Proposed Amendments to IAPS 1005 – Issues Paper Based on Comments Received

**Issue 1: Should IAPS 1005 be Withdrawn?**

1. The explanatory memorandum to the exposure draft noted the IAASB’s decision to limit the scope of the revision of the IAPS to ISAs issued between March 1999 and March 2003 and to withdraw the IAPS over time, i.e. as small entity audit considerations are included in new and revised ISAs.

2. One respondent felt strongly that the IAPS should be withdrawn. The respondent referred to the electronic publication of IAASB pronouncements and recommended a holistic update of ISAs rather than a piecemeal update. Another respondent assumed that the IAPS will be withdrawn when the proposed Audit Risk Standards are issued.

3. One respondent recommended that the IAPS should not be updated, but that the introduction thereto should explain that it has not been updated since March 1999 and should be referred to for information purposes only. In addition, it was recommended that the IAASB accelerates, as much as feasible, the implementation of its decision to include small entity audit considerations in the body of ISAs.

4. Four respondents were of the opinion that the IAPS should not be eliminated over time, and one of the four respondents recommended a full review of the IAPS. This respondent noted that, as ISAs are written primarily with the audit of larger entities in mind, the IAPS is important to small practitioners. Should ISAs be introduced in Europe in 2005, practitioners will need to familiarize themselves with ISAs. This may represent a considerable step for some small practitioners, who may not have the resources available to make the necessary adaptations. Furthermore, several of the ISAs issued since March 1999 for which the IAPS has been updated are themselves in the process of being revised. This means the IAPS will shortly become out of date and small practitioners will need to consult different sources.

5. Eight respondents supported the IAASB’s decision to withdraw the IAPS over time. However, most of the eight respondents, and other respondents who did not specifically comment on the IAASB’s decision, recommended the development of transitional arrangements. See Issue 2 below.

6. FEE commented that it did not believe that the fundamental issue is whether additional guidance for auditors of smaller entities appears within an ISA or in a separate practice statement. The fundamental issue is that such additional guidance should be kept to a minimum through the IAASB adopting a “think small first” approach that may be characterized as follows:

   - Bold type ISA requirements should be drafted in terms of all audits regardless of the size and complexity of the audited entity or the size of the audit team,
   - Grey type ISA guidance should first cover circumstances that apply to all audited entities and audit teams, and
Additional grey type ISA guidance should contain specific references to the circumstances in which it is applicable, for example, when dispersed operations call for formalization of the audited entity’s processes or when the size of the audit team calls for more formal communications and meetings.

According to FEE, such an approach reinforces the idea that “an audit is an audit” and helps ensure that the introduction of ISAs in the EU will not result in excessive costs, particularly amongst smaller entities and their auditors. FEE encourages the IAASB to guard against an alternative approach, which may be characterized as framing bold type ISA requirements and grey type guidance in terms of large and complex audited entities and large audit teams and then providing guidance for auditors of smaller entities which explains how elements of ISAs may be disregarded or interpreted when auditing smaller entities. Such an approach not only undermines the idea that an “audit is an audit” but it also has the unreasonable effect of requiring auditors of smaller entities to have regard to more material than auditors of large and complex entities.

7. IAASB Staff is of the opinion that the IAASB’s decision provides the best solution in the current circumstances. Due to the very full agenda of the IAASB, which focuses on the 2005 adoption of ISAs in the EU, the IAASB will not be able to follow a holistic approach of updating all ISAs for small entity audit considerations. Also, revising ISAs for small entity audit considerations may lead to comments that fall outside the scope of the revision. Furthermore, IAASB Staff is of the opinion that the IAASB’s decision to incorporate small entity audit consideration in ISAs supports the fact that “an audit is an audit” (see FEE’s comment above). Auditors conducting audits of small entities need to be familiar with all the requirements of the ISAs – they cannot rely solely on an IAPS to highlight the relevant considerations.

