

# Determining when to use the ISA (NZ) for LCE

Supplemental guidance on part A  
(the authority)

ISA (NZ) for LCE guidance series



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# Guidance on using the qualitative characteristics to determine the appropriate use of the ISA (NZ) for LCE



This guide is issued to assist adoption and implementation of the International Standard on Auditing (New Zealand) for Audits of Financial Statements of Less Complex Entities ('the **ISA (NZ) for LCE**' or 'the standard').

The guide explains matters and circumstances that may be relevant in determining the appropriate use of the ISA (NZ) for LCE in accordance with part A of the standard, in particular focussing on the qualitative characteristics of a less complex entity. References to financial statements include service performance information and entity information, where relevant.

## This guidance may be useful to:



Firms for developing policies or procedures in relation to the use of the ISA (NZ) for LCE.



Engagement teams or auditors when determining whether the standard is appropriate to use for a specific audit engagement at the client acceptance or continuance phase.



This guide is not meant to be exhaustive and reference to the ISA (NZ) for LCE should always be made to determine the appropriate use of the standard.

## Design of the ISA (NZ) for LCE – why the authority (part A) is important

The ISA (NZ) for LCE has been designed to be proportionate to the typical nature and circumstances of an audit of a LCE. Therefore, the standard does not contain requirements or essential explanatory material for matters or circumstances relating to prohibited entities, or matters that may increase, or indicate the presence of, complexity. Accordingly, the standard does not include any requirements addressing:



### **Entities that are specifically prohibited, such as listed entities or FMC reporting entities with higher levels of public accountability**

Matters that are typically relevant to these types of entities are not included in the standard, including requirements related to reporting on segment information or key audit matters.



### The involvement of component auditors

The standard shall not be used when the audit is a group audit and component auditors are involved except when the component auditors' involvement is limited to circumstances in which a physical presence is needed for a specific audit procedure for the group audit. This is discussed further on pages 13-14.



### The use of work of internal auditors

Internal auditors (ISA (NZ) 610 (Revised 2013))<sup>1</sup> are often used in entities that display higher levels of complexity, to provide management with assurance over, or add value or improve an organisation's operations related to risk management, controls, and governance processes.

In addition, because the standard only includes requirements that are proportionate to the intended nature and circumstances of a LCE, in some specific areas the standard contains requirements to address only less complex circumstances, such as:

- **Accounting estimates.** The standard does not have specific requirements for where there is complex modelling, and where there is high estimation uncertainty (for example, where the accounting estimate is calculated using a highly specialised entity-developed model for which there are no observable inputs).
- **Use of a service organisation by the entity.** The standard includes requirements for certain circumstances where an entity uses a service organisation for processing transactions. For example, many LCEs have payroll processed by a service organisation (see paragraphs [6.3.11.](#), [6.3.12.](#) and [7.4.28.](#) of the standard). However, the ISA (NZ) for LCE does not address situations that are deemed more complex relating to an entity using a service organisation. For example, the standard does not contain requirements relating to the auditor's intended use of a report provided by a service auditor of a service organisation, either as audit evidence about the design and implementation of controls at the service organisation (i.e. a Service Organisation Controls (SOC) Type 1 or Type 2 report), or as audit evidence that controls at the service organisation are operating effectively (i.e. a Type 2 report).

If the standard is used for audit engagements other than those contemplated in its design, the auditor will not obtain sufficient appropriate audit evidence to support a reasonable assurance opinion. In such instance, the auditor is also prohibited from representing compliance with the ISA (NZ) for LCE in the auditor's report.

If it is found that the use of the standard is not appropriate at either the acceptance and continuance phase, or during the course of the audit (because matters of complexity not contemplated by the standard have arisen), the audit will need to be transitioned<sup>2</sup> to being undertaken under the ISAs (NZ) or other applicable auditing standards, as appropriate.

