risks of material misstatement are due to fraud risks at the assertion level, the nature, timing and extent of audit procedures may need to be changed to obtain audit evidence that is more relevant and reliable or to obtain additional corroborative information.*

7.3.2. In designing the further audit procedures, the auditor shall:

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each significant class of transactions, account balance, or disclosure, including:

- (i) The likelihood and magnitude of misstatement due to the characteristics of the significant class of transactions, account balance, or disclosure (that is, the inherent risk); and
  - (ii) Whether the risk assessment takes account of controls that address the risk of material misstatements (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (where the auditor plans to test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures);
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk;
  - (c) In designing and performing tests of controls, obtain more persuasive audit evidence the greater the reliance the auditor places on the operating effectiveness of controls; and
  - (d) Design and perform tests of controls, to obtain sufficient appropriate audit evidence as to the operating effectiveness of such controls, if the auditor intends to test the operating effectiveness of controls or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

*In an audit of an LCE, the auditor may not be able to identify many controls, or the extent of documentation prepared by the entity to which they exist or operate may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures.*

*When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.*

#### *Considerations Specific to Public Sector Entities*

*For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.*

7.3.3. When designing tests of controls and tests of details, the auditor shall determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

#### *Substantive Analytical Procedures*

7.3.4. If the auditor uses substantive analytical procedures to obtain audit evidence, the auditor shall:

- (a) Determine the suitability of the substantive analytical procedure for the purpose of the test and for the given assertion(s);
- (b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over its preparation;
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify material misstatements;
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation being required; and

- (e) Investigate fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount by inquiring of management and obtaining appropriate audit evidence relevant to management's responses and performing additional audit procedures as necessary in the circumstances.

#### *Automated Tools and Techniques*

*Analytical procedures can be performed using a number of tools or techniques, which may also be automated. The evolution of technology, coupled with the increase in number and variety of sources of data, may create more opportunities for the auditor to use ATT in performing substantive analytical procedures.*

*There are countless information sources available (e.g., social media, free access information sources) to the auditor, and some are more reliable than others. The use of ATT to perform substantive analytical procedures allows the auditor to incorporate information from more sources both internal and external to the entity and also to use much greater volumes of data in the analyses. Nonetheless, the auditor's responsibility for addressing the reliability of data used in substantive analytical procedures is unchanged.*

#### *Audit Sampling*

7.3.5. If the auditor uses audit sampling when responding to assessed risks of material misstatement as a means for selecting items for testing, the auditor shall:

- (a) Consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.
- (b) Determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- (c) Select items in a way that each sampling unit in the population has a chance of selection.
- (d) Perform audit procedures, appropriate to the purpose, on each item selected, unless the procedure is not applicable to the selected item in which case the auditor shall select a replacement item or perform a suitable alternative procedure. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to the selected item unless it is not applicable, that item shall be treated as a deviation (in the case of tests of controls) or a misstatement (in the case of tests of details).
- (e) Investigate deviations or misstatements identified in the sample as to their nature and cause, and evaluate their possible effect on the purpose of the audit procedure and other areas of the audit.

7.3.6. For tests of details, project misstatements found in the sample to the population. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

*A misstatement that has been established to be an anomaly need not be projected across the remaining population.*

7.3.7. The auditor shall evaluate:

- (a) The results of the sample; and
- (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

*Tests of Controls*

7.3.8. In designing and performing tests of controls, the auditor shall perform audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of controls, including:

- (a) How the controls were applied at relevant times during the period;
- (b) The consistency with which they were applied; and
- (c) By whom or by what means they were applied.

7.3.9. The auditor shall determine whether the controls to be tested depend on other controls (indirect controls), and if so, consider whether it is necessary to obtain evidence about the effective operation of the indirect controls.

7.3.10. The auditor shall test controls for the period of time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's reliance.

7.3.11. If the auditor obtains audit evidence about the operating effectiveness of controls in the interim period, the auditor shall obtain additional audit evidence about any subsequent significant changes and determine the additional audit evidence to be obtained for the remaining period.

7.3.12. If the auditor intends to use audit evidence about the operating effectiveness of controls obtained in previous periods, the auditor shall:

- (a) Consider the effectiveness of the components of the internal control system, the risks from the characteristics of the control (e.g., manual or automated), the effectiveness of general IT controls, the effectiveness of the control and its application by the entity, whether the lack of a change in a particular control poses a risk due to changing circumstances and the risk of material misstatement and the extent of reliance on the control planned; and
- (b) Establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. If there have been significant changes the auditor shall test the control in the current period, otherwise at least once every third audit.

7.3.13. If the auditor intends to rely on a control that is a control over a significant risk, the auditor shall test the control in the current period.

7.3.14. When evaluating the operating effectiveness of controls upon which the auditor intends to rely, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

7.3.15. If deviations from controls, upon which the auditor intends to rely, are detected, the auditor shall make specific inquiries to understand deviations and the potential consequences, including whether:

- (a) The tests of controls provide an appropriate basis for reliance on the controls;
- (b) Additional tests of control are necessary; or
- (c) The risks of material misstatement need to be addressed using substantive procedures.

#### *Substantive Procedures*

7.3.16. Irrespective of the assessed risks, substantive procedures shall be performed for each material class of transactions, account balance, and disclosure.

7.3.17. The auditor's substantive procedures shall include audit procedures related to the financial statement closing process, including:

- (a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
- (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

7.3.18. The auditor's substantive procedures shall include substantive procedures specifically responsive to significant risks. When the response to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

7.3.19. If the auditor performed substantive procedures at an interim date, the auditor shall cover the remaining period by performing:

- (a) Substantive procedures, combined with tests of controls for the intervening period; or
- (b) If the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

#### *External Confirmations*

7.3.20. The auditor shall consider whether external confirmation procedures are to be performed as substantive procedures.

*External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions.*

7.3.21. When using external confirmation procedures, the auditor shall maintain control over:

- (a) Determining the information to be confirmed or requested and selecting the appropriate confirming party;
- (b) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (c) Sending the requests, including follow-up requests when applicable, to the confirming party.

7.3.22. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

7.3.23. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance. The auditor also shall determine the implications for the audit and the auditor's opinion.

7.3.24. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

7.3.25. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence.

7.3.26. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements.

7.3.27. The auditor shall evaluate whether the results of the external confirmation procedures, if any, provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

#### **7.4. Specific Focus Areas**

##### *Going Concern*

7.4.1. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

*In accordance with the requirements of this Part, the auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern. In many cases, the management of less complex entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. In such cases, it may be appropriate to discuss the medium- and long-term financing of the entity with management, provided that management's plans can be corroborated by sufficient documentary evidence and are consistent with the auditor's understanding of the entity. Therefore, the auditor's evaluation of going concern, for example, may be satisfied by discussion, inquiry and inspection of supporting documentation.*

7.4.2. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as used by management, as required by the applicable financial reporting framework. If that period is less than twelve months from the date of the financial



statements, the auditor shall ask management to extend the period. If management does not make or extend its assessment, the auditor shall consider the implications for the auditor's report.<sup>53</sup>

*The auditor also remains alert to the possibility that there are known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question management's use of the going concern basis of accounting in preparing the financial statements. The further into the future the events or conditions are, the more significant the going concern issues need to be before the auditor takes further action. If events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified after the auditor's risk assessments are made, the auditor's assessment of the risks of material misstatement may need to be revised.*

- 7.4.3. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware of as a result of the audit.
- 7.4.4. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.
- 7.4.5. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional procedures, including consideration of mitigating factors (a "material uncertainty" related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern). These procedures shall include:
- (a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
  - (b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
  - (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
    - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
    - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
  - (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

*A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is, for a fair presentation framework, necessary for the fair presentation of the financial statements or, for a compliance framework, necessary for the financial statements not to be misleading.*

<sup>53</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.S.



7.4.6. If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform additional audit procedures as necessary, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty.

#### *Management Override of Controls*

7.4.7. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and therefore a significant risk.

