

# Agenda Item G.3 For Reference

Please note: This Agenda Item includes a clean version of targeted areas of Proposed ISA for LCE (Part 2 – Part 6, Part 7 as it relates to accounting estimates in Part 7 and specific documentation requirements in each Parts) that will be discussed by the Board at the March 2023 IAASB meeting (Agenda Item 6-C). This paper is provided to the IAASB CAG Representatives in March 2023 for reference purposes.

## Audits of Less Complex Entities – Proposed ISA for LCE (Targeted Areas)

This agenda item presents revised drafting of targeted areas of the proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE).

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

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#### 1.9 Specific Documentation Requirements

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

1.9.1 The auditor shall include in the audit documentation communications about fraud made to management, those charged with governance, regulators and others.

### 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 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.*

*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.*

*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 (ATT)*

*ATT, for the purpose of this 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 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 standard.*

*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.*

- 2.3.1. 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 audit 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.

## 2.5 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, but may be used to explain or clarify information contained in the audit documentation.*

*Audit documentation provides evidence that the audit complies with ISA for LCE. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit.*

*In addition to the general documentation requirements set out in this Part, specific matters to be documented are set out throughout this standard.*

### *Automated Tools and Techniques*

*This 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. 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 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.
  - (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.

*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.*

*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.*

- 2.5.3. 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 standard, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure.
- 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.

#### *Documentation of Communications*

- 2.5.7. Where matters required to be communicated by this 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.

### **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, and has conducted the audit, in accordance with this standard, and 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 and essential explanatory material included in the boxes are only applicable when there are engagement team members other than the engagement partner.*

3.2.1. The engagement partner shall take:

- (a) Overall responsibility for managing and achieving quality on the audit engagement; and
- (b) Responsibility for actions being taken that reflect the firm's commitment to quality.

*The engagement partner's responsibility for managing and achieving quality is supported by a firm culture that demonstrates a commitment to quality.*

## Considerations When There Are Members of the Engagement Team Other Than the Engagement Partner

3.2.1A. In taking overall responsibility for managing and achieving quality on the audit engagement, the engagement partner shall:

- (a) 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.
- (b) Through direction, supervision and review of the work, determine that the nature, timing and extent of direction, supervision and review is:
  - (i) Responsive to the nature and circumstances of the engagement and the resources assigned; and
  - (ii) Planned and performed in accordance with the firm's policies or procedures, this standard, relevant ethical requirements and regulatory requirements.

### *Sufficient and Appropriate Involvement*

*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.*

### *Direction, Supervision and Review*

*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.*

3.2.2 The engagement partner shall take responsibility for establishing and communicating to the members of the engagement team 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;

- (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 exercising professional skepticism throughout the audit engagement.

*In addressing the requirements in paragraphs 3.2.1A. and 3.2.2., 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).*

#### *Relevant Ethical Requirements*

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 been breached, the engagement partner shall take action, including:

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

*If there are no others in the firm to consult with, the engagement partner may consult with others outside the firm such as experienced practitioners in other firms or the professional body where the engagement partner is a member.*

#### Considerations When There Are Members of the Engagement Team Other Than the Engagement Partner

3.2.6A. 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 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 breaches of relevant ethical requirements by members of the engagement team.

#### *Engagement Resources*

3.2.7. The engagement partner shall:

- (a) Determine that:
  - (i) Sufficient and appropriate resources are assigned or made available to the engagement team in a timely manner; and
  - (ii) 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.
- (b) If the conditions in (a) 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.

### *Other Engagement Partner Responsibilities*

3.2.10. The engagement partner shall:

- (a) Obtain an understanding of the information communicated from the firm and, if applicable, of other network firms' monitoring and remediation processes, and:
  - (i) Determine the relevance and effect of that information on the audit engagement; and
  - (ii) Take appropriate action; and
- (b) Remain alert for matters that may be relevant to the firm's monitoring and remediation process and communicate to those responsible for the process.

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 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.

Considerations When There Are Members of the Engagement Team Other Than the Engagement Partner

3.2.13A. The engagement partner shall review audit documentation at appropriate points in time during the audit, including documentation of:

- Significant matters;
- Significant judgments and the conclusions reached; and
- Other matters that, in the engagement partner's professional judgment, are relevant to the engagement partner's responsibilities.