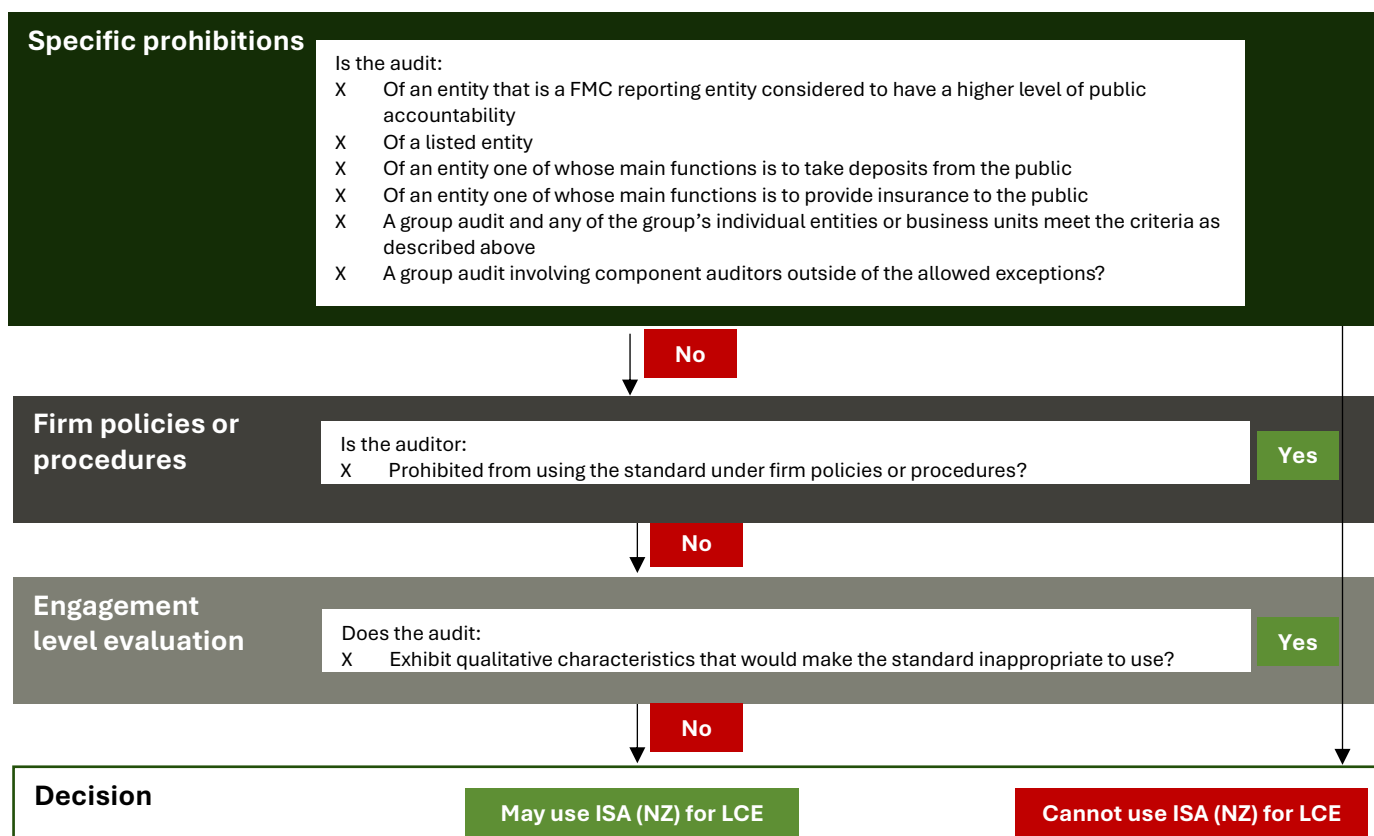
## Deciding when it is appropriate to use the ISA (NZ) for LCE

The following diagram summarises the steps to take in deciding whether or not the ISA (NZ) for LCE would be appropriate to use.

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<sup>1</sup> ISA (NZ) 610 (Revised 2013), *Using the Work of Internal Auditors*

<sup>2</sup> Guidance on transitioning can be found on page 12 of the [First time implementation guide](#) from the IAASB.



Specific prohibitions are set out in [para. A.1.](#) of the standard. The auditor determines that the firm's policies or procedures regarding acceptance and continuance of the audit engagement have been followed at [paragraph 4.3.1.](#) The following pages guide auditors in undertaking the engagement level evaluation – considering qualitative characteristics to determine whether or not the standard is appropriate to use.

## Considering qualitative characteristics

### What is the purpose of qualitative characteristics?

The qualitative characteristics describe characteristics of a LCE for the purpose of determining the appropriate use of the standard.

