

# Agenda Item

## 12-C

### Proposed Revisions to Selected Paragraphs of the International Standard on Auditing for Audits of Financial Statements of Less Complex Entities

This agenda item includes selected paragraphs from Part A, 1, 3 and Appendix 1 of the proposed International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (the ISA for LCE), marked from the ISA for LCE as published in December 2023. This agenda item must be read together with **Agenda Items 12-A** and **12-B**.

#### **A. Authority of the ISA for Audits of Financial Statements of Less Complex Entities**

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#### **Limitations for Using the ISA for LCE**

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#### *Specific Prohibitions*

*Paragraph A.1. sets out the classes of entities for which the use of this standard is specifically prohibited.*

A.1. The ISA for LCE shall not be used if:

- (a) Law or regulation prohibits the use of the ISA for LCE or specifies the use of auditing standards other than the ISA for LCE for the audit of the financial statements in that jurisdiction.
- (b) The entity is a ~~listed entity~~ publicly traded entity.
- (c) The entity falls into one of the following classes:
  - (i) An entity one of whose main functions is to take deposits from the public;
  - (ii) An entity one of whose main functions is to provide insurance to the public; or
  - (iii) A class of entities where use of the ISA for LCE is prohibited for that specific class of entity by a legislative or regulatory authority or relevant local body with standard-setting authority in the jurisdiction.
- (d) The audit is an audit of group financial statements (group audit) and:
  - (i) Any of the group's individual entities or business units meet the criteria as described in paragraph A.1.(b) or A.1.(c); or
  - (ii) Component auditors are involved, except when the component auditor's involvement is limited to circumstances in which a physical presence is needed for a specific audit procedure for the group audit (e.g., attending a physical inventory count or physically inspecting assets or documents).

*A single legal entity may be organized with more than one business unit, for example, a company with operations in multiple locations, such as a store with multiple branches. When those business units have characteristics such as separate locations, separate management, separate general*

ledger and the financial information is aggregated in preparing the single legal entity's financial statements, such financial statements meet the definition of group financial statements because they include the financial information of more than one entity or business unit through a consolidation process.

In some cases, a single legal entity may configure its information system to capture financial information for more than one product or service line for legal or regulatory reporting or other management purposes. In these circumstances, the entity's financial statements are not group financial statements because there is no aggregation of the financial information of more than one entity or business unit through a consolidation process. Further, capturing separate information (e.g., in a sub-ledger) for legal or regulatory reporting or other management purposes does not create separate entities or business units (e.g., divisions) for purposes of this ISA for LCE.

### Component Auditors

A component auditor is an auditor who performs audit work related to a component<sup>1</sup> for purposes of the group audit. A component auditor is a part of the engagement team for a group audit. Component auditors may be from a network firm, a firm that is not a network firm, or the group auditor's firm (e.g., another office within the group auditor's firm).

In some circumstances, the group auditor may perform centralized testing on classes of transactions, account balances or disclosures, or may perform audit procedures related to a component. In these circumstances, the group auditor is not considered a component auditor.

Part 3 contains requirements in relation to engagement quality, including relevant ethical requirements, and the direction and supervision of the members of the engagement team, and the review of their work.

- A.2. The classes in paragraph A.1.(a) ~~(b)~~ and (d) are outright prohibitions and cannot be modified. Legislative or regulatory authorities or relevant local bodies with standard-setting authority can define more explicitly a publicly traded entity (see paragraph A.1.(b)) or modify each class described in paragraph A.1.(c) but a class cannot be removed.

### Publicly Traded Entity

If legislative or regulatory authorities or relevant local bodies with standard-setting authority -define more explicitly a publicly traded entity in a specific jurisdiction, that more explicit definition applies for purposes of the ISA for LCE.

Legislative or regulatory authorities or relevant local bodies with standard-setting authority may use terms other than publicly traded entity for entities where there is significant public interest in their financial condition due to the potential impact of their financial well-being on stakeholders. These terms are regarded as equivalent to "publicly traded entity".