8. As a result, IAASB Staff proposes the following:

(a) The IAASB’s decision to update the IAPS for ISAs issued between March 1999 and March 2003 and to withdraw the IAPS over time should be implemented.

(b) The following text should be inserted in a shaded box preceding the Introduction section:

“In September 2002 the International Auditing and Assurance Standards Board (IAASB) agreed that this International Auditing Practice Statement (IAPS) should be revised to take account of International Standards on Auditing (ISAs) issued between March 1999 and March 2003, and that for ISAs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities should be included in the body of those ISAs.

Guidance contained in this IAPS will be withdrawn as related ISAs are revised, and the IAPS will be eliminated over time.

Accordingly, readers are cautioned that the guidance in this IAPS is not complete. Reference should be made to the special considerations in the audit of small entities included in ISAs issued subsequent to March 2003.”

(c) Paragraph 2 of the IAPS should be amended as follows:
Proposed Amendments to IAPS 1005

“The objective of this IAPS is to describe the characteristics commonly found in small entities and indicate how they may affect the application of ISAs. This IAPS includes:

(a) Discussion of the characteristics of small entities; and
(b) Guidance on the application of ISAs issued until March 2003 to the audit of small entities.”

(d) The transitional arrangements proposed below should be implemented. (See Issue 2.)

(e) To support the small entity audit considerations included in ISAs issued subsequent to March 2003, consideration should be given to including the definition of a small entity, and the approach taken in ISAs with regard to small entity audit considerations, in the Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services.

The definition should be the same as the definition in the IAPS. This will enable the IAASB to amend the Preface without having to expose it for public comment, as the amendment will merely be a duplication of text in an existing pronouncement in order to conform to a decision of the IAASB.

The following wording is proposed for inclusion as a separate section in the Preface:

“Special Considerations in the Audit of Small Entities

ISAs apply to the audit of financial statements of any entity, irrespective of its size, its legal form, ownership or management structure, or the nature of its activities. The IAASB recognizes that small entities give rise to a number of special audit considerations. Where considered necessary by the IAASB, ISAs issued after March 2003 contain special considerations in the audit of small entities. For ISAs issued before March 2003, reference should be made to IAPS 1005, “The Special Considerations in the Audit of Small Entities.”

The meaning of “small entity” gives consideration not only to the size of an entity but also to its typical qualitative characteristics. Quantitative indicators of the size of an entity may include balance sheet totals, revenue and the number of employees, but such indicators are not definitive. Therefore it is not possible to give an adequate definition of a small entity solely in quantitative terms. For purposes of the ISAs, a small entity is any entity in which:

(a) There is concentration of ownership and management in a small number of individuals (often a single individual); and

(b) One or more of the following are also found:
   (i) Few sources of income;
   (ii) Unsophisticated record-keeping;
   (iii) Limited internal controls together with the potential for management override of controls.
The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purpose of the ISAs, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

1. The word “individual” denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a “small entity” for the purpose of the ISAs if the owner exhibits the relevant characteristics.”

- **Is the IAASB still of the opinion that its initial decision to limit the revision of the IAPS, and to withdraw the IAPS over time, provides the best solution under the circumstances?**
- **Does the IAASB agree with the additional text, which explains the fact that the IAPS provides guidance on ISAs issued until March 2003?**
- **Does the IAASB agree that the Preface should be amended to include a definition of a small entity and to describe the approach taken in the ISAs with regard to small entity audit considerations?**
- **Does the IAASB agree with the proposed wording to be included in the Preface?**

**Issue 2: Transitional Arrangements**

9. Many respondents recommended that the IAASB should consider the development of transitional arrangements to ensure that auditors of small entities are aware that reference should be made to the IAPS for small entity audit considerations relating to ISAs issued until March 2003 and to the relevant ISA for ISAs issued subsequent to March 2003.

10. IAASB Staff proposes the following:

   (a) The exposure drafts of proposed revised ISAs should contain a conforming change that indicates the withdrawal of the relevant paragraph(s) in the IAPS and explains that the small entity audit considerations are covered in the ISA.

