INTERNATIONAL AUDITING PRACTICE STATEMENT 1005

THE SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES

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Appendix: Commentary on the Application of ISAs When the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity

This International Auditing Practice Statement (IAPS) has been prepared by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). It was approved by the IAPC in March 1999 for publication in March 1999. The IAPS was revised by the International Auditing and Assurance Standards Board (IAASB) in March 2003 to reflect revised and new International Standards on Auditing (ISAs) issued between March 1999 and March 2003.

The purpose of this IAPS is to provide practical assistance to auditors in applying ISAs in the audit of financial statements of small entities. It does not affect the basic principles and essential procedures of ISAs. Practice Statements are effective when issued.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an IAPS. Where no PSP is added, the IAPS is applicable in all material respects to the public sector.

The text will be revised once proposed revisions to the content of the box, based on the new Preface, have been finalized.

See footnote 1.
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Guidance contained in this IAPS will be withdrawn as related ISAs are revised, and the IAPS will be eliminated over time.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.

Introduction

1. International Standards on Auditing (ISAs) contain basic principles and essential procedures together with related guidance that apply to the audit of the 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. This International Auditing Practice Statement (IAPS) does not establish any new requirements for the audit of small entities; nor does it establish any exemptions from the requirements of ISAs. All audits of small entities are to be conducted in accordance with ISAs.

2. 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.

3. 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 are to 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.

4. In determining the nature and extent of the guidance provided in this IAPS, the IAASB has aimed to provide a level of guidance that will be of general applicability to all audits of small entities and that will assist the auditor in exercising professional judgment with respect to the application of ISAs. However, detailed guidance of a procedural nature has not been provided, as the issue of such guidance may undermine the proper exercise of professional judgment in auditing.

The Characteristics of Small Entities

5. The auditor of any entity adapts the audit approach to the circumstances of the entity and the engagement. The audit of a small entity differs from the audit of a large entity as documentation may be unsophisticated, and audits of small entities are ordinarily less complex and may be performed using fewer assistants.

6. The meaning of “small entity” in this context 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 sheets totals, revenue and the number of employees, but such

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3 The original IAPS was prepared and issued by the International Auditing Practices Committee (IAPC). Effective April 1, 2002, the IAPC was replaced by the IAASB, and the IAASB adopted the pronouncements issued by the IAPC.
Proposed Amendments to IAPS 1005

indicators are not definitive. Therefore it is not possible to give an adequate definition of a small entity solely in quantitative terms.

7. For the purposes of this IAPS, 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 individual4); and

(b) One or more of the following are also found:

• Few sources of income;

• UnSophisticated record-keeping;

• Limited internal controls together with the potential for management override of controls.

8. 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 purposes of this IAPS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

Concentration of Ownership and Management

9. Small business entities ordinarily have few owners; often there is a single proprietor. The owner may employ a manager to run the entity but is in most cases directly involved in running the entity on a day-to-day basis. Likewise, in the case of small not-for-profit organizations and public sector entities, although there are often several individuals charged with formal responsibility for the entity, there may be few people involved in managing the entity on a day-to-day basis.

10. This IAPS uses the term “owner-manager” to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis. Where proprietors are not involved on a day-to-day basis, the term “owner-manager” is used to refer to both the proprietors, and to any managers hired to run the entity.

Few Sources of Income

11. Small entities often have a limited range of products or services and operate from a single or limited number of locations. Such characteristics may make it easier for the auditor to acquire, record, and maintain knowledge of the entity than would be the case with a larger entity. The application of a wide range of audit procedures may be straightforward in such circumstances. For example, effective predictive models for use in analytical procedures can sometimes be constructed. Analytical procedures may provide useful evidence, sometimes reducing the need for other substantive procedures. In addition, in many small entities, accounting populations are often small and easily analyzed.

UnSophisticated Record-keeping

12. Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:

(a) All the transactions and other accounting information that should have been recorded have in fact been recorded;

(b) Assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and

(c) Fraud or error in processing accounting information will be detected.

4 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 this IAPS if the owner exhibits the relevant characteristics.
13. Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated or poor, which results in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.

14. Small entities often find it convenient to use branded accounting software packages designed for use on a personal computer. Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

**Limited Internal Controls**

15. Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor desirable, the fact that there are few employees limits the extent to which segregation of duties is practicable. However, for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. Supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.

16. The owner-manager occupies a dominant position in a small entity. The owner-manager’s direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small entities. The exercise of this control can also compensate for otherwise weak internal control procedures. For example, in cases where there is limited segregation of duties in the area of purchasing and cash disbursements, internal control is improved when the owner-manager personally signs all checks. When the owner manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

17. While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager’s dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial statements. For example, the owner-manager may direct personnel to make disbursements that they would otherwise not make in the absence of supporting documentation.