Paragraph A.3. of the standard that describes characteristics of a LCE for the purpose of determining the appropriate use of the standard.



#### If in doubt, you are out

The auditor must use professional judgement in determining whether the entity exhibits the qualitative characteristics of a less complex entity and therefore

whether the standard is appropriate to use. If there is uncertainty about whether, based on the list of qualitative characteristics of a LCE (as set out in paragraph A.3. of the standard), an audit meets the criteria set out in part A of the standard, the use of the standard is not appropriate. Accordingly, application of the full ISAs (NZ) and, if applicable, NZ AS would be appropriate.

### What qualitative characteristics do auditors need to consider?

The table below further describes and provides examples of the qualitative characteristics detailed in paragraph A.3. of the standard. The list in paragraph A.3. of the standard is intended to illustrate how the requirements in the standard have been designed for audits of LCEs. Therefore:

- The list is not exhaustive nor intended to be absolute, and other relevant matters may also need to be considered.
- Each of the qualitative characteristics may not, on its own, be sufficient to determine whether the standard is appropriate or not in the circumstances. The matters described in the list are intended to be considered both individually and in combination.



#### Numbers guide, judgement decides

Paragraph A.3. of the standard includes numerical indicators in relation to certain qualitative characteristics as illustrative examples only to further describe a typical LCE.

They are not intended to be absolute. The auditor may conclude that a higher or lower number may be appropriate in the circumstances. These numerical indicators should be considered in the context of the particular qualitative characteristic, and in combination with the other qualitative characteristics.

### Qualitative characteristics

In the tables below, characteristics designated by “✓” represent those that are commonly associated with a LCE, and those designated with “✗” are those that are commonly not associated with a LCE. The characteristics in the table should be considered both individually and in combination. The presence of one ‘complex’ characteristic exhibited by an entity does not necessarily exclude the use of the ISA (NZ) for LCE for that entity.



The introductory paragraphs, in green, are from the table in para. [A.3.](#) of the standard.

Business Activities, Business Model and Industry	
<ul style="list-style-type: none"> <li>The entity's business activities, business model or the industry in which the entity operates, do not give rise to significant pervasive business risks.</li> <li>There are no specific laws or regulations that govern the business activities that add complexity (e.g. prudential requirements).</li> <li>The entity's transactions result from a few lines of business or revenue streams.</li> </ul>	
✓	Business activities and business model are well established for the industry and products or services do not give rise to a significant pervasive risk of technological obsolescence, legal liability or reputational risk.
✓	Operations are not subject to a higher degree of regulation or regulatory supervision.
✓	Straightforward or uncomplicated transactions resulting from few lines of business or products, requiring simple record-keeping and few internal controls.
✗	Products or services that give rise to a significant pervasive risk of technological obsolescence, legal liability or reputational risk.
✗	Operations that are subject to a high degree of regulation. <i>Note: For public sector entities, regulation is not always an indicator of complexity.</i>
✗	The entity is subject to regulatory supervision, including where the entity's performance or financial position is measured against regulatory requirements such as prudential requirements, or regulatory ratio or exposure requirements.
✗	The entity's products or services, operations or relationships are such that there is complexity in data collection and processing, including complicated transactions or accounting entries that may involve complex calculations. For example, complexity may arise when transaction processing has to account for different commercial terms with many different suppliers, customers or other parties, there are many interrelated commercial terms, or the processing of data involves many inter-related steps and the data is more difficult to identify, capture, access, understand or process.