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

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

- 3.3.1. 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 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 standard sets out the authority for appropriate use of this standard. This Part sets out the engagement partner's obligations for use of this 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 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 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 ISA for LCE is Appropriate for the Audit Engagement

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

*Part A sets out the matters relevant to the engagement partner's determination of use of the ISA for LCE, in particular in relation to the limitations for using the 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 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 ISA for LCE in accordance with this Part. Part 6 (see paragraph 6.5.A) requires the engagement partner to determine whether the 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 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>1</sup> and that conclusions reached in this regard are appropriate.

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 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 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 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.*

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

<sup>1</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 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.

*Before agreeing to change an audit engagement to a review or a related service, the auditor may need to assess any legal or contractual implications of the change.*

- 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>2</sup>
- 4.6.4. The auditor shall obtain sufficient appropriate audit evidence<sup>3</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>2</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.I.

<sup>3</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.

*The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:*

- *The accounting policies followed by the entity.*
- *The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.*
- *The significance of the opening balances relative to the current period's financial statements.*
- *Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.*

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>4</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>5</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**

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

4.8.1. The auditor shall include in the audit documentation matters identified, relevant discussions with personnel, and conclusions reached with respect to the acceptance and continuance of the client relationship and audit engagement.

<sup>4</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.G.

<sup>5</sup> For the effect on the auditor's report see Part 9, paragraph 9.5.1.H.

- 4.8.2. The auditor shall document the basis for the determination made for using the ISA for LCE.
- 4.8.3. The auditor shall document changes, if any, to the determination of the use of the 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) The objective and scope of the audit of the financial statements;
  - (b) The respective responsibilities of the auditor and management;
  - (c) Identification of the applicable financial reporting framework for the preparation of the financial statements;
  - (d) Reference to the expected form and content of any reports to be issued by the auditor; and
  - (e) 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 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.

## **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 complex or time-consuming exercise. For example, a brief memorandum prepared after the previous audit, based on a review 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 logistical, operational or 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) Obtain an understanding of the work of that expert; and
- (c) Evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion.

#### *Evaluating the Competence, Capabilities and Objectivity of a Management's Expert*

*Competence relates to the nature and level of expertise of the management's expert. Capability relates to the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements.*

#### *Obtaining an Understanding of the Work of the Management's Expert*

*When obtaining an understanding of the work of the management's expert, evaluating the agreement between the entity and that expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:*

- *The nature, scope and objectives of that expert's work;*
- *The respective roles and responsibilities of management and that expert; and*
- *The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.*

### Evaluating the Appropriateness of the Management's Expert's Work

*Considerations when evaluating the appropriateness of the management's expert's work may include:*

- *The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;*
- *If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods;*
- *If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data; and*
- *If that expert's work involves the use of information from an external information source, the relevance and reliability of that information.*

### 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.

### 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 information needs of users of the financial statements.*

*A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:*

- *Whether there are elements of the entity's financial statements on which the attention of the users tends to be focused. For example, assets, liabilities, equity, revenue, expenses;*
- *The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;*
- *The entity's ownership structure and the way it is financed. For example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings; and*
- *The relative volatility of the benchmark.*

*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.*

*There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.*

*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 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.*

*In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.*

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.

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.*

*The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.*

#### Clearly Trivial Misstatements

*The auditor may designate an amount below which misstatements of amounts in the individual statements would be clearly trivial, and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.*

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**

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

5.5.1. The auditor shall include in the audit documentation 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.

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;
- (c) Performance materiality; and
- (d) If calculated, the amount below which misstatements would be considered clearly trivial.

## **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;
- 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 system of internal control enables the auditor to identify and assess the risks of material misstatement. The auditor's risk identification and assessment process is iterative and dynamic.*

### **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 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, the procedures described in paragraph 6.2.2. are still required.*

*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.*

6.2.1A. When obtaining audit evidence to identify and assess risks of material misstatement and design further audit procedures, the auditor shall consider information from:

- (a) The acceptance or continuance procedures; and
- (b) When applicable, other engagements performed by the engagement partner for the entity.