18. The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

**Commentary on the Application of International Standards on Auditing**

19. The commentary that follows provides guidance on the application of ISAs to the audit of a small entity. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant ISA and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of ISAs, the auditor refers to the ISA concerned. Where an ISA is, in principle, applicable to the audit of the financial statements of small entities and there are no special considerations applicable to the audit of a small entity, no guidance is given in respect of that ISA.

**ISA 210: Terms of Audit Engagements**

20. In many cases, owner-managers of small entities are not fully aware of their own responsibilities or those of their auditors. In particular, owner-managers may not appreciate that the financial statements are their responsibility, particularly where the owner-manager has outsourced the preparation of the financial statements.
21. One of the purposes of an engagement letter is to communicate clearly the respective responsibilities of the owner-manager and the auditor. The Appendix to ISA 210 provides an example of an audit engagement letter.

22. Paragraph 7 of ISA 210 states that the auditor may wish to include in the engagement letter the auditor’s expectation of receiving written confirmation concerning representations made in connection with the audit. ISA 580, “Management Representations” requires the auditor to obtain evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements. Other ISAs require certain specific representations. Because of limited or more informal accounting and internal control systems, owner-managers may be reluctant to provide the necessary representations. The auditor may consider including in the engagement letter the types of management representation to be obtained. This provides an opportunity for the auditor to discuss with the owner-manager at the outset of the engagement the reasons for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained, which may help to avoid a problem arising as the audit is nearing completion. It will also help the auditor consider audit and reporting implications if the owner-manager cannot make or refuse to make the necessary representations.

23. In some cases the auditor may determine that it will not be possible to obtain sufficient evidence to form an opinion on the financial statements because of weaknesses that may arise from the characteristics of the small entity. In these circumstances, and where permitted by the relevant jurisdiction, the auditor may decide not to accept the engagement, or to withdraw from the engagement after acceptance. Alternatively, the auditor may decide to continue with the engagement but qualify or disclaim the audit opinion. The auditor has regard to paragraph 41 of ISA 700 “The Auditor’s Report on Financial Statements” which states that the auditor would not ordinarily accept an audit engagement in which the terms of the engagement are such that the auditor believes that the need to express a disclaimer of opinion exists.

**ISA 220: Quality Control for Audit Work**

24. The primary objective of quality control is to provide assurance that audits are conducted in accordance with generally accepted auditing standards. The auditor of a small entity keeps this objective in mind when determining the nature, timing, and extent of the policies and procedures appropriate to the circumstances.

25. Paragraph 5 of ISA 220 states: “The nature, timing and extent of an audit firm’s quality control policies and procedures depend on a number of factors such as the size and nature of the practice…” Many audits of small entities are undertaken by small audit firms. Such firms, in determining appropriate policies and procedures, consider the areas listed in paragraph 6 of ISA 220 which are:
   (a) Professional requirements;
   (b) Skills and competence;
   (c) Assignment;
   (d) Delegation;
   (e) Consultation;
   (f) Acceptance and retention of clients; and
   (g) Monitoring.

26. With the possible exception of “assignment” and “delegation” (which may not be relevant to sole practitioners with no assistants), each of these will ordinarily be reflected in the arrangements established by firms auditing small entities.

27. The requirements of ISA 220 relating to quality control on individual audits are mostly relevant to engagements where some of the work is delegated to one or more assistants. Many small entity audits are carried out entirely by the audit engagement partner (who may
be a sole practitioner). In such situations, questions of direction and supervision of assistants and review of their work do not arise as the audit engagement partner, having personally conducted all significant aspects of the work, is aware of all material issues.

28. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with ISAs. Developing or obtaining a suitably designed form of audit completion checklist may provide a useful tool for testing the completeness and adequacy of the process followed in an audit. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performed the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor’s professional body, on a confidential basis.

**ISA 230: Documentation**

29. The auditor may have an in-depth understanding of the entity and its business, because of the close relationship between the auditor and the owner-manager, the size of the entity being audited, or the size of the audit team and the audit firm. However, that understanding does not eliminate the need for the auditor to maintain adequate working papers. Working papers assist in the planning, performance, supervision and review of the audit, and they record the evidence obtained to support the audit opinion.

30. The discipline imposed by the requirement to record the reasoning and conclusions on significant matters requiring the exercise of judgment can often, in practice, add to the clarity of the auditor’s understanding of the issues in question and enhance the quality of the conclusions. This is so for all audits, even in the case of a sole practitioner with no assistants.