   (b) The electronic version of the IAPS (available from the IFAC website) should be updated whenever a revised ISA is issued. This can be done in one of two ways: The IAPS, under the heading of the relevant ISA, could refer the reader to the relevant revised ISA; or the outdated guidance in the ISA could be deleted with no reference to the revised ISA. IAASB Staff prefers the first-mentioned approach.

11. Two respondents recommended the use of a “roadmap,” which could be included as an appendix to the IAPS. The “roadmap” could identify which ISAs are addressed in the IAPS and which ISAs include small entity audit considerations in the body of the text. IAASB Staff is of the opinion that the proposal in paragraph 10 will achieve the objective, and that it is unnecessary to develop a “roadmap.”

- **Does the IAASB agree with the proposal that the exposure drafts of proposed revised ISAs should contain a conforming change that indicates the withdrawal of the relevant text in the IAPS?**
• Does the IAASB agree that the IAPS should be updated to indicate that the small entity audit considerations relating to a revised ISA issued subsequent to March 2003 are covered in the revised ISA?

Issue 3: Should the Section on Provision of Other Services to Small Entity Audit Clients (Paragraphs 104 to 113) be Deleted?

12. Five respondents were of the opinion that the guidance in paragraphs 104 to 113, which was based on the revised Section 8 of the IFAC Code of Ethics for Professional Accountants, should be deleted. Comments included the following:

(a) Section 8 is a substantial part of the Code and was written to be applicable to all sizes of entity. There is a considerable danger in IAASB trying to interpret this material in the IAPS.

(b) The IAPS is produced by the IAASB to help auditors apply ISAs for which the IAASB is responsible. It is inappropriate for the IAASB to take on a wider interpretative role in relation to the Code.

(c) There is a danger that auditors of small entities will overlook the full requirements of the Code that are relevant to them if they are presented as an abstract in the IAPS.

13. The IFAC Ethics Committee, at its September 8-9, 2003 meeting, noted strong reservations with regard to the IAASB interpreting the Code. The comment was made in the light of the proposed Quality Control Standards.

14. IAASB Staff proposes the following:

(a) Paragraphs 104 to 113, as well as the appendix containing paragraphs 95 to 101 of IAPS 1005 Revised and Issued in March 1999, should be deleted for the reasons set out above.

(b) Paragraphs 115 to 132 provide relevant and important guidance to auditors who also prepare the accounting records and financial statements of small entities and should be retained. However, as stated in paragraph 114, the guidance only applies when auditors are legally and professionally permitted to prepare accounting records and financial statements for their small entity audit clients. Due to its limited application, paragraphs 114 to 132 should be included in an appendix to the IAPS.

(c) Paragraph 3 of the IAPS should read as follows:

“The owner-manager of a small entity often needs assistance with the preparation of accounting records and financial statements. Section 8 of the IFAC Code of Ethics for Professional Accountants (the Code) deals with independence, and auditors considering rendering other services to small entity audit clients refer to the Code and their national independence requirements. The appendix to this IAPS contains a commentary on the application of ISAs when auditors also prepare the accounting records and financial statements of small entity audit clients.”

(d) When all the guidance in the IAPS has been included in revised ISAs and the IAPS is finally withdrawn, the appendix should be included in a document that falls under
the “other papers published by the IAASB” category (see paragraph 21 of the Preface). This document should not be included in the Handbook of International Auditing, Assurance, and Ethics Pronouncements, but should be available from the IFAC website. IAASB Staff should review the document periodically and consider whether it should be amended for ISAs issued after March 2003. (It could be argued that the proposed approach could be implemented as part of this revision; however, that will cause those interested in small entity audit considerations to have to refer to three documents, i.e. the IAPS, ISAs issued after March 2003 and the “other paper.”)