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 by this Part.*

*Analytical procedures help to identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that indicate matters that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, including those relating to revenue accounts.*

*Analytical procedures performed as a risk assessment procedure may include both financial (e.g., sales price) and non-financial information (e.g., volume of goods sold) and the use of data aggregated at a high level. In the audit of an LCE, the auditor may perform a simple comparison of information, such as the change in interim or monthly account balances from balances in prior periods, to identify potential higher risk areas.*

*Observation and inspection may support, corroborate or contradict inquiries of management and others, and may also provide information about the entity and its environment. Where policies or procedures are not documented, or the entity's controls lack formality, the auditor may still be able to obtain some audit evidence to support the identification and assessment of the risks of material misstatement through observation or inspection of the performance of the control.*

#### *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.*

*In a LCE there may be different fraud risk factors than in more complex entities. On one hand, management or the owner-manager may be able to exercise more effective oversight than in a more complex entity which may compensate for more limited opportunities for segregation of duties. On the other hand, less segregation of duties and more direct involvement of management or the owner-manager may provide management or the owner management with a greater opportunity to override controls and commit fraud. LCEs, including owner-managers may also have different pressures or incentives to commit fraud than management in more complex entities. Appendix 3 sets out fraud risk factors relevant to less complex entities.*

#### *Related Parties*

*In some LCEs, related party transactions between owner-managers and close family members may be common, in particular in closely held entities. These transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration, or for consideration significantly different from fair value.*

#### *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, close family members or owner-managers 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.*

- 6.2.6. 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 relevant aspects of the entity, including the entity and its environment, the applicable financial reporting framework and the entity's system of internal control 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.*

*Inquiries of Management and Others within the Entity*

6.3.A. The auditor shall inquire of management and, when applicable, those charged with governance, regarding:

- (a) How the entity identifies business risks relevant to the preparation of the financial statements and how they are addressed;
- (b) The risks of fraud in the entity and the controls that management has established to mitigate these risks;
- (c) The nature and extent of management's direct involvement in operations or other activities that may help management to prevent or detect misstatements in accounting information, or identify controls that are not operating as intended.
- (d) 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; and
- (e) Whether the entity is in compliance with laws or regulations that may have an effect on the financial statements, and if there has been any correspondence with relevant licensing or regulatory authorities that may be relevant to the financial statements.
- (f) Where applicable, the basis for the intended use of the going concern basis of accounting, whether events or conditions exist 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.

*Inquiries of management and, when applicable, those charged with governance, assist the auditor to identify and assess risks of material misstatement and respond to those risks.*

*Inquiries about how the entity identifies and assesses its business risks relevant to the preparation of the financial statements may assist the auditor in understanding:*

- *Where there are identified business risks;*
- *Whether, and how the entity has responded to those risks;*
- *Whether the risks faced by the entity have been identified, assessed and addressed as appropriate to the nature and circumstances of the entity.*

*Inquiries about the risks of material misstatement due to fraud in the entity may assist the auditor in understanding:*

- *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;*
- *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;*

- *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;*

*Inquiring about how management performs activities to prevent or detect misstatements in accounting information and identifies controls that are not operating as intended may include inquiring about what information management uses and the basis upon which management considers the information to be sufficiently reliable, as well as inquiring about how deficiencies are remediated. These inquiries assist the auditor to understand whether the other aspects of the entity's internal control system are present and functioning as appropriate to the entity's circumstances considering the nature and complexity of the entity.*

*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.*

6.3.B. The auditor shall make inquiries of management, and, where 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.

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

6.3.1. The auditor shall obtain an understanding of:

- (a) The entity's organizational structure, ownership and governance, and business model.
- (b) The industry and other external factors affecting the entity.
- (c) How the entity's financial performance is measured.
- (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 or future commitments.

*Understanding the entity's business model helps the auditor to understand the entity's objectives and strategy, and to understand the business risks the entity takes and faces. Understanding the entity's business risks 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. When obtaining an understanding of the entity's business model, the auditor may consider how the entity uses IT.*

*Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Other external factors affecting the entity that the auditor may consider include climate-related risks, the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.*

*When understanding agreements or relationships that may result in unrecognized liabilities or future commitments the auditor may consider inspecting minutes of meetings and correspondence with legal counsel and inspecting legal expense accounts.*

#### *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.*

### *Understanding the Applicable Financial Reporting Framework*

6.3.3. The auditor shall obtain an understanding of:

- (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.

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

*In less complex entities, and in particular owner-managed entities, the way in which the entity's system of internal control is designed, implemented and maintained will vary with the entity's size and complexity. When there are no formalized processes or documented policies or procedures, the auditor is still required to obtain an understanding of 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 system of internal control may be broader and more detailed.*

### *Understanding the Entity's Control Environment*

6.3.6. The auditor shall:

- (a) Obtain an understanding of the control environment relevant to the preparation of the financial statements; and
- (b) Evaluate whether the control environment provides an appropriate foundation for the entity's system of internal control considering the nature and complexity of the entity.