31. Different techniques may be used to document the entity’s accounting and internal control systems, depending on their complexity. However in small entities the use of flowcharts or narrative descriptions of the system are often the most efficient techniques. These can be kept as permanent information and are reviewed and updated as necessary in subsequent years.

32. Paragraph 11 of ISA 230 provides examples of the contents of working papers. These examples are not intended to be used as a checklist of matters to be included in all cases. The auditor of a small entity uses judgment in determining the contents of working papers in any particular case.

33. Nevertheless, the auditor of a large or a small entity, records in the working papers:
   (a) The audit planning;
   (b) An audit program setting out the nature, timing, and extent of the audit procedures performed;
   (c) The results of those procedures; and
   (d) The conclusions drawn from the audit evidence obtained together with the reasoning and conclusions on all significant matters requiring the exercise of judgment.

**ISA 240: The Auditor’s Consideration of Fraud and Error in an Audit of Financial Statements**

34. Appendix 1 to ISA 240 contains examples of fraud risk factors. An example relevant to small entities is “management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.” Although the presence of a dominant owner-manager is an important factor in the overall control environment, as the need for management authorization can compensate for otherwise weak control procedures and reduce the risk of employee fraud and error, it can be a potential weakness since there is the opportunity for management override of controls. The owner-manager’s attitude to control issues in general and to the personal exercise of supervisory controls can have a significant influence on the auditor’s approach. The auditor’s assessment of the effect of such matters is conditioned by knowledge of that
particular entity and the integrity of its owner-manager. Examples of matters that auditors take into account in this assessment include the following:

- Whether the owner-manager has a specific identifiable motive (for example, dependence of the owner-manager on the success of the entity) to distort the financial statements, combined with the opportunity to do so.
- Whether the owner-manager makes no distinction between personal and business transactions.
- Whether the owner-manager’s life-style is materially inconsistent with the level of his or her remuneration (this includes other sources of income of which the auditor may be aware by completing the owner-manager’s tax return, for example).
- Frequent changes of professional advisers.
- Whether the start date for the audit has been repeatedly delayed or there are unexplained demands to complete the audit in an unreasonably short period of time.
- Unusual transactions around the year-end that have a material effect on profit.
- Unusual related party transactions.
- Payments of fees or commissions to agents and consultants that appear excessive.
- Loan accounts, which are not serviced properly and for which the owner-manager is unable to provide any satisfactory explanation.
- Advances given to or taken from third parties for supply of goods and services against which no goods or services have been provided for an unreasonably long period.
- Disputes with tax authorities.
- Unusual delay in providing explanations or representations sought by the auditor for unusual transactions.

35. Paragraph 20 of ISA 240 requires the auditor, when planning the audit, to discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error. Many small entity audits are carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations this requirement is not relevant, but the audit engagement partner, who will be planning the conduct of the audit personally, considers whether, and where, errors may be more likely to occur or how fraud might be perpetrated when assessing the risks of material misstatement and designing further audit procedures to respond to those risks.

36. Paragraph 22 of ISA 240 requires the auditor, when planning the audit, to make inquiries of management to obtain:

(a) An understanding of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud, and the accounting and internal control systems management has put in place to address such risk; and

(b) Knowledge of management’s understanding regarding the accounting and internal control systems in place to prevent or detect error.

In small entities the owner-manager’s assessment may be less formal and less frequent, or the owner-manager may not conduct an assessment at all. Also, as noted in paragraphs 12 to 18 of this IAPS, limited or more informal accounting and internal control systems may exist. Nevertheless, the auditor still makes the inquiries, as they provide a basis for obtaining an understanding of the actions the owner-manager has taken to prevent and detect fraud and error, and are also important in obtaining an understanding of the owner-manager’s attitude towards fraud and error.

37. Paragraph 51(a) of ISA 240 requires the auditor to obtain written representation from management that it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error. As noted in paragraph 12 to 18 of this IAPS, limited or more informal accounting
and internal control systems may exist. As a result, the owner-manager may be reluctant to provide the required representation. The primary responsibility for the prevention and detection of fraud and error rests with management, irrespective of the size of the entity. It therefore is important to obtain the owner-manager’s acknowledgement of this responsibility. Such acknowledgement could be expanded to cover compensating controls (refer paragraph 16 of this IAPS). 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.

38. Paragraph 51(d) of ISA 240 requires the auditor to obtain written representations from management that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud. As noted in paragraph 36 of this IAPS, the owner-manager of a small entity may not have conducted such assessment and therefore may be reluctant to provide the required representation. The auditor requests the owner-manager to reflect in the written representation that such assessment was not conducted, as well as any actions that the owner-manager has taken to prevent or detect fraud and error. 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.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

39. ISA 250 requires the auditor to obtain a general understanding of the legal and regulatory framework to which the entity is subject. Apart from those laws and regulations that relate directly to the preparation of the financial statements, there may also be laws and regulations that provide a legal framework for the conduct of the entity and that are central to the entity’s ability to conduct its business. As most small entities have uncomplicated activities, the legal and regulatory environment to which they are subject is less complicated than the environment in which larger more diversified entities operate.