- Does the IAASB agree with the proposal to delete paragraphs 104 to 113, as well as the appendix that was included in the exposure draft?
- Does the IAASB agree with the proposal to include paragraphs 114 to 132 in a new appendix to the IAPS?
- Does the IAASB have any additional recommendations with regard to the proposed future positioning of the guidance?

**Issue 4: Specific Comments That Need Further Consideration**

**Management Representation Letters**

15. In updating the IAPS the IAASB identified the ISA 240 and ISA 545 requirements to obtain certain specific management representations as an area of special consideration in the audit of small entities. Related guidance is included in paragraphs 22, 37, 38, 82 and 98a of the IAPS.

16. Paragraphs 37 and 38 (dealing with the ISA 240 requirements) and paragraph 82 (dealing with the ISA 545 requirements) state that “if the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor considers the impact thereof on the auditor’s report.”

17. Three respondents were of the opinion that this was not an area of special consideration, while two respondents were of the opinion that the guidance goes beyond the requirements of the ISAs. Reference was made to ISA 580.15, which states that failure to provide a representation constitutes a scope limitation if the auditor considers that representation to be necessary.

18. With regard to paragraph 82, one respondent referred to ISA 580.15, questioning whether there are circumstances, such as in the case of a dormant company, when the specific representation may not be necessary.

19. ISA 240 (revised) and ISA 545 were issued subsequent to ISA 580. ISA 240 and ISA 545 do not provide for the auditor to consider whether to obtain such representations, but require the auditor to obtain the specific representations. As a result, these representations are considered necessary and should be obtained.

20. One respondent also questioned why the exposure draft did not include guidance on ISA 240.51(b) and (c), dealing with management’s believe that the aggregation of uncorrected misstatements is immaterial (ISA 240.51(a)), and the fact that management has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management (ISA 240.51(b)). These were not identified as special considerations in the audit
of small entities, as the auditor prepares the list of uncorrected misstatements for consideration by management, and management does not need formal accounting and internal systems, or to perform a risk assessment, to be able to disclose known frauds or suspected frauds to the auditor.

21. One respondent commented that in some cases the fact that a management representation was not obtained may have little or no impact on the auditor’s report and that a reference to “potential impact” would be less controversial.

22. IAASB Staff proposes that the guidance as per the exposure draft should be retained, but that it is amended as follows:

“If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor considers the potential impact thereof on the auditor’s report.”

- Does the IAASB agree with the proposed guidance when management refuses to provide a specific representation?

GOING CONCERN

23. The exposure draft proposed limited terminology amendments to paragraphs 92 to 95, as the IAASB agreed that ISA 560 (revised) did not necessitated small entity audit considerations in addition to those already reflected in the IAPS.

24. One respondent indicated that the IAPS does not deal adequately with small entity audit considerations in the following areas:

(a) Management’s assessment of the entity’s ability to continue as a going concern, as such assessment will not be made in many cases.

(b) The period used by management in performing the assessment. In many cases, the financial statements will be prepared, and the assessment will be performed almost a year after the balance sheet date. Management’s assessment (12 months from the balance sheet date) will therefore consist of a very short period.

25. As similar concepts were covered in the original ISA 570 and the IAPC at the time did not consider it necessary to cover it in the IAPS, IAASB Staff is of the opinion that the comment falls outside the scope of the revision and should not be processed.

- Does the IAASB agree with the proposal not to expand the guidance with regard to going concern?

Issue 4: Comments Falling Outside the Scope of the Revision

26. The explanatory memorandum made it clear that comments should be limited to the appropriateness and completeness of the proposed amendments, which were based on ISAs issued between March 1999 and March 2003, and that comments falling outside the scope of
the revision will not be considered. A number of such comments were received and were not considered in preparing the proposed final amendments for consideration by the IAASB.

27. IAASB Staff proposes that these comments should be placed on the dossier kept for each ISA and considered by IAASB Staff when ISAs are revised and small entity audit considerations are included in the revised ISAs.

- **Does the IAASB agree with the fact that comments falling outside the scope of the revision were not considered?**