7.4.8. The auditor shall design and perform audit procedures to:

- (a) Test the appropriateness of manual and automated journal entries recorded in the general ledger and other adjustments, made in the preparation of the financial statements, including:
  - (i) Making inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
  - (ii) Selecting journal entries and other adjustments made at the end of a reporting period; and
  - (iii) Considering the need to test journal entries and other adjustments throughout the period.
- (b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud, including:
  - (i) Evaluate whether the judgments and decisions made by management indicate a possible bias on the part of the entity's management, even if they are individually reasonable, that may represent a risk of material misstatement due to fraud. If so, the auditor shall reevaluate the accounting estimates taken as a whole; and
  - (ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.
- (c) For significant unusual transactions outside the normal course of business for the entity or that otherwise appear to be unusual, evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
- (d) Respond to the identified risks of management override of controls to the extent not already addressed by (a) to (c).

*Material misstatement of financial statements due to fraud often involves the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or both, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through reclassifications.*

### *Automated Tools and Techniques*

*In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of ATT.*

### *Related Parties*

7.4.9. The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions, including inspecting:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;
- (b) Minutes of meetings of shareholders and of those charged with governance; and
- (c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

7.4.10. The auditor shall share relevant information obtained about the entity's related parties with other members of the engagement team.

7.4.11. For identified arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

- (a) Determine whether the underlying circumstances confirm the existence of those relationships or transactions;
- (b) Promptly communicate the relevant information to the other members of the engagement team;
- (c) Where the applicable financial reporting framework establishes related party requirements:
  - (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
  - (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- (d) Perform appropriate substantive audit procedures for such newly identified related parties or significant related party transactions;
- (e) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
- (f) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

7.4.12. For significant related party transactions outside of the entity's normal course of business the auditor shall inspect the underlying contracts or agreements, if any, and evaluate whether:

- (a) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

- (b) The terms of transactions are consistent with management's explanations; and
- (c) The transactions have been appropriately accounted for, presented and disclosed in accordance with the applicable financial reporting framework.

7.4.13. The auditor shall obtain audit evidence that identified significant related party transactions outside the entity's normal course of business have been appropriately authorized and approved.

7.4.14. If the auditor identifies significant transactions outside the entity's normal course of business, the auditor shall inquire of management about the nature of these transactions and whether related parties could be involved.

7.4.15. If management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

#### *Accounting Estimates*

7.4.16. The auditor shall design and perform further audit procedures related to accounting estimates to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level, including for disclosures.

7.4.17. The auditor's further audit procedures shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to understand estimation uncertainty and address that uncertainty by selecting appropriate point estimates. If management has not undertaken such steps, the auditor shall request management to perform additional procedures to address estimation uncertainty by reconsidering the selection of point estimates or providing additional disclosures related to the estimation uncertainty.

7.4.18. The auditor's further audit procedures to respond to assessed risks of material misstatement at the assertion level relating to an accounting estimate shall include one or more of the following approaches:

- (a) Obtaining audit evidence from events occurring up to the date of the auditor's report. In doing so, the auditor shall evaluate any changes in circumstances and other relevant conditions between the event and the measurement date that may affect the relevance of such evidence;
- (b) Testing how management made the accounting estimate and developed related disclosures about estimation uncertainty. In doing so, the auditor's procedures shall address whether:
  - (i) The method selected is appropriate, including any changes from the prior period;
  - (ii) The significant assumptions and data are consistent and appropriate, and their integrity maintained in applying the method;
  - (iii) Management has the intent to carry out specific courses of actions;
  - (iv) The judgments made in selecting these give rise to indicators of possible management bias, and if possible indicators of bias are identified, evaluate the implications for the audit, including determining whether there is an intention to mislead such that it is fraudulent in nature;
  - (v) Changes from prior periods are appropriate;
  - (vi) The data is relevant and reliable in the circumstances; and

- (vii) Calculations are mathematically accurate and whether judgements have been applied consistently; or
- (c) Developing an auditor's point estimate or range. In doing so, the auditor shall:
  - (i) Evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework; and
  - (ii) Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence.

### *Inventory*

7.4.19. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
  - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
  - (ii) Observe the performance of management's count procedures;
  - (iii) Inspect the inventory; and
  - (iv) Perform test counts;
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results; and
- (c) Performing audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements have been properly reflected if the physical inventory counting is at a date other than the date of the financial statements.

7.4.20. If the auditor has not attended the inventory count due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, or if not possible, determine the effect on the auditor's report.<sup>54</sup>

*In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. In some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, the auditor is required to modify the opinion in the auditor's report as a result of the scope limitation.*

<sup>54</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.O.

7.4.21. If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory, either through confirmation as to the quantities and condition or performing inspection or other audit procedures appropriate in the circumstances.

#### *Litigation and Claims*

7.4.22. The auditor shall design and perform further audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Inspecting minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Inspecting legal expense accounts.

7.4.23. If the auditor identifies a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by this [draft] standard, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.<sup>55</sup>

#### *Audit Procedures When Non-Compliance with Law or Regulation is Identified or Suspected*

7.4.24. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws or regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.<sup>56</sup>

7.4.25. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with law or regulation, the auditor shall:

- (a) Understand the nature and circumstances, and obtain further information necessary to evaluate the possible effect on the financial statements;
- (b) Discuss the non-compliance with management, and where appropriate, those charged with governance, unless prohibited to do so by law or regulation;
- (c) If sufficient information about suspected non-compliance cannot be obtained, evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion; and
- (d) Evaluate the implications on other aspects of the audit, including the auditor's risk assessment and the reliability of written representations and take appropriate action.<sup>57</sup>

#### *Using the Services of a Service Organization*

7.4.26. If the entity is using the services of a service organization, the auditor shall:

- (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available at the entity; and, if not,

<sup>55</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.N.

<sup>56</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.J.

<sup>57</sup> For the effect on the auditor's report see Part 9, paragraphs 9.5.1.K., 9.5.1.L. and 9.5.1.M.

- (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the auditor's behalf.

*Less complex entities may often use external bookkeeping services ranging from the processing of certain transactions (for example, payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organization for the preparation of its financial statements does not relieve management of the less complex entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.*

#### *Using the Work of an Auditor's Expert*

7.4.27. When the auditor has determined to use the work of an auditor's expert, the auditor shall evaluate the adequacy of the auditor's expert's work, including:

- (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
- (b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and
- (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

7.4.28. If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall agree on further work to be done by that expert or perform additional audit procedures appropriate to the circumstances.

### **7.5. Accumulation of Misstatements**

7.5.1. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.

*Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of nature, size or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the misstatement is considered not to be clearly trivial.*

7.5.2 The auditor shall request management to correct all misstatements accumulated during the audit.

7.5.3. If the auditor identifies a misstatement during the audit, the auditor shall evaluate whether the misstatement is indicative of fraud. If there is such an indication, the auditor shall determine the implications on other aspects of the audit, including on the identified and assessed risks of material misstatement and the reliability of management representations.

7.5.4. If the auditor identifies a misstatement that may be the result of fraud, and suspects that management is involved, the auditor shall:

- (a) Reevaluate the risks of material misstatement due to fraud and the auditor's responses thereto;  
or

- (b) Consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.

*The implications of identified or suspected fraud depends on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.*

7.5.5. The auditor shall determine whether the audit plan needs to be revised if:

- (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; and
- (b) The aggregate of misstatements accumulated during the audit approaches materiality.

## **7.6. Specific Communication Requirements**

7.6.1. The auditor shall communicate:

- (a) Significant deficiencies in the entity's internal control system identified during the audit to those charged with governance in writing and on a timely basis.
- (b) With management, in writing and on a timely basis, matters that have been communicated to those charged with governance (unless it would be inappropriate to communicate directly with management in the circumstances) and other deficiencies in internal control identified that have not been communicated but are of sufficient importance to merit management's attention.

*The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral.*

7.6.2. For communication of significant deficiencies to those charged with governance, the auditor shall include a description and explanation of the potential impact of the deficiencies, and sufficient information to understand the context of the communication.

7.6.3. In communicating with management and, where appropriate, those charged with governance, the auditor shall consider if there are any matters to communicate regarding accounting estimates, taking into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity or other inherent risk factors in making accounting estimates and related disclosures.

## **7.7. Specific Documentation Requirements**

7.7.1. In addition to the general documentation requirements (Part 2.5.) for an audit engagement, the auditor shall include the following in the audit documentation:

- (a) The overall responses to the assessed risks of material misstatement at the financial statement level;
- (b) The linkage between the procedures performed and the assessed risks at the assertion level;
- (c) The results of the audit procedures, including the conclusions where these are not otherwise clear;

- (d) The results of audit procedures designed to address the risk of management override of controls;
- (e) The amount below which misstatements would be considered clearly trivial; and
- (f) All misstatements accumulated during the audit and whether they have been corrected.