40. Once the auditor of a small entity has identified any relevant industry-specific laws and regulations, this information is recorded as permanent information as part of the knowledge of the entity and is reviewed and updated as necessary in subsequent years.

ISA 260: Communications of Audit Matters With Those Charged With Governance

41. Paragraph 5 of ISA 260 requires the auditor to determine the relevant individuals who are charged with governance and with whom audit matters of governance interest are communicated. The governance structure in a small entity may not be well defined, or those charged with governance of the small entity may be the same individuals as those charged with management of the entity. It may also include spouses or other relatives, who may not be involved in the supervision or control of the entity on a day-to-day basis. The auditor determines who are entrusted with the supervision, control and direction of the small entity.

ISA 300: Planning

42. Audits of small entities are conducted by very small audit teams, many involve the audit engagement partner (or sole practitioner) working with one audit assistant (or without audit assistants). With a smaller team, co-ordination and communication between team members is easier. Planning the audit of a small entity need not be a complex or time-consuming exercise, it varies according to the size of the entity and the complexity of the audit. For example, on some small audits, planning may be carried out at a meeting with the owner-manager of the entity or when the entity’s records become available to the auditor for audit. Planning the audit can, however, start at the completion of the previous period’s audit as the auditor will be well placed to plan for the next period. A brief file note prepared at this time, based on a review of the working papers and highlighting issues identified in the audit just completed can be particularly helpful. This file note, amended for changes arising during the subsequent period, could then be the initial basis for planning the next audit. Discussion with the owner-manager is a very important part of planning, especially in a first-year audit. Such discussions do not need a special meeting they can often take place as a part of other meetings, conversations or correspondence.
43. In principle, planning comprises developing a general strategy (reflected in an overall audit plan) and a detailed approach for implementing the strategy in terms of the nature, timing and extent of the audit work (reflected in an audit program). However, a practical approach to the audit of a small entity need not involve excessive documentation. In the case of a small entity where, because of the size or nature of the entity, the details of the overall plan can be adequately documented in the audit program, or vice versa, separate documentation of each may not be necessary. When standard audit programs are used, these are appropriately modified and tailored to the particular client circumstances.

ISA 310: Knowledge of the Business
Paragraphs 44 to 46 have been withdrawn. ISA 200, “Objectives and General Principles Governing an Audit of Financial Statements” and ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” issued in … contain special considerations in the audit of small entities.

ISA 320: Audit Materiality
47. “Materiality” is defined in the International Accounting Standards Board’s “Framework for the Preparation and Presentation of Financial Statements” as follows: “Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.”

Planning Stage
48. For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgment about materiality is to focus the auditor’s attention on the more significant financial statement items while determining the audit strategy. As there are no authoritative pronouncements on how materiality is assessed in quantitative terms, the auditor in each case applies professional judgment in the light of the circumstances. One approach to the assessment of quantitative materiality is to use a percentage of a key figure in the financial statements such as one of the following:

- Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure such as the owner-manager’s remuneration).
- Revenue.
- Balance sheet total.

49. Often in the case of small entities, draft financial statements are not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year’s trial balance may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgment of materiality is to calculate materiality on the previous year’s audited financial statements as amended for known circumstances in relation to the year subject to audit.

50. Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method to, for example, revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to considering materiality at the overall financial statement level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.
Assessment of Materiality when Evaluating the Results of Audit Procedures

51. Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial statements, incorporating all agreed adjustments and information obtained during the course of the audit.

52. Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgment. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.

53. In addition, although planning may have been based on a quantitative assessment of materiality, the auditor’s opinion will take into account not only the amount but also the qualitative nature of unadjusted misstatements within the financial statements.

ISA 400: Risk Assessments and Internal Control

Paragraphs 54 to 60 have been withdrawn. ISA 200, “Objectives and General Principles Governing an Audit of Financial Statements,” ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” and ISA XX, “Auditor’s Procedures in Response to Assessed Risks” issued in … contain special considerations in the audit of small entities.

ISA 401: Auditing in a Computer Information Systems Environment

Paragraphs 61-65 have been withdrawn. ISA XX, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and ISA XX, “Auditor’s Procedures in Response to Assessed Risks” issued in … contain special considerations in the audit of small entities.