### Classes of Entities in Paragraph A.1(c)

A.1.(c) sets out some classes of entities that may exhibit public interest characteristics. Entities that have public interest characteristics could embody a level of complexity in fact or appearance and are

<sup>1</sup> A component is an entity, business unit, function or business activity, or some combination thereof, determined by the group auditor for the purposes of planning and performing audit procedures in a group audit.

*specifically prohibited from using the ISA for LCE. Modifications can be made by adding a class of entities to the list of prohibited entities, permitting specific sub-sets within a class to be able to use this standard or using quantitative thresholds to prohibit use of this standard. Legislative or regulatory authorities or relevant local bodies with standard-setting authority may subsequently remove or amend modifications that they have made.*

### Qualitative Characteristics

*The requirements in this ISA for LCE have been designed to be proportionate to the typical nature and circumstances of an audit of an LCE.*

*The ISA for LCE has not been designed to address:*

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

*Also, the ISA for LCE does not include any requirements addressing:*

- *Procedures or matters typically relevant to ~~listed~~ publicly traded entities, including reporting on segment information or key audit matters.*
- *When the auditor intends to use the work of internal auditors, as this would ordinarily not be applicable to an audit of an LCE.*
- *When the auditor intends to use a report provided by a service auditor of a service organization either as audit evidence about the design and implementation of controls at the service organization (i.e., a type 1 or type 2 report), or as audit evidence that controls at the service organization are operating effectively (i.e., a type 2 report), as this would ordinarily not be applicable to an audit of an LCE.*

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

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

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#### *Professional Skepticism*

1.4.4. The auditor shall plan and perform the audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

1.4.5. The auditor shall design and perform procedures in a way that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

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

- *Audit evidence that contradicts other audit evidence obtained.*
- *Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.*
- *Information that indicates that one or more fraud risk factors are present.*
- *Circumstances that may be indicative of fraud or suspected fraud. ~~Conditions that may indicate possible fraud.~~*
- *Circumstances that suggest the need for audit procedures in addition to those required by this standard.*

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

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

*Conditions of the engagement can create pressures on the engagement team that may impede the appropriate exercise of professional skepticism when designing and performing audit procedures and when evaluating audit evidence.*

### **1.5. Fraud**

*Responsibility of the Auditor, Management and Those Charged with Governance*

*An auditor conducting an audit in accordance with this standard is responsible for:*

- *Planning and performing the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud.*

- Communicating and reporting about matters related to fraud.

The primary responsibility for the prevention and detection of fraud rests with both management, and where appropriate, those charged with governance of the entity.

#### Characteristics of Fraud

~~Although fraud is a broad legal concept, for the purposes of this standard, the auditor is concerned with fraud that causes a material misstatement in the financial statements.~~

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Although fraud is a broad legal concept, for the purposes of this standard, the auditor is concerned with a material misstatement in the financial statements due to fraud. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

#### Inherent Limitations

~~An auditor conducting an audit in accordance with this standard is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. While t~~The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error that does not diminish the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement due to fraud. Because of the significance of the inherent limitations of an audit as it relates to fraud, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with this standard. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence.

#### Professional Skepticism and Professional Judgment

When obtaining reasonable assurance, the auditor is responsible for:

- Maintaining professional skepticism throughout the audit;
- Considering the potential for management override of controls; and
- Recognizing ~~the fact~~ that audit procedures that are effective for detecting error may not be effective in detecting fraud.

#### Non-Compliance with Laws and Regulations

Fraud ordinarily constitutes an instance of non-compliance with laws and regulations. As such, if the auditor identifies fraud or suspected fraud, the auditor also has responsibilities in accordance with section 1.6. of this standard.

*Relationship of Fraud with Corruption, Bribery and Money Laundering*

*Corruption, bribery and money laundering are forms of illegal or unethical acts and may be fraudulent acts, or may be carried out to facilitate or conceal fraud. Depending on the nature and circumstances of the entity, certain laws, regulations or aspect of relevant ethical requirements dealing with corruption, bribery or money laundering may be relevant to the auditor's responsibilities to consider laws and regulations in an audit of financial statements.*

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

- (a) Identifying and assessing risks of material misstatement, whether due to fraud or error. In doing so, the auditor shall evaluate whether information obtained from the procedures to identify and assess risks, and related activities, indicates that one or more fraud risk factors are present;<sup>2</sup>
- (b) Obtaining sufficient appropriate audit evidence through designing and implementing appropriate responses to assessed risks of material misstatement, including risks of material misstatement due to fraud; and
- (c) Responding appropriately to fraud or suspected fraud identified during the audit.

