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Appendix 1: Commentary on the Application of ISAs when the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity

Appendix 2: Where to Find Small Entity Audit Considerations

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International Auditing Practice Statement (IAPS) 1005, “The Special Considerations in the Audit of Small Entities” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the application and authority of IAPSSs.
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Guidance contained in this IAPS will be withdrawn when revisions to related ISAs become effective.

Accordingly, readers are cautioned that, in addition to the guidance in this IAPS, 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\(^1\) 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\(^2\) (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.

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\(^1\) The original IAPS was prepared and issued by the International Auditing Practices Committee (IAPC). Effective April 1, 2002, the IAPC was replaced by the International Auditing and Assurance Standards Board (IAASB).

\(^2\) Section 290 of the IFAC Code of Ethics for Professional Accountants issued in June 2005.
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 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 individual); and

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

      (i) Few sources of income;
      (ii) Unsophisticated record-keeping; or
      (iii) 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).

3 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.
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.
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. The auditor may consider including in the engagement letter an indication of the anticipated matters on which management representations will 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.-28. ISA 220, “Quality Control for Audits of Historical Financial Information” issued in February 2004 is effective for audits of financial information for periods beginning on or after June 15, 2005. Paragraphs 24-28 of this IAPS were withdrawn when ISA 220 became effective.

ISA 230: Documentation

29.-33. ISA 230, “Audit Documentation” issued in September 2005 is effective for audits of financial information for periods beginning on or after June 15, 2006. Paragraphs 29-33 of this IAPS were withdrawn when ISA 230 became effective.

ISA 240: The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements

34.-38. ISA 240 issued in February 2004 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 34-38 of this IAPS were withdrawn when ISA 240 became effective.

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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 the Audit of Financial Statements

42.-43. ISA 300 issued in June 2004 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 42 and 43 of this IAPS were withdrawn when ISA 300 became effective.

ISA 315: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements

44.-46. ISA 315 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 44-46 of this IAPS were withdrawn when ISA 315 became effective.
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, for example, to 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 330: The Auditor’s Procedures in Response to Assessed Risks

54.-65. ISA 330 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 54-65 of this IAPS were withdrawn when ISA 330 became effective.

ISA 500: Audit Evidence

66.-70. ISA 500 issued in October 2003 is effective for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 66-70 of this IAPS were withdrawn when ISA 500 became effective.

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 Means of Testing

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

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 applicable financial reporting framework.

81. 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.

82. 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 recognizes that the use of an expert, such as an independent valuer, may represent a significant cost to the small entity. However, if considered necessary in the circumstances, the auditor recommends to the owner-manager the use of an expert.

83. 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.

84. 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. Because of the reasons set out in paragraph 82, the owner-manager may be of the opinion that it is not possible 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 expresses a qualified opinion or a disclaimer of opinion.
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 auditor’s 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 auditor’s 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

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6 See footnote 4.
expect to find detailed forecasts relevant to the consideration of going
cconcern. 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 of the matters identified.

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 auditor’s 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 of the opinion that it is not possible 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 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.-105. ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” and ISA 701, “Modifications to the Independent Auditor’s Report” were issued in December 2004 and are effective for auditors’ reports dated on or after December 31, 2006. Paragraphs 102-105 of this IAPS were withdrawn when ISA 700 and ISA 701 became effective.

**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. In the case of a small entity, it may be practical to combine terms of engagement for audit and other services in a single combined letter of engagement.

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

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7 ISA 230, “Documentation” was withdrawn when ISA 230, “Audit Documentation” became effective. The latter is effective for audits of financial information for periods beginning on or after June 15, 2006.
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: The Auditor’s Responsibility to Consider Fraud in an Audit of
Financial Statements

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 an Audit of Financial Statements

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 315: Understanding the Entity and Its Environment and Assessing the
Risks of Material Misstatement and ISA 330: The 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 500: 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 measurements or disclosures, 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.
## Appendix 2

### Where to Find Small Entity Audit Considerations

The table below lists the ISAs on which the IAASB (and its predecessor, the IAPC) has prepared small entity audit considerations, and provides an indication of where the considerations can be found.

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