ISA 500: Audit Evidence

Paragraphs 66 to 70 have been withdrawn. ISA XX, “Auditor’s Procedures in Response to Assessed Risks” and ISA XX, “Audit Evidence” issued in … contain special considerations in the audit of small entities.

ISA 520: Analytical Procedures

Analytical Procedures in Planning the Audit

71. The auditor applies analytical procedures at the planning stage of the audit. The nature and extent of analytical procedures at the planning stage of the audit of a small entity may be limited by the timeliness of processing of transactions by the small entity and the lack of reliable financial information at that point in time. Small entities may not have interim or monthly financial information that can be used in analytical procedures at the planning stage. The auditor may, as an alternative, conduct a brief review of the general ledger or such other accounting records as may be readily available. In many cases, there may be no documented information that can be used for this purpose, and the auditor may obtain the required information through discussion with the owner-manager.

Analytical Procedures as Substantive Procedures

72. Analytical procedures can often be a cost-effective means of obtaining evidence required by the auditor. The auditor assesses the controls over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

73. An unsophisticated predictive model can sometimes be effective. For example, where a small entity has employed a known number of staff at fixed rates of pay throughout the period, it will ordinarily be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit
margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items. The extent of analytical procedures in the audit of a small entity may be limited because of the non-availability of information on which the analytical procedures are based.

74. Predictive analytical procedures can often be an effective means of testing for completeness, provided the results can be predicted with a reasonable degree of precision and confidence. Variations from expected results may indicate possible omissions that have not been detected by other substantive tests.

75. However, different types of analytical procedure provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can be a very persuasive source of evidence and may eliminate the need for further verification by means of tests of details. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may be a less persuasive source of evidence, but may provide useful corroboration if used in combination with other audit procedures.

Analytical Procedures as Part of the Overall Review

76. The analytical procedures ordinarily performed at this stage of the audit are very similar to those that would be used at the planning stage of the audit. These include the following:

• Comparing the financial statements for the current year to those of previous years.
• Comparing the financial statements to any budgets, forecasts, or management expectations.
• Reviewing trends in any important financial statement ratios.
• Considering whether the financial statements adequately reflect any changes in the entity of which the auditor is aware.
• Inquiring into unexplained or unexpected features of the financial statements.

ISA 530: Audit Sampling and Other Selective Testing Procedures

77. There are a variety of methods of selecting items for testing, the auditor’s choice of an appropriate method will be guided by considerations of effectiveness and efficiency. The means available to the auditor are:

(a) Selecting all items (100% examination);
(b) Selecting specific items; or
(c) Audit sampling.

78. The small populations ordinarily encountered in small entities may make it feasible to test:

(a) 100% of the population; or
(b) 100% of some part of the population, for example, all items above a given amount, applying analytical procedures to the balance of the population, if it is material.

79. When the above methods of obtaining audit evidence are not adopted, the auditor considers the use of procedures involving audit sampling. When the auditor decides to use audit sampling, the same underlying principles apply in both large and small entities. The auditor selects sample items in such a way that the sample can be expected to be representative of the population.

ISA 545: Auditing Fair Value Measurements and Disclosures

1. 80. In accordance with paragraph 4 of ISA 545, management is responsible for making the fair value measurements and disclosures included in the financial statements. Management is also responsible for establishing an accounting and financial reporting process for determining the fair value measurements and disclosures, selecting appropriate valuation methods, identifying and adequately supporting any significant
assumptions used, preparing the valuation and ensuring that the presentation and disclosure of the fair value measurements are in accordance with the entity’s identified financial reporting framework.

2. According to paragraph 11 of ISA 545, in some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process.

3. The owner-manager of a small entity may not have the expertise and experience necessary to fulfill the responsibilities referred to in paragraph 80 for fair value measurements other than those based on published price quotations. The auditor considers recommending to the owner-manager the use of an expert, such as an independent valuer. However, for many small entities it will be unlikely to have complex fair value measurements and, as the use of an expert may represent a significant cost to many small entities, the auditor does not make such recommendation unless considered necessary.

4. Any assistance provided by the auditor may create threats to the independence of the auditor. The auditor is to refer to paragraphs 8.171 to 8.176 of the Code for guidance on valuation services that may pose a threat and the potential safeguards that can be considered.

5. Paragraph 63 of ISA 545 requires the auditor to obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures. The owner-manager of a small entity may be reluctant to provide the required representation. The responsibility for making the fair value measurements and disclosures included in the financial statements rests with the owner-manager. 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.

ISA 550: Related Parties

85. Significant transactions are often entered into between the small entity and the owner-manager, or between the small entity and entities related to the owner-manager. Small entities seldom have sophisticated policies and codes of conduct on related party transactions. Indeed, related party transactions are a regular feature of many entities that are owned and managed by an individual or by a family. Further, the owner-manager may not fully understand the definition of a related party, especially where relevant accounting standards deem certain relationships to be related and others not. The provision of management representations in respect of the completeness of disclosure may entail some explanation by the auditor of the technical definition of a related party.