*The auditor's understanding may include:*

- *How management, and where appropriate, those charged with governance, oversee the entity, demonstrate integrity and ethical values, for example, through communication to employees regarding expectations for business practices and ethical behavior;*
- *The culture of the entity, including whether management supports honesty and ethical behavior;*
- *The entity's assignment of authority and responsibility;*
- *How the entity attracts, develops, and retains competent individuals; and*
- *When applicable, how, owner-managers are actively involved in the business and how this may impact 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 aspects of the entity's system of internal control, and deficiencies may undermine the rest of the entity's system of internal control. Although it does not directly prevent or detect and correct misstatements, it may influence the effectiveness of other controls in the system of internal control. 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 system of internal control and its importance in the entity.*

*Because the control environment is foundational to the entity's system of internal control, any deficiencies could have pervasive effects on the preparation of the financial statements. Therefore, the auditor's understanding and evaluation of the control environment affects 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 assessed risks.*

*Some or all aspects of the control environment for an LCE may not be applicable or may be less formalized. 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.*

*Some entities may be dominated by a single individual who may exercise a great deal of discretion. The actions and attitudes of that individual may have a pervasive effect on the culture of the entity, which in turn may have a pervasive effect on the control environment. 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 control deficiency since there is an opportunity for management override of controls.*

## Understanding the Entity's Process to Prepare its Financial Statements

6.3.9. The auditor shall obtain an understanding of the entity's process to prepare its financial statements, by understanding for significant classes of transactions, account balances and disclosures:

- (a) The accounting records and other records that support the classes of transactions, account balances and disclosures in the financial statements;
- (b) How transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) How events and conditions, other than transactions are identified, processed and disclosed
- (d) The entity's resources, including the IT environment, relevant to (a) to (c) above.

*The auditor's understanding 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 process to prepare the financial statements;*
- *Observation of the performance of the policies or procedures by entity's personnel; or*
- *Selecting transactions and tracing them through the applicable process to prepare the financial statements (i.e., performing a walk-through).*

*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 shall obtain an understanding of how management:

- (a) 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) Understands the degree of estimation uncertainty and addresses such uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements; and
- (c) Reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

6.3.12A. The auditor shall evaluate whether the entity's process to prepare its financial statements, including for accounting estimates, appropriately supports the preparation of its financial statements in accordance with the applicable financial reporting framework.

#### Understanding the Services Provided by a Service Organization

6.3.12B. If the entity uses the services of a service organization and those services are relevant to the entity's process to prepare its financial statements, the auditor shall obtain an understanding of:

- (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;

*The services of a service organization are relevant to the entity's process to prepare its financial statements when those services, and the controls over them, are part of, or affect the process described at paragraph 6.3.9. Where the services of a service organization are relevant to an entity's process to prepare its financial statements, an understanding of the matters above are obtained in addition to the understanding obtained in paragraph 6.3.9.*

*The auditor's understanding 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 the service organization's 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.*

#### Understanding the Entity's Control Activities

6.3.14. The auditor shall obtain an understanding of the entity's control activities by identifying controls that address risks of material misstatement at the assertion level as set out below. For each control identified in (a)—(d) below, the auditor shall perform procedures, beyond inquiry, to evaluate whether the control is designed effectively and has been implemented:

- (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, if any, 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; and
- (d) Controls, if any, related to significant transactions and relationships with related parties and significant transactions and arrangements outside the normal course of business.

*The auditor's required understanding of the entity's control activities involves identifying specific controls, as appropriate in the entity's circumstances, and evaluating their design and determining whether the controls have been implemented. Evaluating the design and implementation of controls includes the evaluation of 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 the determination whether the control has 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.*

*If the entity's use of the services of a service organization and those services are relevant to the entity's process to prepare its financial statements (see paragraph 6.3.12B), controls (a) to (d) may include those at the user entity related to the services provided by the service organization, including those that are applied to the transactions processed by the service organization.*

#### *Journal Entries*

*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.*

#### *Related Parties*

*Controls in less complex entities are likely to be less formal and such entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.*

6.3.15. For the controls identified in paragraph 6.3.14. the auditor shall:

- (a) Identify the IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT and what those related risks are;
- (b) Identify the entity's general IT controls that respond to those identified risks; and
- (c) By performing procedures in addition to inquiries, evaluate whether the identified general IT controls are designed effectively and have been implemented.