*Considerations Specific to Public Sector Entities*

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

*Auditor Unable to Continue the Engagement*

1.5.2. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall determine the legal and professional responsibilities applicable in the circumstances, and consider whether:

- (a) or consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under law or regulation; or*
- (b) Where withdrawal is prohibited by law or regulation, to include a disclaimer of opinion in the auditor's report.*

*Considerations Specific to Public Sector Entities*

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

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

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

<sup>2</sup> Appendix 4 sets out fraud risk factors relevant to less complex entities.

1.8.2. The auditor shall communicate with those charged with governance the relevant ethical requirements, including those related to independence, that the auditor applies for the audit engagement.

1.8.3. The auditor shall communicate, on a timely basis, with management and, where appropriate, those charged with governance.

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

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

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

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

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

*Communication with management and, where appropriate, those charged with governance, often may occur in a less structured manner and matters may be communicated orally. This standard requires that the auditor exercises professional judgement to determine when oral communication of a matter would not be adequate and communication in writing is appropriate. In addition, certain matters are required to be communicated in writing, as set out in this standard.*

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

1.8.6. Where ~~the~~ responses to inquiries of management, and where appropriate, those charged with governance or others within the entity about a particular matter are inconsistent, the auditor shall investigate the inconsistencies.

#### *Specific Communications in Relation to Fraud*

1.8.7. If the auditor ~~has identified~~ fraud or suspected fraud or has obtained information that indicates that fraud may exist, the auditor shall communicate these matters, unless prohibited by law or regulation,



on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

*Considerations Specific to Public Sector Entities*

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

1.8.8. Unless prohibited by law or regulation, the auditor shall communicate with those charged with governance, on a timely basis, if the auditor has identified or suspects fraud involving:

- (a) Management, unless those charged with governance are involved in managing the entity;
- (b) Employees who have significant roles in the entity's system of internal control; or
- (c) Others, except for matters that are clearly inconsequential where the fraud results in a material misstatement in the financial statements.

1.8.9. If the auditor identifies suspected fraud involving management, the auditor shall communicate ~~discuss~~ with those charged with governance the nature, timing and extent of audit procedures necessary to complete the audit.

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

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

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- 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.

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

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

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

##### **3.2.1. The engagement partner shall take:**

- (a) Overall responsibility for managing and achieving quality on the audit engagement, including being 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; and
- (b) Responsibility for clear, consistent and effective 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**

##### **3.2.2. In taking overall responsibility for managing and achieving quality on the audit engagement, the engagement partner shall determine that the nature, timing and extent of direction, supervision and review is:**

- (a) Responsive to the nature and circumstances of the engagement and the resources assigned; and
- (b) 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.*
- *Fraud risk factors, fraud or suspected fraud, or control deficiencies related to the prevention or detection of fraud identified during the course of the audit engagement.*
- *The competence and capabilities of the individual engagement team members performing the audit work.*

3.2.3. 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 3.2.2. and 3.2.3., the engagement partner may communicate directly to other members of the engagement team and reinforce this communication conduct and actions (e.g., leading by example).*

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### *Engagement Resources*

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

- (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.

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### **Glossary of Terms**

This glossary lists the terms that are defined for the purpose of the ISA for LCE. The definitions assist in the consistent application and interpretation of this standard, and are not intended to override definitions that may be established for other purposes, whether in law or regulation or otherwise. Unless otherwise indicated, the definitions carry the same meanings throughout this standard. In addition, this glossary includes descriptions of other terms found in the ISA for LCE to assist in common and consistent interpretation and translation (such other terms are identified by an asterisk “\*”).

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**Publicly traded entity**—An entity that issues financial instruments that are transferrable and traded through a publicly accessible market mechanism, including through listing on a stock exchange. A listed entity as defined by relevant securities, law or regulation is an example of a publicly traded entity.

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