86. The auditor of a small entity ordinarily performs substantive procedures on the identification of related parties and related party transactions. However, if the auditor assesses the risk of undisclosed related party transactions as low, such substantive procedures need not be extensive. The auditor often acts as the auditor of other entities related to the small entity, which may assist in identifying related parties.

87. The auditor’s in-depth knowledge of the small entity may be of assistance in the identification of related parties, which in many instances, will be with entities controlled by the owner-manager. This knowledge can also help the auditor assess whether related party transactions might have taken place without recognition in the entity’s accounting records.

ISA 560: Subsequent Events

Subsequent Events Between the Period End and the Date of the Auditor’s Report

88. It is not common for small entities to be required to report shortly after their period-end. It is often the case that more time elapses between the period end and the approval or
signature of the financial statements by the owner-manager in the case of small entities, than in the case of large entities. The period to be covered by the auditor’s subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunity for the occurrence of subsequent events that can affect the financial statements. ISA 560 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the audit report.

89. The subsequent events procedures that the auditor of a small entity performs will depend on the information that is available and, in particular, the extent to which the accounting records have been written up since the period-end. When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant procedures can take the form of inquiry of the owner-manager, recording the owner-manager’s responses and inspection of bank statements. Paragraph 5 of ISA 560 gives examples of some of the matters that it may be appropriate for the auditor to consider in the course of these inquiries.

90. The auditor may, depending on the circumstances, consider that the letter of representation should cover subsequent events. The letter of representation is ordinarily dated on the same day as the audit report, thus covering the entire period since the period end.

91. Guidance on the auditor’s procedures relating to subsequent events (if any) in the period between the approval of the financial statements and the date of the auditor’s report is given in the guidance provided in this IAPS on ISA 700 “The Auditor’s Report on Financial Statements.”

Subsequent Events Between the Date of the Auditor’s Report and the Financial Statements Being Issued

92. Where, as in many small entities, the meeting at which the financial statements are approved or signed is immediately followed by the annual general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.

93. If the auditor becomes aware of a fact that materially affects the financial statements, the auditor considers whether the financial statements require amendment, discusses the matter with management, and takes action appropriate in the circumstances.

ISA 570: Going Concern

94. The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but may lack reserves to sustain operations.

95. ISA 570 requires that the auditor considers whether there are any events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the possibility of the loss of a principal supplier, major customer or key employee, and the possible loss of the right to operate under a license, franchise or other legal agreement.

96. ISA 570 gives guidance on additional audit procedures that may be relevant when events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern. Such procedures may include a review of documentation such as cash flows and profit forecasts. In the audit of a small entity, the auditor does not ordinarily expect to find detailed forecasts relevant to the consideration of going concern. Nevertheless, the auditor discusses with the owner-manager the going concern status of the entity and in particular, the financing of the entity in the medium and long-term. The auditor considers these discussions in the light of corroborative documentation and the auditor’s knowledge of the business. The auditor seeks written representation from the owner-manager in this regard.

97. Where the small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating his loan to the entity in favor of banks or other financial institutions. In such circumstances the
auditor inspects appropriate, documentary evidence of the subordination of the owner-manager’s loan. Where an entity is dependent on additional support from the owner-manager, the auditor considers the owner-manager’s ability to meet the obligation under the support arrangement. In addition, the auditor may ask for a written representation confirming the owner-manager’s intention or understanding.

**ISA 580: Management Representations**

98. Paragraph 6 of ISA 580 states that, when representations relate to matters that are material to the financial statements, the auditor:

(a) Seeks corroborative audit evidence from sources inside or outside the entity;

(b) Evaluates whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and

(c) Considers whether the individuals making the representations can be expected to be well-informed on the particular matters.

99. Paragraph 7 of ISA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor expects to be available. If such audit evidence cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the audit report. However, in certain instances, a representation by management may be the only audit evidence that the auditor can reasonably expect to be available.

100. In view of the particular characteristics of small entities, the auditor may judge it appropriate to obtain written representations from the owner-manager as to the completeness and accuracy of the accounting records and of the financial statements (for example, that all income has been recorded). Such representations, on their own, do not provide sufficient audit evidence. The auditor assesses the representations in conjunction with the results of other relevant audit procedures, the auditor’s knowledge of the business and of its owner-manager, and considers whether, in the particular circumstances, it would be reasonable to expect other audit evidence to be available. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.