Organisational Structure and Size	
<ul style="list-style-type: none"> <li>The organisational structure is relatively straightforward, with few reporting lines or levels and a small key management team (e.g., 5 individuals or less).</li> </ul>	
✓	Few levels of management with responsibility for a broad range of controls, including that many controls may be directly applied by management.
✓	<p>All of those charged with governance are involved in managing the entity (i.e. those with a governance role generally do not include an independent or outside member(s)).</p> <p><i>Note: For charities or public sector entities, the presence of independent members in a governance role is not always an indicator of complexity.</i></p>
X	The organisational structure includes multiple levels and reporting lines to accommodate the entity's business activities.
X	A large key management team with many individuals involved in managing different areas of the entity.
X	Organisational structure that involves unusual entities or arrangements, off-balance sheet finance or other complex financing arrangements.
Ownership structure	
<ul style="list-style-type: none"> <li>The entity's ownership structure is straightforward and there is clear transparency of ownership and control, such that all individual owners and beneficial owners are known.</li> </ul>	
✓	An owner-managed entity, including a single owner-manager or when there is a concentration of ownership and management in a small number of individuals.
X	Complex ownership arrangements (for example, joint ownership arrangements) or difficulty in determining the organisation or individuals that have controlling or beneficial interests in the entity.
X	The influence of related parties is unclear, such as when related parties operate through an extensive and complex range of relationships and structures.
Nature of Finance Function	
<ul style="list-style-type: none"> <li>The entity has a centralised finance function, including centralised activities related to financial reporting.</li> <li>There are few employees involved in financial reporting roles (e.g., 5 individuals or less).</li> </ul>	
✓	The entity's finance function performs the initiation, authorisation, recording, processing, and reporting of transactions relevant to the preparation of financial statements in one location.
✓	The entity uses a service organisation for processing straightforward or uncomplicated transactions (for example, processing of payroll).
X	The entity's finance function is not centralised, for example, activities relating to the accounting and financial reporting functions are performed in a number of different locations.
X	The entity has a shared service centre(s), whether as part of the entity itself or as part of the group to which the entity belongs, to centralise activities or processes relevant to the entity's financial reporting.
X	The entity uses a service organisation where the auditor intends to use a report provided by a service auditor of a service organisation either as audit evidence about the design and implementation of controls at the service organisation (i.e., a type 1 or type 2 report), or as audit evidence that controls at the service organisation are operating effectively (i.e. a type 2 report), as this would ordinarily not be applicable to an audit of a LCE.



Information Technology (IT)	
<ul style="list-style-type: none"> <li>The IT environment of the entity, including its IT applications and IT processes, is straightforward.</li> <li>The entity uses commercial software and does not have the ability to make any program changes other than to configure the software (e.g. the chart of accounts, reporting parameters or thresholds).</li> <li>Access to the software is generally limited to one or two designated individuals for the purpose of making the configurations.</li> <li>Few formalised general IT controls are needed in the entity's circumstances.</li> </ul>	
✓	The nature of the IT applications and the underlying IT infrastructure are simple, such as small, simple laptop or client server-based solution.
✓	The IT organisational structure is straightforward or uncomplicated, for example, the entity may not have dedicated IT resources but may have a person assigned in an administrator role for the purpose of granting employee access or installing vendor-provided updates.
✓	The volume and complexity of data in digital form being processed by the information system is low and the data is simple and able to be verified manually.
✓	Management may use system-generated reports in the processing of information but does not rely on these reports. Instead, management reconciles the reports back to the original documentation and verifies the calculations in the reports.
X	The IT organisational structure involves a dedicated IT department(s) that has/have structured processes, develop(s) and implement(s) program changes, manage(s) access rights and is/are supported by personnel that have software development and IT environment maintenance skills. Alternatively, the entity may use internal or external service providers to manage certain aspects of, or IT processes within, its IT environment to meet its IT needs as indicated by the nature and extent of its business activities and related transactions and events.
X	The entity has numerous IT systems and applications where information is passed from one IT system/application to another with complicated data interface.
X	The entity's IT environment includes highly customised or highly integrated IT applications, including financial reporting processes or IT applications that may be integrated with other applications (such as ERP systems).
X	There is a large volume of data, the data is based on complex legal or contractual terms or the data is stored in warehouses or housed with service providers (for example, third-party storage).
X	Management relies heavily on complex system-generated reports in their controls.