*The auditor's understanding of the entity's process to prepare the financial statements (which may be done by performing walk-through procedures) includes the IT environment relevant to the flows of transactions and processing of information. 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.*

#### *Deficiencies Within the Entity's System of Internal Control*

6.3.18. The auditor shall determine whether one or more deficiencies have been identified in the entity's system of internal control and if so, if they individually or in combination, constitute significant deficiencies.

*In understanding the entity's system of internal control, the auditor may determine that certain of the entity's policies or procedures are not appropriate to the nature and circumstances of the entity. Such a determination may be an indicator that assists the auditor in identifying deficiencies in internal control. If the auditor has identified one or more deficiencies, the auditor may consider the effect of those deficiencies on the identification and assessment of risks of material misstatement and on the design of further audit procedures.*

*The auditor uses professional judgment in determining whether a deficiency represents a significant deficiency in internal control.*

#### **6.4. Identifying and Assessing the 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 and assess the risks of material misstatement, due to fraud or error, at:

- (a) The financial statement level. In doing so, the auditor shall consider the nature and extent of the pervasive effect of identified risks on the financial statements and determine whether they affect risks at the assertion level; and
- (b) The assertion level for classes of transactions, account balances, and disclosures. In doing so, the auditor shall:
  - (i) Determine the relevant assertions and related significant classes of transactions, account balances and disclosures; and
  - (ii) Assess inherent risk for identified risks of material misstatement at the assertion level by assessing the likelihood and magnitude of misstatement.

*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 related to 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.*

*An assertion about a class of transactions, account balance or disclosure is a relevant assertion when it has an identified risk of material misstatement. The determination of whether an assertion is a relevant assertion is made 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 (i.e., likelihood), and being material if they were to occur (i.e., magnitude). Significant classes of transactions, account balances and disclosures are those for which there is one or more relevant assertions. Determining relevant assertions and the significant classes of transactions, account balances and disclosures provides a basis for the identification and assessment of risks of material misstatement.*

#### *Assessing Inherent Risk*

*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.*

*In considering the likelihood of a misstatement, the auditor considers the possibility that a misstatement may occur. 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).*

*When assessing inherent risk, factors relating to the preparation of information required by the applicable financial reporting framework that affect the susceptibility of assertions to misstatement may 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 these factors may give rise to higher inherent risk and may be an indication that the ISA for LCE is not appropriate for the audit.*

*When risks of material misstatement relate more pervasively to the financial statements as a whole, and potentially affect many assertions, the risks of material misstatement are assessed at the*

*financial statement level. When assessing risk at the assertion level, the auditor then takes into account the degree to which the risks of material misstatement at the financial statement level affects the assessment of inherent risks for risks of material misstatement at the assertion level.*

*In identifying and assessing risks of material misstatement, the results of the engagement team discussion and any inquiries relating to fraud and going concern are relevant.*

#### *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.*

6.4.2. In identifying and assessing 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.

*When identifying and assessing risks of material misstatement due to fraud, the auditor may consider whether unusual or unexpected relationships have been identified in performing analytical procedures, including those related to revenue accounts.*

6.4.3A. 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, change or management bias:

- (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.

#### *Significant Risks*

6.4.3B. 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 paragraph 6.4.3D. 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.*

6.4.3C. The auditor shall determine whether the assessed risks associated with related party relationships and transactions, and assessed risks relating to accounting estimates are significant risks.

6.4.3D. The auditor shall treat the following as significant risks:

- (a) Risk of material misstatement from management override of controls;
- (b) Any other identified fraud risks, including risks that the auditor identified in accordance with paragraph 6.4.2.;
- (c) Identified significant related party transactions outside the entity's normal course of business.

*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.*

### Assessing Control Risk

6.4.3E. The auditor shall assess control risk if:

(a) The auditor has determined that substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level;  
or

(b) The auditor otherwise plans to test the operating effectiveness of controls,

otherwise, the assessed 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 6.3.15. (b). 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.*

*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.*

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

6.4.3F. 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.

6.4.3G. 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.

6.4.3H. 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.

*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.*

## **6.5. Evaluation of the Appropriateness of Using the ISA for LCE**

6.5.A. Based on the procedures performed to identify and assess the risks of material misstatement, the engagement partner shall evaluate whether the 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 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 ISA for LCE, the auditor may need to change the original determination to use the ISA for LCE.*

*[Additional EEM still to be proposed by Task Force for discussion with the Board, alongside discussion of the specific questions in the EM relating to guidance on transitioning]*

## **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**

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

*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 system of internal control.*
- *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. 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 system of internal control;

*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;
- (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 6.3.15 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 basis for the evaluation about whether the 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**

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

...