7.7.2. Where the assessed risk of material misstatement is due to fraud, the auditor's documentation shall include the specific fraud response.

7.7.3. Where the auditor has identified or suspected non-compliance with law or regulation, the auditor shall document the audit procedures performed, the significant professional judgments made, and the conclusions reached thereon.

7.7.4. For accounting estimates, the auditor shall document significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

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## **8. Concluding**

### *Content of this Part*

Part 8 sets out the requirements for:

- Evaluating corrected and uncorrected misstatements identified during the audit.
- Subsequent events.
- Concluding activities, including the related evaluations.
- Concluding on going concern and related disclosures.
- Written representations and performing concluding analytical procedures.

### *Scope of this Part*

The evaluations performed and the conclusions reached will form the basis for the auditor's opinion in Part 9.

### **8.1. Objectives**

8.1.1. The objectives of the auditor are to:

- (a) Evaluate, when applicable, the effect of identified misstatements on the audit and the effect of any uncorrected misstatements on the financial statements;
- (b) Conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (c) Conclude on whether sufficient appropriate audit evidence has been obtained on which to base the auditor's opinion.

### **8.2. Evaluation of Misstatements Identified During the Audit**

8.2.1. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

8.2.2. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.

8.2.3. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate by considering the:

- (a) Nature and size of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- (b) Effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

### 8.3. Analytical Procedures that Assist When Forming an Overall Conclusion

- 8.3.1. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity, and to identify any indications of a previously unidentified risk of material misstatement due to fraud or error.
- 8.3.2. The auditor shall investigate fluctuations or relationships that are inconsistent with other relevant information obtained during the course of the audit, by inquiring of management and performing other audit procedures as necessary in the circumstances.

### 8.4. Subsequent Events

*Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:*

- (a) Those that provide evidence of conditions that existed at the date of the financial statements; and*
- (b) Those that provide evidence of conditions that arose after the date of the financial statements.*

*The auditor is not, however, expected to perform additional procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.*

#### *Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report*

- 8.4.1. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- 8.4.2. The auditor shall perform those procedures in accordance with paragraph 8.4.1. for the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto, including:
- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
  - (b) Inquiring of management, and where appropriate, those charged with governance, as to whether any subsequent events have occurred that may affect the financial statements.
  - (c) Reading minutes of meetings of the owners, those charged with governance and management held after the balance sheet date and inquiring about matters discussed at any such meetings for which minutes are not yet available.
  - (d) Reading the entity's monthly or quarterly information, if available.
- 8.4.3. If the auditor has identified events that require adjustment to the financial statements or disclosures therein to comply with the entity's applicable financial reporting framework when performing the procedures in paragraphs 8.4.1. and 8.4.2, the auditor shall determine whether each such event is appropriately reflected in the financial statements.

*Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements Are Issued*

- 8.4.4. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if the auditor becomes aware of facts or events that, had it been known to the auditor at the date of the auditor's report but before the financial statements are issued, may have caused the auditor to amend the auditor's report, the auditor shall discuss with management, and where appropriate, those charged with governance, and determine whether the financial statements need amendment and if so, inquire how management intends to address the matter.
- 8.4.5. If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment, including extending the audit procedures performed to the date of the new auditor's report and providing a new auditor's report on the amended financial statements.

*Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued*

- 8.4.6. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
- (a) Discuss the matter with management and, where appropriate, those charged with governance;
  - (b) Determine whether the financial statements need amendment; and, if so,
  - (c) Inquire how management intends to address the matter in the financial statements.

**8.5. The Auditor's Evaluations and Other Activities to Support the Auditor's Conclusion**

*Evaluations Required*

- 8.5.1. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate whether the assessments of the risks of material misstatement at the financial statement and assertion levels remain appropriate.

*An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.*

*The auditor may also consider whether such information changes the auditor's determination about the appropriateness of use of the[draft] ISA for LCE for the audit, which may necessitate a modification to the terms of engagement.*

- 8.5.2. For accounting estimates, the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether:
- (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;

- (b) Management's decisions about the recognition, measurement, presentation and disclosure of accounting estimates in the financial statements are reasonable in the context of the applicable financial reporting framework; and
- (c) Sufficient appropriate audit evidence has been obtained.

8.5.3. The auditor shall evaluate whether two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the audit and take action as appropriate.

*For example, the original risk assessments may need to be revised, the auditor's opinion may need to be modified on the basis of a scope limitation or other actions may need to be taken as appropriate.*

8.5.4. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:

- (a) Classification and description of financial information and the underlying transactions, events and conditions; and
- (b) Presentation, structure and content of the financial statements

#### *Concluding*

8.5.5. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to be corroborative or contradictory.

8.5.6. If the auditor has not obtained sufficient appropriate audit evidence as to a relevant assertion, the auditor shall attempt to obtain additional audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.<sup>58</sup>

8.5.7. The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.<sup>59</sup>

8.5.8. The auditor shall conclude, based on the audit evidence obtained, whether in the auditor's professional judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.<sup>60</sup>

8.5.9. If the auditor concludes, based on the audit evidence obtained, that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether adequate disclosure about a material uncertainty related to going concern has been made in the financial statements, including:

<sup>58</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.W.

<sup>59</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.P.

<sup>60</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.q.

- (a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- (b) Disclosing clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

In such cases, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Relating to Going Concern"

8.5.10. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

8.5.11. If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications on the audit including on the assessed risks of material misstatement and the auditor's report.

## 8.6. Written Representations from Management and Those Charged with Governance

*Written representations are necessary information that the auditor requests in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. However, although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.*

8.6.1. The auditor shall obtain written representations from management for all periods referred to in the auditor's opinion, who have appropriate knowledge of the matters concerned and responsibility for the financial statements, and where appropriate, those charged with governance about the following matters:

- (a) That they have fulfilled their responsibility for the preparation of the financial statement in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- (b) That they have provided the auditor with all relevant information and access as agreed in the terms of the audit engagement;<sup>61</sup>
- (c) That all transactions are recorded and are reflected in the financial statements;
- (d) That they acknowledge their responsibility for the design, implementation and maintenance of controls to prevent and detect fraud;
- (e) That they have disclosed to the auditor the result of its assessment of the risk that the financial statements may be materially misstated because of fraud;

<sup>61</sup> The management representation shall be described in the same way as described in the terms of engagement.

- (f) That their knowledge of fraud, or suspected fraud, or allegations of fraud or suspected fraud has been disclosed to the auditor;
- (g) That they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware;
- (h) That they have appropriately accounted for and disclosed related party relationships and transactions in accordance with the requirements of the financial reporting framework;
- (i) That all known instances of non-compliance or suspected non-compliance with law or regulation whose effects should be considered when preparing financial statements have been disclosed to the auditor;
- (j) That all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework;
- (k) With regard to accounting estimates, whether the methods, significant assumptions and data used in making the accounting estimates and disclosures are appropriate to achieve recognition, measurement or disclosure is in accordance with the applicable financial reporting framework;
- (l) That all events occurring subsequent to date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed;
- (m) With regard to going concern, if a material uncertainty exists, information about their plans for future actions and the feasibility of these plans;
- (n) Regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information; and
- (o) Other representations the auditor determines necessary to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, including where necessary to support oral representations.

8.6.2. The auditor shall consider the need to obtain representations about specific accounting estimates.

8.6.3. The written representation shall be in the form of a representation letter addressed to the auditor. Appendix 6 sets out an example management representation letter.