Application of the Financial Reporting Framework and Accounting Estimates	
<ul style="list-style-type: none"> <li>Few accounts or disclosures in the financial statements of the entity necessitate the use of significant management judgement in applying the requirements of the financial reporting framework.</li> <li>The entity's financial statements ordinarily do not include accounting estimates that involve the use of methods, models, assumptions, or data, that are complex.</li> </ul>	
<p>Accounting estimates vary widely in nature and are subject to varying degrees of estimation uncertainty, which is the susceptibility to a lack of precision in measurement.</p> <p>The financial statements of less complex entities ordinarily do not include accounting estimates that involve the use of methods or models, assumptions or data that are complex. Rather, the accounting estimates are often relatively straightforward and exhibit a lower degree of estimation uncertainty, complexity and subjectivity.</p> <p>However, the presence of one or a small number of accounting estimates with a higher degree of complexity may not be indicative of the complexity of the entity as a whole and therefore the word “ordinarily” is used in the description of the qualitative characteristic, to indicate that the focus is not on isolated or “one-off” occurrences of such accounting estimates.</p> <p>In addition, accounting estimates with greater complexity may arise during the course of the audit due to unexpected events, conditions or transactions (i.e. when new information come to the auditor's knowledge). By not focusing on isolated or “one-off” occurrences of such accounting estimates, there would be no need to “automatically” transition out of the standard during the engagement because of the complexity specific to the accounting estimate that arose during the course of the audit. However, the auditor would always need to consider if the entity is still a LCE and in certain scenarios the use of the standard would not be appropriate regardless of whether there is one or a small number of accounting estimates with a higher degree of complexity.</p> <p>When considering the complexity of accounting estimates in the determination of whether the standard is appropriate for use, using an auditor's expert with regard to an accounting estimate is not automatically a proxy for complexity. The nature and circumstances (inherent characteristics) of the underlying accounting estimate are what drives the auditor's determination of complexity, not necessarily the need for using an auditor's expert.</p>	
✓	Estimate has a limited number of assumptions for which it is relatively straightforward to obtain sufficient audit evidence and relevant information can be obtained. For example, where an allowance for doubtful accounts is based on applying estimated loss percentages (which can be supported by reference to actual loss experience) to respective accounts receivable aging categories.
✓	Fair value accounting estimates that use quoted prices in active markets for identical assets or liabilities. Such inputs are readily available and observable. For example, New Zealand equivalents to IFRS Accounting Standards ( <b>NZ IFRS</b> ) and Public Benefit Entity Standards ( <b>PBE Standards</b> ) refer to such inputs as Level 1 inputs; these provide the most reliable evidence of fair value.
✓ or X	Fair value accounting estimates that use inputs other than quoted prices and that are observable for the asset or liability, either directly or indirectly (for example, referred to as Level 2 inputs under NZ IFRS and PBE IPSAS) could involve varying levels of management judgement, estimation uncertainty and complexity. The specific circumstances, including whether characteristics such as those described in other examples below are present, would indicate whether it is appropriate for such an estimate to be associated with a LCE.

X	Fair value accounting estimates that use unobservable inputs to measure the fair value of the asset or liability. For example, inputs which an entity develops using the best information available in the circumstances (including the entity's own data) and that reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. NZ IFRS refer to such inputs as Level 3.
X	The accounting estimate(s) is known to be associated with complicated transactions, or with accounting entries that involve significant subjectivity in judgements, complex calculations, or complex modelling.
X	Financial instruments classified as complex under the applicable financial reporting frameworks that may distinguish accounting estimates based on the degree of complexity inherent in the recognition criteria, measurement basis, and related presentation and disclosure requirements.
X	The measurement basis required by the applicable financial reporting framework results in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them, or that use a long forecast period.
X	Complexity in the model, as reflected by the degree to which there may be a need to apply probability-based valuation concepts or techniques, or simulation techniques to predict uncertain future outcomes or hypothetical behaviours.
X	Difficulty in applying the method due to many valuation attributes with many interrelationships between them, the use of multiple data sets, data from multiple sources, multiple iterations of the calculation, or the calculation involves the application of sophisticated mathematical or statistical concepts.
X	The data used is inherently difficult to understand. For example, the data used requires an understanding of technically complex business or legal concepts, or complex contractual terms.