#### *Management Override of Controls*

...

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

...

- (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. In performing the review, the auditor shall:
  - (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.

...

### *Accounting Estimates*

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 (see paragraph 7.4.18B).
- (b) Testing how management made the accounting estimate (see paragraphs 7.4.18C–7.4.18D).
- (c) Developing an auditor's point estimate or range (see paragraph 7.4.18E).

*Given the nature of many accounting estimates for an LCE, the final outcome of an accounting estimate may be known before the date of the auditor's report. In these circumstances, audit evidence obtained from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the assessed risks of material misstatement. For some accounting estimates, however, events occurring up to the date of the auditor's report may not provide sufficient appropriate audit evidence about whether the accounting estimate is reasonable or misstated (e.g., when events or conditions develop only over an extended period). In these circumstances, the auditor's further audit procedures include the approaches in (b) or (c).*

7.4.18A. The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate.

### *Obtaining Audit Evidence from Events Occurring Up to the Date of the Auditor's Report.*

7.4.18B. When the auditor's further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor's report, the auditor shall evaluate whether the audit evidence is sufficient and appropriate, taking into account any changes in circumstances and other relevant conditions between the event and the measurement date that may affect the relevance of such evidence.

### *Testing How Management Made the Accounting Estimate*

7.4.18C. When testing how management made the accounting estimate, the auditor's further audit procedures shall address whether:

- (a) The method selected is appropriate, including any changes from the prior period;
- (b) The significant assumptions and data are consistent and appropriate, and their integrity maintained in applying the method;
- (c) Management has the intent to carry out specific courses of actions;
- (d) The judgments made in selecting the method, significant assumptions and data, 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;

- (e) Changes from prior periods are appropriate;
- (f) The data is relevant and reliable in the circumstances; and
- (g) Calculations are mathematically accurate and whether judgements have been applied consistently.

*Method, Significant Assumptions and Data*

*Relevant considerations for the auditor regarding the appropriateness of the method, significant assumptions and data in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:*

- *Management's rationale for the selection of the method, assumption and data;*
- *Whether the method, assumption and data are appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates;*
- *Whether a change from prior periods in selecting a method, assumption or data is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial statements or may be an indicator of possible management bias.*
- *When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences.*
- *Whether the significant assumptions are inconsistent with each other and with those used in other accounting estimates.*

7.4.18D. The auditor's further audit procedures also shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to understand and address estimation uncertainty by selecting appropriate point estimates and developing related disclosures. 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.

*When the applicable financial reporting framework does not specify how to select a point estimate from among reasonably possible outcomes or does not require specific disclosures, the exercise of judgment by management is an important consideration for the auditor regarding the appropriateness of the point estimate selected and the related disclosures.*

*Matters that may be relevant for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures:*

- *That describe the amount as an accounting estimate and explain the nature and limitations of the process for making it; and*

- *About material accounting policy information related to accounting estimates, which may include significant or critical management judgments as well as significant forward-looking assumptions or other sources of estimation uncertainty.*

#### Developing an Auditor's Point Estimate or Range

7.4.18E. When the auditor develops a point estimate or range to evaluate management's point estimate, the auditor's further audit procedures shall include audit procedures to:

- (a) Evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework; and
- (b) Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence.

*The auditor's decision as to whether to develop a point estimate rather than a range may depend on the nature of the accounting estimate and the auditor's judgment in the circumstances. For example, the nature of the accounting estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.*

*The requirement for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.*

...

### 7.6 Specific Communication Requirements

...

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. In doing so, the auditor takes into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, change or management bias in making accounting estimates and related disclosures.

### 7.7. Specific Documentation Requirements

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

7.7.1. 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; 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:

- (a) The results of discussion with management, and where appropriate, those charged with governance and others; including how the matter has been responded to; and
- (b) 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.

...

## **8. Concluding**

...

### **8.9. Specific Documentation Requirements**

*In addition to the general documentation requirements at Part 2.5 which apply throughout the audit engagement, specific matters to be documented relevant to this Part are described below.*

8.9.1. The auditor shall include the following in the audit documentation:

- (a) 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; and
- (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 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.

**APPENDIX 2**

Changes to this diagram are not tracked from Appendix 2 of ED-ISA for LCE.

**Identifying and Assessing the Risks of Material Misstatement (Part 6)**