*If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by this [draft] standard, the relevant matters covered by such statements need not be included in the representation letter.*

8.6.4. The auditor shall request a written representation from management, and where appropriate, those charged with governance, whether they believe the effects of uncorrected misstatements are immaterial, individually or in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

8.6.5. If the auditor has concerns about the competence, integrity, ethical values, or diligence of management, or about its commitment to or enforcement of these, or representations received are inconsistent with other audit evidence, the auditor shall determine the effect on audit evidence more

generally and take appropriate actions, including considering the possible effect on the opinion in the auditor's report.<sup>62</sup>

8.6.6. If management does not provide one or more of the requested written representations, the auditor shall:

- (a) Discuss the matter with management;
- (b) Reevaluate the integrity of management and evaluate the effect this may have on the reliability of oral and written representations and audit evidence in general; and
- (c) Take appropriate actions, including disclaiming an opinion on the financial statements when management refuses to provide one or more required written representations or there is sufficient doubt about management's integrity.<sup>63</sup>

8.6.7. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

## **8.7. Taking Overall Responsibility for Managing and Achieving Quality**

8.7.1. Prior to dating the auditor's report, the engagement partner shall determine that the engagement partner has taken overall responsibility for managing and achieving quality on the audit engagement. In doing so, the engagement partner shall determine that:

- (a) The engagement partner's involvement has been sufficient and appropriate throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement; and
- (b) The nature and circumstances of the audit engagement, any changes thereto, and the firm's related policies or procedures have been taken into account.

8.7.2. On or before the date of the auditor's report, the engagement partner shall determine that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

8.7.3. Prior to dating the auditor's report, the engagement partner shall review the financial statements and the auditor's report to determine that the auditor's report being issued is appropriate in the circumstances.

## **8.8. Specific Communication Requirements**

8.8.1. The auditor shall communicate, on a timely basis, all misstatements accumulated during the audit with the appropriate level of management, and as appropriate, those charged with governance, unless prohibited by law or regulation.

8.8.2. The auditor shall communicate to those charged with governance:

- (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

<sup>62</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.T.

<sup>63</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.U.

- (b) Significant difficulties, if any, encountered during the audit.
- (c) Significant matters arising during the audit that were discussed, or subject to correspondence, with management.
- (d) Significant findings from the audit. If, in the auditor's professional judgment, oral communications would not be adequate this communication shall be in writing.
- (e) Other matters, not already reported, related to fraud that may be relevant to the responsibilities of those charged with governance, unless prohibited by law or regulation.
- (f) Circumstances, if any, that affect the form and content of the auditor's report.
- (g) Written representations the auditor is requesting.
- (h) Other significant matters, if any, arising from the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.
- (i) The expectation thereof and the wording if the auditor expects to include an Emphasis of Matter or Other Matter Paragraph in the auditor's report.

8.8.3. The auditor shall communicate to those charged with governance significant matters arising during the audit in connection with the entity's related parties.

8.8.4. In regard to uncorrected misstatements, the auditor shall communicate to those charged with governance:

- (a) Uncorrected material misstatements (identified individually) and the effect that they, individually or in aggregate, may have on the auditor's opinion, unless prohibited by law or regulation; and
- (b) The effect of uncorrected misstatements from prior periods on the current year financial statements.

8.8.5. Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including:

- (a) Whether the events or conditions constitute a material uncertainty;
- (b) Whether management's use of the going concern basis of accounting is appropriate in the preparation of the financial statements;
- (c) The adequacy of related disclosures in the financial statements; and
- (d) Where applicable, the implications for the auditor's report.

## **8.9. Specific Documentation Requirements**

8.9.1. In addition to the general documentation requirements (Part 2.5.) for an audit engagement, the auditor shall include the following in the audit documentation:

- (a) The amount below which misstatements would be regarded as clearly trivial, all misstatements accumulated during the audit and whether they have been corrected, and the auditor's conclusion as to whether the uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.
- (b) The nature and scope of, and conclusions from, consultations undertaken during the audit, including how such conclusions were implemented.



- 8.9.2. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.
- 8.9.3. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.
- 8.9.4. After assembly of the final audit file is complete, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.
- 8.9.5. If applicable, the auditor shall document the failure to meet an objective of any Part of the [draft] ISA for LCE, and the resulting action (such as the effect on the auditor's opinion or withdrawal from the engagement if the overall objective of the auditor cannot be met).
- 8.9.6. If the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document:
- (a) The specific reasons for making them; and
  - (b) When and by whom they were made and reviewed.

## **9. Forming an Opinion and Reporting**

### *Content of this Part*

Part 9 sets out the requirements for:

- Forming an opinion;
- The types of audit opinions; and
- The content of the auditor's report.
- Other Information and Comparative Information.

### *Scope of this Part*

This Part explains the content of the auditor's report, and sets out the auditor's determination of modifications, as well as when other adjustments to the auditor's report are needed. It also sets out the auditor's required procedures in relation to corresponding figures and comparative financial statements, and other information (if applicable).

Examples of modified opinions, material uncertainty related to going concern, emphasis of matter and other matter paragraphs can be found in the *Auditor Reporting Supplemental Guide* (which can be found on the [ISA for LCE Exposure Draft webpage](#)).

### **9.1 Objectives**

9.1.1. The objectives of the auditor are to:

- (a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained and to express clearly that opinion through a written report; and
- (b) Consider whether there is a material inconsistency between the other information, if any, and the:
  - (i) Financial statements; and
  - (ii) Auditor's knowledge obtained in the audit.

### **9.2 Forming an Opinion on the Financial Statements**

9.2.1. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

9.2.2. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (a) Whether sufficient appropriate audit evidence has been obtained;
- (b) Whether uncorrected misstatements, individually or in aggregate are material; and
- (c) The evaluations required by paragraphs 9.2.3. to 9.2.6.

9.2.3. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

9.2.4. In performing the evaluation in paragraph 9.2.3., the auditor shall evaluate, in view of the applicable financial reporting framework, whether:

- (a) The financial statements appropriately disclose the entity's significant accounting policies, and whether they have been presented in an understandable way;
- (b) The entity's accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates and related disclosures made by management are reasonable;
- (d) The identified related party relationships and transactions have been appropriately accounted for, presented and disclosed in accordance with the applicable financial reporting framework;
- (e) The information presented in the financial statements is relevant, reliable, comparable and understandable including whether:
  - (i) The information that should have been included has been included;
  - (ii) Such information is appropriately classified, aggregated or disaggregated, and characterized; and
  - (iii) The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed;
- (f) The financial statements provide adequate disclosures to enable intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (g) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

9.2.5. When the financial statements are prepared in accordance with a fair presentation framework, the auditor shall also evaluate whether the financial statements achieve fair presentation. This evaluation shall include consideration of:

- (a) The overall presentation, structure and content of the financial statements; and
- (b) Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

*The auditor's evaluation about whether the financial statements achieve fair presentation, both in respect of presentation and the disclosures necessary to achieve it, is a matter of professional judgment.*

9.2.6. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

### 9.3. Form of Opinion

9.3.1. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

*Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework.*

9.3.2. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, determine whether to modify the opinion.<sup>64</sup>

9.3.3. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes, based on the audit evidence obtained, that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report.<sup>65</sup>

### 9.4. Auditor's Report

9.4.1. The auditor shall report in accordance with the specified format and content below unless:

- (a) Amendment to the auditor's report is required for compliance with law or regulation, including when law or regulation prescribes the layout or wording of the auditor's report. When the layout or wording of the auditor's report is prescribed, the auditor's report shall refer to this [draft] ISA for LCE only if all significant elements of the specified format and content are included; or
- (b) The auditor's report includes a modified opinion, emphasis of matter paragraph, other matter paragraph, material uncertainty related to going concern, other reporting responsibilities, or a separate section dealing with Other Information, in which case the auditor shall modify the auditor's opinion (according to Part 9.5.) or amend the auditor's report (according to Part 9.8.).

<sup>64</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.X.

<sup>65</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.Y.

## **INDEPENDENT AUDITOR'S REPORT**

To the [*Shareholders of ABC Company or Other Appropriate Addressee*]<sup>66</sup>

### **Opinion**

We have audited<sup>67</sup> the financial statements of [*ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies (replace these report names with the appropriate titles)*].<sup>68</sup>

In our opinion, the accompanying financial statements [*“present fairly, in all material respects” or “give a true and fair view of”*]<sup>69</sup> the financial position of the Company as at [*December 31, 20X1*], and [*of*] its financial performance and its cash flows for the year then ended in accordance with [*applicable financial reporting framework*].<sup>70</sup>

### **Basis for Opinion**

We conducted our audit in accordance with the [International Standard for Auditing on Audits of Financial Statements of Less Complex Entities (the ISA for LCE)]. Our responsibilities under the ISA for LCE are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report.<sup>71</sup> We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.<sup>72</sup>

### **Responsibilities of [Management] for the Financial Statements<sup>73</sup>**

[*Management*] is responsible for the preparation [*and fair presentation of*] the financial statements in accordance with [*applicable financial reporting framework*],<sup>74</sup> and for such internal control as [*management*] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, [*management*] is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless [*management*] either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

### **Auditor's Responsibilities for the Audit of the Financial Statements<sup>75</sup>**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the ISA for LCE will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with the ISA for LCE, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Understand internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- [Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.]<sup>76</sup>

We communicate with those charged with governance regarding, among other matters, the planned scope and

<sup>66</sup> Matters reflected in the specified format and content of the auditor's report in square brackets (e.g. [ ]) are to be tailored accordingly.

