Audits of Less Complex Entities – Illustrative Drafting: Requirements Proportionate to LCEs — Part 6

As described in Agenda Item 5 (paragraphs 77-80) this Paper presents initial illustrative drafting of requirements relating to the section of the proposed ISA for LCE on understanding relevant aspects of the entity.

Tracked changes are shown from the requirements presented in the Exposure Draft of the Proposed International Standard on Auditing for Financial Statements of Less Complex Entities.

Requirements and guidance not yet considered by the Less Complex Entities (LCE) Task Force for future revisions are highlighted in grey.

6.3. Understanding Relevant Aspects of the Entity

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

Understanding the Entity and Its Environment

6.3.1. The auditor shall understand:

(a) The entity’s organizational structure, ownership and governance, business model (including how the entity uses IT in its business model).

(b) The industry and other external factors affecting the entity.

(c) How the entity’s financial performance is measured internally and externally.

(d) The legal and regulatory framework applicable to the entity, and how the entity is complying with that framework.

(e) The entity’s transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed.

(f) Agreements or relationships that may result in unrecognized liabilities or future commitments, or changes to current asset valuations through inspecting minutes of meetings and correspondence with legal counsel and inspecting legal expense accounts.

Understanding the entity’s objectives, strategy and business model helps the auditor to understand the entity at a strategic level, and to understand the business risks the entity takes and faces. This understanding 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 understanding agreements or relationships that may result in unrecognized liabilities or future commitments or changes to current asset valuations the auditor may consider inspecting minutes of meetings and correspondence with legal counsel and inspecting legal expense accounts.

When understanding the entity’s business model, the auditor may consider how the entity uses IT.
Other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Considerations Specific to Public Sector Entities

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

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

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

Understanding the Applicable Financial Reporting Framework

6.3.3. The auditor shall understand:

(a) The applicable financial reporting framework including, for accounting estimates, the recognition criteria, measurement bases, and the related presentation and disclosure requirements and how these apply in the context of the nature and circumstances of the entity and its environment.

(b) The entity's accounting policies and reasons for any changes thereto.

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

Inherent Risk Factors

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

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

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

The presence of inherent risk factors that give rise to higher inherent risk, related to accounting estimates may be indicators that the [draft] ISA for LCE is not appropriate for the audit.
Understanding the Entity’s Internal Control System

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

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

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

Considerations Specific to Public Sector Entities

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

Indirect Controls

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

For this purpose, the auditor shall understand:

(a) How management, and where appropriate, those charged with governance, oversee the entity, and demonstrate integrity and ethical values;
(b) The entity’s assignment of authority and responsibility;
(c) The culture of the entity, including whether the culture supports honesty and ethical behavior; and
(d) When applicable, how owner managers have an active involvement and influence the risks arising from management override of controls due to lack of segregation of duties.
Consideration of the following matters may facilitate the auditor’s understanding given the nature and circumstances of the entity. For this purpose, the auditor shall understand:

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

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

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

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

6.3.7. The auditor shall evaluate understand whether the entity’s risk assessment process (formalized or not) is appropriate to the entity’s circumstances considering the nature and complexity of the entity. For this purpose, the auditor shall understand the entity’s risk assessment process relevant to the preparation of the financial statements (i.e., how risks are identified, assessed and addressed), including how this process identifies and addresses risks related to accounting estimates.

Understanding how the entity assesses its business risks and other risks can assist the auditor in understanding:

- Where there are identified risks:
• Whether 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.

This understanding may also help inform the auditor in understanding whether the risks faced by the entity have been identified, assessed and addressed as appropriate to the nature and circumstances of the entity, and help the auditor in identifying and assessing risks of material misstatement and responding to those risks.

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

The auditor’s understanding of the entity’s monitoring of the internal control system may include understanding the sources of information and the basis upon which management considers the information to be sufficiently reliable, as well as how deficiencies are remediated.

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

This understanding may also help the auditor identify and assess risks of material misstatement and respond to those risks.

Direct Controls

6.3.9. [Removed – combined into 6.3.11] The auditor shall understand the information system relevant to the preparation of the financial statements, including:

(a) (i) For significant classes of transactions, account balances and disclosures, how those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements, as well as:

(ii) How the information system captures, processes and discloses events and conditions, other than transactions;

(iii) The accounting records, specific accounts in the financial statements and other supporting records for the flows of information;

(iii) The entity’s resources used in the financial reporting process;

(iv) The financial reporting process used to prepare the entity’s financial statements, including disclosures; and

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

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

**The auditor’s understanding of the information system relevant to the preparation of the financial statements may include:**

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

- The IT environment relevant to the matters above.

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

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

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

**Automated Tools and Techniques**

The auditor may also use ATT to obtain direct access to, or a digital download from, the databases in the entity’s information system that store accounting records of transactions. By applying ATT to this information, the auditor may confirm the understanding obtained about how transactions flow
through the information system by tracing journal entries, or other digital records related to a particular transaction, or an entire population of transactions, from initiation in the accounting records through to recording in the general ledger. Analysis of complete or large sets of transactions may also result in the identification of variations from the normal, or expected, processing procedures for these transactions, which may result in the identification of risks of material misstatement.

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

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

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

### 6.3.14. The auditor shall identify controls that address risks of material misstatement at the assertion level as follows: set out below. For each control identified in (a)—(e) 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; |
| (d) | Other controls, based on the auditor’s professional judgment, where the auditor considers it appropriate to meet the objectives of identifying risks of material misstatement at the assertion level; |
| (e) | If applicable, controls that relate to information processed by a service organization; and |
| (f) | Controls, if any, related to identify, account for, and disclose related-party relationships and transactions in accordance with the applicable financial reporting framework, authorize and |
approve significant transactions and relationships with related parties, and authorize and approve significant transactions and arrangements outside the normal course of business.

For each control identified in (a)–(f) above, the auditor shall evaluate whether the control is designed effectively to address the risk of material misstatement at the assertion level, or effectively designed to support the operation of other controls, and determine whether the control has been implemented, by performing procedures more than inquiry.

The auditor is required to identify specific controls, evaluate the design and determine whether the controls have been implemented. 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.

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

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

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

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

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

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

(a) The nature of the services provided by the service organization and the significance of those services to the entity;
(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization;
(c) The relevant contractual terms for the activities undertaken by the service organization;
(d) Controls at the service organization relevant to the entity’s transactions; and
(e) The controls applied to transactions with the service organization.

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

Deficiencies in the Entity’s Internal Control System

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