101. Due to the nature of small entities, owner-managers may be reluctant to provide certain specific representations. This may particularly be the case for the specific representations in ISA 240, ISA 545 and ISA 570 (refer paragraphs 37, 38, 84, 96 and 97 of this IAPS). The auditor is encouraged to discuss with the owner-manager the reasons for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained. As noted in paragraph 22 of this IAPS, it may be useful to discuss these representations with management when agreeing the terms of engagement.

**ISA 700: The Auditor’s Report on Financial Statements**

102. The objective of any audit is for the auditor to obtain sufficient appropriate audit evidence to be able to express an opinion on the financial statements. In many cases the auditor will be able to express an unqualified opinion on the financial statements of small entities. However there may be circumstances that necessitate a modification of the auditor’s report.

**Scope Limitations**

103. When the auditor is unable to design or carry out procedures to obtain sufficient appropriate audit evidence as to the completeness of accounting records, this may constitute a limitation in the scope of the auditor’s work. The limitation would lead to a qualification of the opinion or, in circumstances where the possible effects of the limitation are so significant that the auditor is unable to express an opinion on the financial statements, a disclaimer of opinion.

104. The following illustrative paragraphs may be used for this purpose:
Example of paragraphs for an auditor’s report qualified when completeness of accounting records is not substantiated—scope limitation that does not prevent the auditor from expressing an opinion

The company’s recorded sales include $X in respect of cash sales. There was no system of control over such sales on which we could rely for the purpose of our audit and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the completeness and accuracy of the accounting records in respect of sales, the financial statements give a true and fair view of (or ‘present fairly, in all material respects,’) the financial position of the company as of ... and the results of its operations and its cash flows for the year then ended in accordance with ... (and comply with...).

Example of paragraphs for an auditor’s report with disclaimer of opinion when completeness of accounting records is not substantiated—scope limitation that is so significant that the auditor is unable to express an opinion

The company’s sales were made entirely on a cash basis. There was no system of control over such sales on which we could rely for the purpose of our audit and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

Because of the significance of the matter discussed in the preceding paragraph, we do not express an opinion on the financial statements.

Date and Signature of the Auditor’s Report

105. The auditor dates the audit report as of the completion date of the audit. This date should not be earlier than the date on which the owner-manager approves or signs the financial statements. Approval may be in the form of a management representation. In the audit of small entities, for practical reasons, the auditor may actually sign the report on a date later than that on which the owner-manager approves or signs the financial statements. Prior planning by the auditor, and discussion with the management of their procedures for finalizing the financial statements will often prevent this situation from arising. Where it cannot be avoided, there is a possibility that some event during the intervening period could materially affect the financial statements. Therefore, the auditor takes such steps as are appropriate:

(a) To obtain assurance that, on that later date, the owner-manager would have acknowledged responsibility for the financial statements or the items appearing therein; and

(b) To ensure that their procedures for reviewing subsequent events cover the period up to that date.

ISA 720: Other Information in Documents Containing Audited Financial Statements

106. The auditor reads the other information to identify material inconsistencies with the audited financial statements. Examples of “other information” often included with the financial statements of a small entity are the detailed income and expenditure statement, that is often attached with audited financial statements for taxation purposes, and the management report.
Commentary on the Application of ISAs when the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity

This appendix is relevant to auditors who are legally and professionally permitted to prepare accounting records and financial statements for their small entity audit clients. In preparing the accounting records and financial statements, the auditor may obtain useful information about the entity and its owner-manager’s aims, management style, and ethos. The auditor also acquires an in-depth knowledge of the entity, which assists in planning and conducting the audit. The auditor nevertheless remembers that the preparation of accounting records and financial statements for the small entity audit client does not relieve the auditor from obtaining sufficient and appropriate audit evidence. The matters set out below may be relevant in the application of the ISAs by the auditor who also prepares the accounting records and financial statements for the small entity audit client.

ISA 210: Terms of Audit Engagements

1. Where the auditor has assisted with the preparation of the financial statements, owner-managers of small entities may not be fully aware of their own legal responsibilities or those of the auditor. Owner-managers may not appreciate that the financial statements are their responsibility, or that the audit of the financial statements is legally quite distinct from any other services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.

2. Paragraph 3 of ISA 210 states that the auditor may agree terms of engagement for other services by means of separate letters of engagement. However, there is no requirement for separate letters and, in the case of a small entity, there may be practical reasons why a single combined letter may be more appropriate.

ISA 230: Documentation

3. When the auditor prepares the accounting records or financial statements for a small entity, such services are not audit work and the requirements of ISA 230 do not ordinarily apply to, for example, documentation of the work done in preparing the financial statements.