<sup>67</sup> When disclaiming an opinion, the statement which indicates that the financial statements have been audited is amended to state that the auditor was engaged to audit the financial statements.

<sup>68</sup> Identify the entity whose financial statements have been audited; identify each financial statement, refer to the notes and significant accounting policies and the date and period of each financial statement covered.

<sup>69</sup> See also 9.4.2 below. When the financial statements are prepared in accordance with a compliance framework, the opinion and description of the auditor's responsibilities refer instead to whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

<sup>70</sup> Identify the jurisdiction of origin of the financial reporting framework if it is not International Financial Reporting Standards or International Public Sector Accounting Standards as issued by the International Public Sector Accounting Standards Board.

<sup>71</sup> When the auditor disclaims an opinion on the financial statements, this statement is not included in the auditor's report.

<sup>72</sup> When the auditor expresses a qualified or adverse opinion, the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion is amended to include the word "qualified" or "adverse", as appropriate. When the auditor disclaims an opinion on the financial statements, this statement is not included in the auditor's report.

<sup>73</sup> Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.

<sup>74</sup> Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with [applicable financial reporting framework], and for such ..."

<sup>75</sup> When the auditor disclaims an opinion on the financial statements, the description of the auditor's responsibilities only includes the matters required by paragraph 9.5.4.

<sup>76</sup> Relevant when the financial statements are prepared in accordance with a fair presentation framework.

timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

*[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]*

*[Auditor Address: name the location in the jurisdiction where the auditor practices]*

*[Date: No earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that (i) All the statements and disclosures that comprise the financial statements have been prepared; and (ii) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.]*

9.4.2. When the financial statements are prepared in accordance with a fair presentation framework, the auditor shall refer to “the preparation and fair presentation of these financial statements” or “the preparation of financial statements that give a true and fair view,” as appropriate in the circumstances, in the description of responsibilities for the financial statements in the auditor’s report.

9.4.3. The auditor shall not refer to the work of an auditor’s expert in an auditor’s report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor’s report that the reference does not reduce the auditor’s responsibility for the auditor’s opinion.

## 9.5 Modifications to the Opinion

*Tables A to C below set out the requirements for which modified opinion is to be used in different situations, and the form and content of a modified opinion.*

9.5.1.A. The auditor shall modify the opinion in the auditor’s report according to Tables A to C below when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

9.5.1.B. When the auditor modifies the audit opinion, the auditor shall:

- (a) Amend the heading “Basis for Opinion” to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion” as set out in tables A–C; and
- (b) Within the basis for opinion section, include a description of the matter giving rise to the modification.

*Table A below specifies how the auditor’s judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.*

| <b>TABLE A</b>  | <i>Auditor’s Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements</i> |                                   |
|---|--|-----------------------------------|
|   | <i>Nature of Matter Giving Rise to the Modification</i>  | <i>Material but Not Pervasive</i> |
| Financial statements are materially misstated             | Qualified opinion  | Adverse opinion                   |
| Inability to obtain sufficient appropriate audit evidence | Qualified opinion  | Disclaimer of opinion             |

Table B below specifies the modification to be made to the opinion for each type of opinion in Table A.

| <b>TABLE B</b>  | <b>Fair Presentation Framework</b>   | <b>Compliance Framework</b>   |
|---|--|---|
| <b>Form of opinion</b>  |  |   |
| <p><b><u>9.5.1.C. Qualified opinion</u></b></p> <p>Auditor’s Report–Heading for opinion:<br/>“Qualified Opinion”</p> <p>Auditor’s Report–Heading for Basis for Opinion:<br/>“Basis for Qualified Opinion”</p> | <p>“In our opinion, except for the [effects or possible effects]<sup>77</sup> of the matter(s) described in the Basis for Qualified Opinion section, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]”</p> | <p>“...except for the [effects or possible effects] of the matter(s) described in the Basis for Qualified Opinion section, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework]”</p> |
| <p><b><u>9.5.1.D. Adverse opinion</u></b></p> <p>Auditor’s Report–Heading for opinion: “Adverse Opinion”</p> <p>Auditor’s Report–Heading for Basis for Opinion:<br/>“Basis for Adverse Opinion”</p>           | <p>“...the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]”</p>  | <p>“...the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework]”</p>   |
| <p><b><u>9.5.1.E. Disclaimer of opinion</u></b></p> <p>Auditor’s Report–Heading for opinion:</p>  | <p>“[The auditor does] not express an opinion on the accompanying financial statements.</p> <p>Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, [the auditor has] not</p>  |   |

<sup>77</sup> Matters reflected in square brackets (e.g., [ ]) are to be tailored accordingly



|  |  |
|--|--|
| <p>“Disclaimer of Opinion”</p> <p>Auditor’s Report–Heading for Basis for Opinion:</p> <p>“Basis for Disclaimer of Opinion”</p> | <p>been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements.”</p> |
|--|--|

*Table C below sets out specific circumstances when the auditor’s opinion is to be modified, and the types of opinions expressed in those circumstances based on the nature of the matter giving rise to the modification (see Table A). Table C is not an exhaustive list of all circumstances when the auditor’s opinion is to be modified.*

| <b>Table C</b>   | <b>Para Ref</b> | <b>Qualified</b> | <b>Adverse</b> | <b>Disclaimer</b> |
|--|-----------------|------------------|----------------|-------------------|
| <b>Specific Circumstances When the Auditor’s Opinion is to be Modified</b>   |                 |                  |                |                   |
| <i>Opening Balances</i>  |                 |                  |                |                   |
| 9.5.1.F. The auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances. <sup>78</sup>   | 4.6.4.          | ✓                |                | ✓                 |
| 9.5.1.G. The auditor concludes, based on the audit evidence obtained, that the opening balances contain a misstatement that materially affects the current period’s financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed.  | 4.6.5.          | ✓                | ✓              |                   |
| 9.5.1.H. The auditor concludes, based on the audit evidence obtained, that the current period’s accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework or a change in accounting policies is not appropriately accounted for or adequately presented or disclosed, in accordance with the financial reporting framework. | 4.6.6.          | ✓                | ✓              |                   |
| 9.5.1.I. The prior period’s financial statements included a modification that remains relevant and material to the current period’s financial statements.  | 4.6.3.          | ✓                | ✓              | ✓                 |

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| <b>Table C</b><br><b>Specific Circumstances When the Auditor's<br/>Opinion is to be Modified</b>   | <b>Para<br/>Ref</b> | <b>Qualified</b> | <b>Adverse</b> | <b>Disclaimer</b> |
|--|---------------------|------------------|----------------|-------------------|
| <i>Non-Compliance with Laws and Regulations</i>  |                     |                  |                |                   |
| 9.5.1.J. Sufficient information about suspected non-compliance cannot be obtained.   | 7.4.24.             | ✓                |                | ✓                 |
| 9.5.1.K. The auditor concludes that the identified or suspected non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements.   | 7.4.25              | ✓                | ✓              |                   |
| 9.5.1.L. The auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred. | 7.4.25.             | ✓                |                | ✓                 |
| 9.5.1.M. The auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance.  | 7.4.25.             | ✓                |                | ✓                 |
| <i>External Confirmations</i>  |                     |                  |                |                   |
| 9.5.1.N. The auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures.                       | 7.3.23.             | ✓                |                | ✓                 |
| 9.5.1.O. If alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory cannot be performed.   | 7.4.20.             | ✓                |                | ✓                 |
| <i>Going Concern</i>   |                     |                  |                |                   |
| 9.5.1.P. The financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate.    | 7.4.1.<br>8.5.7.    |                  | ✓              |                   |