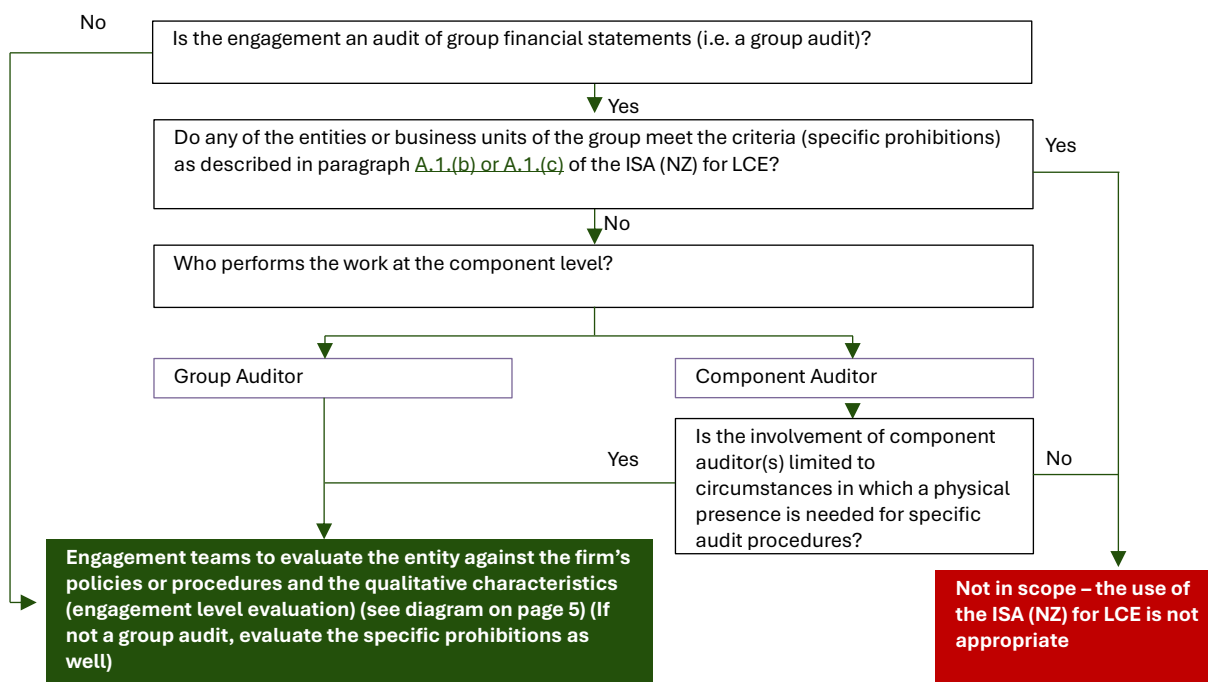
### **Reconsider the characteristics on recurring audits each audit period**

Just because an entity was considered to be an LCE in the last period it was audited does not mean that will be a LCE in the next. The auditor reconsiders whether the ISA (NZ) for LCE is appropriate on recurring audits for each engagement including whether the entity's characteristics have changed, or whether new indicators of complexity have emerged that would result in a determination that the standard is not appropriate for use.

## Guidance for group audits

The following diagram summarises the steps to take in deciding whether or not the ISA (NZ) for LCE would be appropriate to use in a group audit. Reference should also be made to the diagram on page 5.

The Essential Explanatory Material (EEM) below [paragraph A.1.\(d\)](#) of the standard provides further guidance on determining if an audit is a group audit. The terms group financial statements, component, and component auditor are defined in [Appendix 1, Glossary of Terms](#), of the standard and [Part 10](#) sets out the special considerations that apply to a group audit.



## The use of the ISA (NZ) for LCE is prohibited for some group audit engagements

### Specific prohibitions

Paragraph [A.1.\(d\)](#) of the standard explains that the standard shall not be used if the audit is a group audit and:

- (a) Any of the group's individual entities or business units meet the criteria in paragraph [A.1.\(b\)](#) or [A.1.\(c\)](#), or
- (b) 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 (for example, attending a physical stocktake, or inventory count, or physically inspecting assets or documents).

## What is a group auditor and what are their responsibilities?

The term "group auditor" is intended to have a consistent meaning across XRB standards, including the ISA (NZ) for LCE. When deciding on the appropriateness of using of the ISA (NZ) for LCE for a group audit, and when using the ISA (NZ) for LCE for a group audit, "group auditor" refers to the engagement partner who is responsible for the group audit and members of the engagement team other than component auditors. The group auditor is responsible for:

- (a) Setting the scope, timing and direction of the group audit (i.e. the overall group audit strategy and group audit plan)
- (b) Directing and supervising component auditors and reviewing their work
- (c) Evaluating the conclusions drawn from audit evidence obtained as the basis for forming an opinion on the group financial statements.



### When being onsite matters: the only time component auditors are permitted

Part A of the standard prohibits the use of the ISA (NZ) for LCE for group audits where component auditors are involved, except in limited circumstances.