4. A consideration when establishing a retention policy for the working papers of a small entity is that owner-managers often request copies of the working papers containing accounting information to assist them in the administration of their entity. Paragraph 14 of ISA 230 states that working papers are the property of the auditor. Although portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity’s accounting records. It may be helpful for the engagement letter to set out these requirements regarding the accounting records.

ISA 240: Fraud and Error

5. The auditor may have obtained knowledge of the owner-manager’s personal financial position and lifestyle through the provision of other services to the entity or the owner manager. This knowledge may enhance the quality of the auditor’s assessment of the inherent risk of fraud. Unexplained demands to prepare the financial statements and complete the audit in an unreasonably short period of time may also indicate that there is an increased risk of fraud or error occurring.

ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

6. Most entities are subject to requirements relating directly to the preparation of financial statements, including the relevant companies legislation. The accounting expertise of the auditor as regards the legislation relating to the preparation of the financial statements helps the owner-manager ensure that the relevant statutory obligations have been complied with.
ISA 300: Planning
7. When the auditor prepares the accounting records or financial statements, sufficient flexibility is required in the overall audit plan to take account of any areas of audit risk identified, and evidence obtained in performing those services. The auditor of a small entity therefore plans to take into consideration knowledge obtained from the preparation of the accounting records or financial statements so that the approach to obtaining evidence is properly co-ordinated and that efficiency of work and cost can be secured.

ISA XX: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
ISA XX: Auditor’s Procedures in Response to Assessed Risks
8. In preparing the accounting records or financial statements, the auditor may obtain an understanding of the accounting and internal control system. Consideration is given to whether there are certain internal controls the auditor may wish to assess and test, which may affect the nature, timing and extent of substantive procedures required for the audit.

ISA XX: Audit Evidence
9. The auditor of a small entity when preparing the accounting records or financial statements, applies professional judgment in considering whether those services result in a reduction in the audit work necessary to support the auditor’s opinion. The preparation of accounting records or financial statements will seldom provide all, and may not even provide any, of the audit evidence required by the auditor. In particular, those services will ordinarily do no more than provide some of the necessary evidence regarding the completeness of a population, or the value at which items are stated in the financial statements. However, audit evidence can often be obtained at the same time that the accounting records or financial statements are being prepared. Specific audit work will ordinarily be required, for example, on the recoverability of debtors, the valuation and ownership of inventories, the carrying value of fixed assets and investments and the completeness of creditors.

ISA 520: Analytical Procedures
10. In small entities where the auditor has been engaged to prepare accounting records or financial statements, analytical procedures carried out at the planning stage of the audit will be more effective if those services have been completed before the audit planning is finalized.

ISA 540: Audit of Accounting Estimates
11. Although the owner-manager is responsible for determining the amount of the estimate to be included in the financial statements, the auditor of a small entity is often asked to assist with or advise on the preparation of any accounting estimates. By assisting with the process of preparing the accounting estimate, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 540. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the estimates.

ISA 545: Auditing Fair Value Measurements and Disclosures
12. Although the owner-manager is responsible for fair value measurements and disclosures, the auditor of a small entity may be asked to assist with the process of preparing the fair value measurements or disclosures. Management remains responsible for the reasonableness of the assumptions on which the fair value measurements and disclosures are based and, as a result, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgement of responsibility.

13. By assisting with the process of preparing the fair value measurement or disclosure, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 545. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the measurements or disclosures.
ISA 550: Related Parties

14. When assessing the risk of undisclosed related party transactions, the auditor considers matters arising when preparing the accounting records or financial statements of the small entity, assisting with the preparation of personal and corporate tax matters, or reviewing the owner-manager’s current accounts.

15. This, taken together with information obtained through discussion with the owner-manager, assists in the assessment of the risk in this area and may provide a reasonable basis for the risk to be assessed as low.

16. This assistance and the close relationship between the auditor and the owner-manager can assist in the identification of related parties, which, in most instances, will be with entities controlled by the owner-manager.

ISA 570: Going Concern

17. In some small entities, the auditor may be asked to assist the owner-manager with the assessment of going concern and sometimes with the preparation of any necessary cash flows or profit forecasts. In all cases, the owner-manager remains responsible for the assessment of going concern for any information prepared (even if the auditor assisted in its compilation), and for the reasonableness of the assumptions on which it is based. In such circumstances, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgment of responsibility.

ISA 580: Management Representations

18. In the audit of a small entity, it is particularly important for the auditor to obtain management representations in which the owner-manager acknowledges responsibility for the fair presentation of the financial statements. This is particularly necessary where the auditor has prepared the financial statements, because of the danger of the auditor’s role and responsibility in relation to the financial statements being misunderstood. In order to ensure that the representations are meaningful, the auditor considers explaining these matters to management before the representations are obtained.