| <b>Table C</b><br><b>Specific Circumstances When the Auditor's Opinion is to be Modified</b>   | <b>Para Ref</b>        | <b>Qualified</b> | <b>Adverse</b> | <b>Disclaimer</b> |
|--|------------------------|------------------|----------------|-------------------|
| <p>9.5.1.Q. Adequate disclosures are not made about a material uncertainty in the financial statements.</p> <p>9.5.1.R. In this circumstance, the basis for qualified (or adverse) opinion section shall state that "a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter."</p> | <p>7.4.5<br/>8.5.8</p> | <p>✓</p>         | <p>✓</p>       |                   |
| <p>9.5.1.S. When evaluating management's assessment of the entity's ability to continue as a going concern, if the period is less than twelve months from the date of the financial statements, and management does not make or extend its assessment, leading to the auditor being unable to obtain sufficient appropriate audit evidence.</p>  | <p>7.4.2.</p>          | <p>✓</p>         |                | <p>✓</p>          |
| <p><i>Written Representations</i></p>  |                        |                  |                |                   |
| <p>9.5.1.T. The auditor concludes that there is sufficient doubt about the competence, integrity, ethical values, or diligence of management, such that the written representations required by this [draft] standard are not reliable.</p>  | <p>8.6.5.</p>          | <p>✓</p>         |                | <p>✓</p>          |
| <p>9.5.1.U. The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by this [draft] standard are not reliable; or management does not provide the written representations required by paragraphs 8.6.1(a)–(c).</p>   | <p>8.6.6.</p>          |                  |                | <p>✓</p>          |
| <p><i>Corresponding Figures</i></p>  |                        |                  |                |                   |
| <p>9.5.1.V. When corresponding figures are presented and the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved.</p>  | <p>9.7.4</p>           | <p>✓</p>         | <p>✓</p>       | <p>✓</p>          |

| <b>Table C</b><br><b>Specific Circumstances When the Auditor's Opinion is to be Modified</b>   | <b>Para Ref</b> | <b>Qualified</b> | <b>Adverse</b> | <b>Disclaimer</b> |
|--|-----------------|------------------|----------------|-------------------|
| The Basis for Modification paragraph shall either: (a) refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material,; or (b) in other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. |                 |                  |                |                   |
| <i>Other Items</i>   |                 |                  |                |                   |
| 9.5.1.W. If the auditor is unable to obtain sufficient appropriate audit evidence.   | 8.5.6.          | ✓                |                | ✓                 |
| 9.5.1.X. The financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation.  | 9.3.2.          | ✓                | ✓              |                   |
| 9.5.1.Y. If the financial statements are prepared in accordance with a compliance framework and, in extremely rare circumstances, the auditor concludes, based on the audit evidence obtained, that such financial statements are misleading.  | 9.3.3           | ✓                | ✓              | ✓                 |

*Other Matters Relating to Modifications*

9.5.2 If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

9.5.3. If there is a material misstatement of the financial statements that relates to:

- (a) Specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.
- (b) Qualitative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

- (c) The non-disclosure in the financial statements of information required to be disclosed, the auditor shall:
  - (i) Discuss the non-disclosure with those charged with governance;
  - (ii) Describe in the Basis for Opinion section the nature of the omitted information; and
  - (iii) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

9.5.4. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities in the template in paragraph 9.4.1 to include only the following:

- (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with the [draft] ISA for LCE and to issue an auditor's report;
- (b) A statement that because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- (c) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

## 9.6. Other Paragraphs in the Auditor's Report

*Emphasis of Matter paragraphs and Other Matter paragraphs in the auditor's report are used when the auditor considers it necessary to:*

- (a) *Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or*
- (b) *Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.*

### *Emphasis of Matter Paragraphs*

9.6.1. If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to the users' understanding of the financial statements, and the auditor would not be required to modify the opinion, the auditor shall include an Emphasis of Matter paragraph in the auditor's report indicating that the auditor's report is not modified in respect of the matter emphasized.

*Examples of where Emphasis of Matter paragraphs may be needed include:*

- (a) *When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.*
- (b) *When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).*

*The inclusion of an Emphasis of Matter paragraph in the auditor’s report does not affect the auditor’s opinion. An Emphasis of Matter paragraph is not a substitute for:*

- (a) *A modified opinion when required by the circumstances of a specific audit engagement;*
- (b) *Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or*
- (c) *Reporting when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity’s ability to continue as a going concern.*

**Other Matter Paragraphs**

*The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards for the confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.*

9.6.2. If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor’s professional judgment, is relevant to the users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report the auditor shall include an Other Matter paragraph in the auditor’s report provided this is not prohibited by law or regulation.

9.6.3. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period’s financial statements, the auditor shall state in an Other Matter paragraph:

- (a) That the financial statements of the prior period were audited by a predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (c) The date of that report, unless the predecessor auditor’s report on the prior period’s financial statements is reissued with the financial statements.

9.6.4. When the auditor includes an Emphasis of Matter, Other Matter paragraph, a material uncertainty relating to going concern in the auditor’s report, or a section dealing with other information, the auditor shall include the paragraph or section according to Table D below:

| <b>Table D:<br/>Paragraph or<br/>Section</b> | <b>Location</b>                            | <b>Heading shall<br/>include</b>                       | <b>Content shall include</b>   |
|--|--|--|--|
| 9.6.5. Emphasis of Matter paragraph          | A separate section of the auditor’s report | Appropriate heading that includes “Emphasis of Matter” | A clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements.<br><br>A reference only to information presented or disclosed in the financial statements. |

| Table D:<br>Paragraph or<br>Section                            | Location                                   | Heading shall<br>include                         | Content shall include   |
|--|--|--|---|
|  |  |  | An indication that the auditor's opinion is not modified in respect of the matter emphasized.   |
| 9.6.6. Other Matter paragraph                                  | A separate section of the auditor's report | Appropriate heading that includes "Other Matter" | As appropriate in the circumstances.  |
| 9.6.7. Material Uncertainty Related to Going Concern paragraph | A separate section of the auditor's report | "Material Uncertainty Relating to Going Concern" | Draw attention to the note in the financial statements that discloses the matters related to the material uncertainty.<br><br>State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter. |

## 9.7. Comparative Information—Corresponding Figures and Comparative Financial Statements

9.7.1. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. In doing so, the auditor shall evaluate whether:

- (a) The amounts and disclosures in the prior period agree with comparative information or have been restated; and
- (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, where changes occurred, have been properly accounted for and adequately presented or disclosed.

9.7.2. If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

9.7.3. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures or comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

### *Corresponding Figures*

9.7.4. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in accordance with paragraph 9.7.3 or in the following circumstances:

- (a) If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.<sup>79</sup>
- (b) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

### *Comparative Financial Statements*

- 9.7.5. When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.
- 9.7.6. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph.

### **9.8. Other Information**

*"Other information" is financial or non-financial information (other than the financial statements and the auditor's report thereon) included in an entity's annual report.*

- 9.8.1. The auditor shall determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s).
- 9.8.2. The auditor shall read the other information, and:
  - (a) Consider whether there is a material inconsistency between the other information and the financial statements; and
  - (b) Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit.
- 9.8.3. As the basis for the considerations in paragraph 9.8.2.(a), the auditor shall, to evaluate their consistency, compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about, the amounts or other items in the financial statements) with such amounts or other items in the financial statements.

*In evaluating the consistency of selected amounts or other items, the auditor is not required to compare all amounts or other items in the other information that are intended to be the same as, or summarize, or to provide greater details about, the amounts or other items within the financial statements, with such amounts or other items in the financial statements.*

- 9.8.4. While reading the other information, the auditor shall also remain alert for indications that the remainder of the other information, which is unrelated to the financial statements or the auditor's knowledge obtained in the audit, appears to be materially misstated.

<sup>79</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.V.



9.8.5. If the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall discuss the matter with management and, if necessary, perform other procedures to conclude whether:

- (a) A material misstatement of the other information exists;
- (b) A material misstatement of the financial statements exists; or
- (c) The auditor’s understanding of the entity and its environment needs to be updated.

9.8.6. If the auditor concludes, based on the audit evidence obtained, that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

- (a) Agrees to make the correction, the auditor shall determine that the correction has been made; or
- (b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made. If the correction is still not made, the auditor shall consider the implications for the auditor’s report in accordance with Table E below or withdraw from the engagement where this is possible.

9.8.7. If the auditor obtained some or all of the other information at the date of the auditor’s report, the auditor shall include an Other Information section in the auditor’s report in accordance with Table E.