Component auditors can only be used in a group audit using the ISA (NZ) for LCE when their physical presence is needed for a specific audit procedure. In all other cases, using component auditors under this standard is prohibited.

Examples of procedures where a physical presence may be required include attending a physical inventory count, physically inspecting assets or documents (for example, bonds, precious metals, machinery, vehicles, etc.), or observing the performance of internal controls.

Examples of when component auditors are involved in a group audit:

- The auditor has identified two components for the group audit. The audit involves two engagement teams, one for each component. Both engagement teams are under the direction and supervision of the engagement partner. The engagement team responsible for one of the components fulfils the responsibilities as group auditor. The other engagement team (i.e. component auditor) will perform audit work on the entire financial information of the other component under the direction, supervision and review of the group auditor. As the involvement of the component auditor is not limited to a specific audit procedure where a physical presence is needed, the ISA (NZ) for LCE *cannot* be used to conduct the group audit.
- The auditor has identified two components for the group audit and the group auditor will perform all procedures required at both the components. Therefore, there are no component auditors involved in the group audit and the ISA (NZ) for LCE *can* be used to conduct the group audit.
- The auditor has identified five components for the group audit and the group auditor will perform all procedures required at the component level. However, the group auditor has involved component auditors to observe the inventory counts for two of the components. As the involvement of the component auditors is limited to a specific audit procedure for the group audit where a physical presence is needed, the ISA (NZ) for LCE *can* be used to conduct the group audit.

## What are the group auditor's responsibilities when component auditors are used?

The group auditor is responsible for identifying, assessing and determining appropriate responses to the assessed risks of material misstatement, including determining the nature, timing and extent of the further audit procedures. For example, the group auditor determines the purpose of the procedure (i.e. test of controls or substantive procedure), the type of procedure (for example, inspection or observation), the period or date to which the audit evidence applies and the sample size, and communicates the instructions for the specific audit procedure to the component auditor and, if applicable, component management.

## Considering qualitative characteristics in the context of a group audit

For group audits, the following qualitative characteristics are to be considered in addition to those on pages 7-11:

Group Structure and Activities	
<ul style="list-style-type: none"><li>The group has few entities or business units (e.g. 5 or less).</li><li>Entities or business units within the group operate in jurisdictions with similar characteristics, for example laws or regulations and business practices.</li></ul>	
✓	The entity has two business units, one for manufacturing and one for delivering the products. However, management duties and oversight are performed by the same individual.
✓	The group consists of a few legal entities that are based in jurisdictions with different languages but have otherwise similar characteristics.
✗	The parent company is based in New Zealand and its wholly owned subsidiary is based in another jurisdiction where business practices differ.
✗	The group structure includes many levels of subsidiaries, entities under common control, and non-controlling interests.
Access to Information or People	
<ul style="list-style-type: none"><li>Group management will be able to provide the engagement team with access to information and unrestricted access to persons within the group as determined necessary by the group auditor.</li></ul>	
✓	The group has a non-controlling interest in an entity that is accounted for under the equity method. There are no restrictions for the group auditor to obtain information from management of the entity in which the non-controlling interest is held (i.e. group management can facilitate access to component management).
✗	Access to information or people at a component is restricted by component management, laws or regulations or other conditions, for example, war, civil unrest, or outbreaks of disease.
✗	The group has a non-controlling interest in an entity that is accounted for under the equity method and the group auditor's access to component management is restricted (i.e. group management cannot facilitate access to component management). There is publicly available information, such as audited financial statements of the entity in which the non-controlling interest is held.



Consolidation Process	
<ul style="list-style-type: none"> <li>• The group has a simple consolidation process. For example: <ul style="list-style-type: none"> <li>○ Intercompany or other consolidation adjustments are not complex;</li> <li>○ Financial information of all entities or business units has been prepared in accordance with similar accounting policies applied to the group financial statements; and</li> <li>○ All entities or business units have the same financial reporting period-end as that used for group financial reporting.</li> </ul> </li> </ul>	
✓	Intercompany transactions and balances can easily be identified when processing the consolidation adjustments.
✓	The differences between the accounting policies of the entities and business units and the group can easily be identified and harmonised.
X	The consolidation process requires adjustments and reclassifications to amounts reported in the group financial statements that do not pass through the usual IT applications and may not be subject to the same controls to which other financial information is subject.