9.8.8. Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor’s report shall not include an Other Information section.

9.8.9. The auditor shall document the procedures performed in relation to other information and the final version of the other information.

| Table E:<br>Paragraph or<br>Section     | Location  | Heading shall<br>include                                   | Content shall include  |
|---|---|--|--|
| 9.8.10. Other<br>Information<br>Section | A separate<br>section of the<br>auditor’s<br>report | “Other<br>Information” or<br>other<br>appropriate<br>title | <ul style="list-style-type: none"> <li>(a) A statement that management is responsible for the other information;</li> <li>(b) An identification of the other information, if any, obtained by the auditor prior to the date of the auditor’s report;</li> <li>(c) A statement that the auditor’s opinion does not cover the other information and, accordingly, that the auditor does not express an audit opinion or any form of assurance conclusion thereon;</li> <li>(d) A description of the auditor’s responsibilities relating to reading, considering and reporting on other information as required by this [draft] ISA for LCE; and</li> </ul> |

|  |  |  |   |
|--|--|--|---|
|  |  |  | <p>(e) When other information has been obtained prior to the date of the auditor's report, either:</p> <ul style="list-style-type: none"><li>(i) A statement that the auditor has nothing to report; or</li><li>(ii) If the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.</li></ul> |
|--|--|--|---|

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**APPENDIX 1**

**Glossary of Terms**

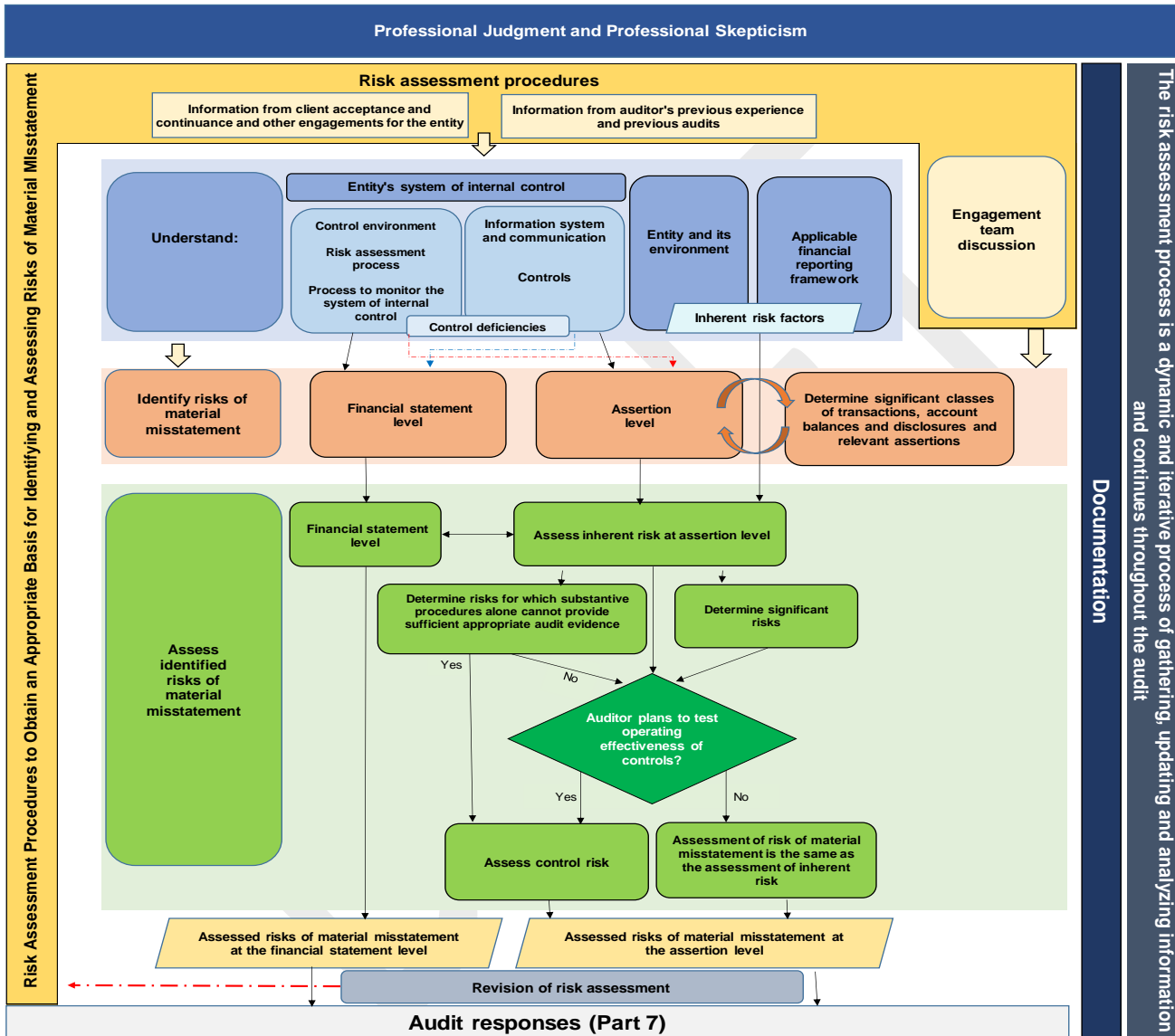
See [Proposed Appendix 1 - Glossary of Terms](#) for a full list of definitions.

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APPENDIX 2

Identifying and Assessing the Risks of Material Misstatement (Part 6)

Identifying and Assessing the Risks of Material Misstatement (Part 6)



## APPENDIX 3

### Fraud Risk Factors

The fraud risk factors set out below are examples of factors that may be faced by auditors during an audit of less complex entities. Examples are separately presented for the two types of fraud—fraudulent financial reporting and misappropriation of assets.

The risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different sizes or with different ownership characteristics or circumstances. Also, the order of the examples risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

#### Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

##### *Incentives/Pressures*

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- Significant declines in customer demand or increasing business failures in the industry or overall economy.
- High degree of competition or market saturation, accompanied by declining margins.
- Operating losses causing the threat of bankruptcy or foreclosure.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations.

Pressure exists for management to meet the requirements or expectations of third parties due to:

- Pressure to renew, or obtain additional, financing, or to meet debt repayment or debt covenant requirements and therefore to overstate performance or position in order to demonstrate profitability and long-term viability.
- Pressure to understate revenue in order to reduce tax liabilities.

##### *Opportunities*

Opportunities to engage in fraudulent financial reporting that can arise from the following:

- Related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- The monitoring of management is not effective, as a result of the domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Internal control components are deficient as a result of the following:
  - Limited segregation of duties or anti-fraud controls (e.g., fraud hotlines, internal audit function.)
  - Inadequate monitoring of controls.
  - Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

#### *Attitudes/Rationalizations*

- Poor communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management or owners to justify marginal or inappropriate accounting on the basis of materiality or to help the company survive.
- The relationship between management and the current or predecessor auditor is strained by disputes, unreasonable demands on the auditor, restrictions on access to people or information, or domineering management behavior.

#### **Risk Factors Arising from Misstatements Arising from Misappropriation of Assets**

Some of the risk factors related to misstatements arising from fraudulent financial reporting may also be present when misstatements arising from misappropriation of assets occur, which often is a common fraud in less complex entities. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

#### *Incentives/Pressures*

- Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example:
- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

#### *Opportunities*

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate record keeping or physical safeguards over cash, inventory, or fixed assets.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology.

#### *Attitudes/Rationalizations*

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control by overriding existing controls or failing to take appropriate remedial action on known misappropriations, including petty theft.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.

## Assertions

**Assertions** are representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.

In identifying and assessing the risks of material misstatement, the auditor of less complex entities (LCEs) may use the categories of assertions as described below or may express them differently provided all aspects described below have been covered. The auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

An auditor of an LCE may use the following assertions in considering the different types of potential misstatements that may occur. The assertions may fall into the following categories:

*Assertions about classes of transactions and events, and related disclosures, for the period under audit:*

- Occurrence—transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
- Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
- Cutoff—transactions and events have been recorded in the correct accounting period.
- Classification—transactions and events have been recorded in the proper accounts.
- Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

*Assertions about account balances, and related disclosures, at the period end:*

- Existence—assets, liabilities and equity interests exist.
- Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- Accuracy, valuation and allocation—assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

- Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
- Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The assertions described above, adapted as appropriate, may also be used by the auditor in considering the different types of misstatements that may occur in disclosures not directly related to recorded classes of transactions, events or account balances.

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### Illustrative Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with [applicable financial reporting framework]. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in the [draft] ISA for LCE. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 4.5.2).

\*\*\*

To the appropriate representative of management or those charged with governance of ABC Company:<sup>80</sup>

*[The objective and scope of the audit]*

You<sup>81</sup> have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the International Standard on Auditing Financial Statements of Less Complex Entities (ISA for LCE) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

*[The responsibilities of the auditor]*

We will conduct our audit in accordance with the ISA for LCE. The ISA for LCE requires that we comply with ethical requirements. As part of an audit in accordance with the ISA for LCE, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Understand internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the

<sup>80</sup> The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction

<sup>81</sup> Throughout this letter, references to "you," "we," "us," "management," "those charged with governance" and "auditor" would be used or amended as appropriate in the circumstances

effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with the ISA for LCE.

Our audit will be conducted on the basis that [management, and where appropriate, those charged with governance]<sup>82</sup> acknowledge and understand that they have responsibility:

- (a) For the preparation and fair presentation of the financial statements in accordance with [applicable financial reporting framework];<sup>83</sup>
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
  - (i) Access to all information of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - (ii) Additional information that we may request from [management] for the purpose of the audit; and
  - (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management, and where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

<sup>82</sup> Use terminology as appropriate in the circumstances

<sup>83</sup> Or, if appropriate, "For the preparation of financial statements that give a true and fair view in accordance with [applicable financial reporting framework]"

[*Other relevant information*]

[*Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.*]

[Reporting]

[*Insert appropriate reference to the expected form and content of the auditor's report including, if applicable, the reporting on other information.*]

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.

Acknowledged and agreed on behalf of ABC Company by

(signed)

.....

Name and Title

Date

## Illustrative Representation Letter

The following illustrative letter includes written representations that are required by Part 8.6 of the [draft] ISA for LCE. It is assumed in this illustration that the requirement to obtain a written representation relating to going concern is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with [applicable financial reporting framework].

We confirm that:

### *Financial Statements*

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with [applicable financial reporting framework]; in particular the financial statements are fairly presented (or give a true and fair view) in accordance therewith.
- The methods, the data, and the significant assumptions used in making accounting estimates, and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of [applicable financial reporting framework].
- All events subsequent to the date of the financial statements and for which [applicable financial reporting framework] require adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
- Any actual or possible litigation and claims whose effects should be considered when preparing the financial statements are accounted for and disclosed in accordance with the applicable financial reporting framework.
- [Any other matters that the auditor may consider appropriate.]

### *Information Provided*

- We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;

- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with law or regulation whose effects should be considered when preparing financial statements.
- We have disclosed to you all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.
- [Any other matters that the auditor may consider necessary.]

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Management

Management

# CONFORMING AMENDMENTS TO THE PREFACE TO THE INTERNATIONAL QUALITY MANAGEMENT, AUDITING, REVIEW, OTHER ASSURANCE, AND RELATED SERVICES PRONOUNCEMENTS

The following sets out the proposed conforming amendments to the preface to the International Quality Management,<sup>84</sup> Auditing, Review, Other Assurance, and Related Services Pronouncements to facilitate the new category of auditing standard, the Proposed International Standard on Auditing (ISA) for Audits of Financial Statements of Less Complex Entities (ISA for LCE).

## Introduction

1. This preface to the *International Quality Management, Auditing, Review, Other Assurance, and Related Services Pronouncements* is issued to facilitate understanding of the scope and authority of the pronouncements the International Auditing and Assurance Standards Board (IAASB) issues, as set forth in the IAASB's Terms of Reference.
2. The IAASB is committed to the goal of developing a set of International Standards and other pronouncements which are generally accepted worldwide. IAASB members act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their country or firm or not in accordance with the position taken by those who put them forward for membership of the IAASB.

## The IAASB's Pronouncements

### IAASB Authoritative Pronouncements

3. The IAASB's pronouncements govern audit, review, other assurance, and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all standards relevant to the engagement.
4. The authoritative pronouncements of the IAASB are the International Standards, which are issued following the IAASB's stated due process.

## The Authority Attaching to International Standards Issued by the International Auditing and Assurance Standards Board

5. International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.
6. The International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE) may be applied in the audit of the financial statements of a less complex entity in accordance with the authority of the standard.
67. International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.
78. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information.

<sup>84</sup> This preface has been updated to reflect the conforming amendments arising from the IAASB's Quality Management projects.

~~89.~~ International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.

~~910.~~ ISAs, the ISA for LCE, ISREs, ISAEs, and ISRSs are collectively referred to as the IAASB's Engagement Standards.

~~4011.~~ International Standards on Quality Management (ISQMs) are to be applied for all services falling under the IAASB's Engagement Standards.

### **International Standards on Auditing**

~~412.~~ ISAs are written in the context of an audit of financial statements<sup>85</sup> by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of ISAs is set out in ISA 200.<sup>86</sup>

### **The International Standard on Auditing for Audits of Financial Statements of Less Complex Entities**

13. The ISA for LCE is written in the context of an audit of financial statements of a less complex entity by an independent auditor. The authority of the ISA for LCE is set out in the preface and Part A of the standard.

### **International Standards on Quality Management**

~~4214.~~ ISQMs are written to apply to firms in respect of all their services falling under the IAASB's Engagement Standards. The authority of ISQMs is set out in the introduction to each ISQM.

### **Other International Standards**

~~4315.~~ Some International Standards identified in paragraphs ~~76–98~~ contain: objectives, requirements, application and other explanatory material, introductory material and definitions. These terms are to be interpreted in a directly analogous way to how they are explained in the context of ISA and financial statement audits in ISA 200.

~~4416.~~ Other International Standards identified in paragraphs ~~76–98~~ contain basic principles and essential procedures (identified in bold type lettering and by the word "should") together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures.

~~4517.~~ The basic principles and essential procedures of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement. In exceptional circumstances, however, a professional accountant may judge it necessary to depart from a relevant essential procedure in order to achieve the purpose of that procedure. When such a situation arises, the professional accountant is required to document how alternative procedures performed achieve the purpose of the procedure and, unless otherwise clear, the reasons for the departure. The need for the professional accountant to depart from a relevant essential procedure is expected to arise only where, in the specific circumstances of the engagement, that procedure would be ineffective.

~~4618.~~ Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself.

<sup>85</sup> Unless otherwise stated, "financial statements" mean financial statements comprising historical financial information.

<sup>86</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

## Professional Judgment

4719. The nature of the International Standards requires the professional accountant to exercise professional judgment in applying them.

## Applicability of the International Standards

4820. The scope, effective date and any specific limitation of the applicability of a specific International Standard is made clear in the Standard. Unless otherwise stated in the International Standard, the professional accountant is permitted to apply an International Standard before the effective date specified therein.

4921. International Standards are relevant to engagements in the public sector. When appropriate, additional considerations specific to public sector entities are included:

- (a) Within the body of an International Standard in the case of ISAs, the ISA for LCE and ISQMs; or
- (b) In a Public Sector Perspective (PSP) appearing at the end of other International Standards.

## Non-Authoritative Material

2022. Non-authoritative material includes Practice Notes issued by the IAASB and staff publications. Non-authoritative material is not part of the IAASB's International Standards.

## International Auditing Practice Notes

2423. International Auditing Practice Notes (IAPNs) do not impose additional requirements on auditors beyond those included in the ISAs or the ISA for LCE, nor do they change the auditor's responsibility to comply with all ISAs, or the ISA for LCE, relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

2224. Depending on the nature of the topic(s) covered, an IAPN may assist the auditor in:

- Obtaining an understanding of the circumstances of the entity, and in making judgments about the identification and assessment of risks of material misstatement;
- Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
- Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

## Practice Notes Relating to Other International Standards

2325. The IAASB may also issue International Review Engagement Practice Notes (IREPNs), International Assurance Engagement Practice Notes (IAEPNs), and International Related Services Practice Notes (IRSPNs) to serve the same purpose for ISREs, ISAEs, and ISRSs respectively.

## Staff Publications

2426. Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

## Language

2527. The sole official text of an IAASB International Standard, Practice Note, exposure draft or other publication is that published by the IAASB in the English language.



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