

## APPLYING ISAs PROPORTIONATELY WITH THE SIZE AND COMPLEXITY OF AN ENTITY

This Questions & Answers (Q&A) publication is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to highlight how the design of the International Standards on Auditing (ISAs) issued by the IAASB under the Clarity Project enables them to be applied in a manner proportionate with the size and complexity of an entity. Specifically, while ISAs apply to audits of entities of all sizes and complexities, this Q&A focuses on matters that are likely to be of particular relevance to their application in the context of an audit of a small- and medium-sized entity (SME). Small and medium practices (SMPs), other auditors of SMEs, and others with responsibility for financial statement audits may find this Q&A helpful in effectively implementing the clarified ISAs.

This publication does not amend or override the ISAs,<sup>1</sup> the texts of which alone are authoritative. Reading this Q&A is not a substitute for reading the ISAs. The Q&A is not meant to be exhaustive and reference to the ISAs themselves should always be made. This publication does not constitute an authoritative or official pronouncement of the IAASB.

### BACKGROUND

In March 2009, the IAASB completed its Clarity Project as a result of which it issued 36 ISAs under new drafting conventions designed to enhance the overall readability and understandability of the standards. Among other improvements, the clarified ISAs now specify more clearly the objectives of the auditor and the requirements with which the auditor has to comply when conducting an audit under the ISAs.

It is in the public interest that users of audited financial statements have confidence that audits of entities, whether small or large, and simple or complex, have been performed to the same high standards. In clarifying the ISAs, the IAASB paid particular attention to that overall goal. At the same time, however, the IAASB was alert to the needs of those that audit SMEs—an important sector of national economies and one that is particularly sensitive to standards-overload. Accordingly, the IAASB was mindful of the importance of setting requirements that would be generally applicable in virtually all engagements. An understanding of the design and intent of the ISAs will help auditors of SMEs to apply the ISAs in a relevant and cost-effective way.

### QUESTIONS AND ANSWERS

#### Q1. *How do the ISAs address the fact that the characteristics of an SME are significantly different from those of a larger, more complex entity?*

The auditor's objectives are the same for audits of entities of different sizes and complexities. This, however, does not mean that every audit will be planned and performed in exactly the same way. The ISAs recognize that the specific audit procedures to be undertaken to achieve the auditor's objectives and to comply with the requirements of the ISAs may vary considerably depending on whether the entity being audited is large or small and whether it is complex or relatively simple. The requirements of the ISAs, therefore, focus on matters that the auditor needs to address in an audit and do not ordinarily detail the specific procedures that the auditor should perform.<sup>2</sup>

<sup>1</sup> All references to ISAs in this publication are to the clarified ISAs that come into effect for audits of financial statements for periods beginning on or after December 15, 2009.

<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 19, requires the auditor to understand the entire text of an ISA to understand its objectives and to apply its requirements properly. ISA 200, paragraph A59,

The ISAs also explain that the appropriate audit approach for designing and performing further audit procedures depends on the auditor's risk assessment. For example, based on the required understanding of the entity and its environment, including its internal control and the assessed risks of material misstatement, the auditor may determine that a combined approach using both tests of controls and substantive procedures is an effective approach in the circumstances in responding to the assessed risks.<sup>3</sup> In other cases, for example, in the context of an SME audit where there are not many control activities in the SME that can be identified by the auditor, the auditor may decide that it is efficient to perform further audit procedures that are primarily substantive procedures.<sup>4</sup>

It is also important to note that the ISAs acknowledge that the appropriate exercise of professional judgment is essential to the proper conduct of an audit. Professional judgment is necessary, in particular, regarding decisions about the nature, timing, and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence.<sup>5</sup> However, while the auditor of an SME needs to exercise professional judgment, this does not mean that the auditor can decide not to apply a requirement of an ISA except in exceptional circumstances and provided that the auditor performs alternative audit procedures to achieve the aim of the requirement.<sup>6</sup>

**Q2. *How might the work effort in an SME audit differ from that in a larger entity audit?***

Often, SMEs engage in relatively simple business transactions, which means that their audits under the ISAs will generally be relatively straightforward.

As an illustration, consider the requirement in ISA 315 for the auditor to obtain an understanding of the entity and its environment.<sup>7</sup> While the audit considerations underlying this requirement will be equally relevant for both large and small entities, the typically simpler structure and processes in an SME often mean that the auditor may obtain an understanding of the entity and its environment quite readily and document this in a straightforward manner.

Similarly, internal control in the context of an SME may be simpler. This is emphasized several times in the ISAs, for example:

“Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.”<sup>8</sup>

“Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities...”<sup>9</sup>

explains that “where necessary, the application and other explanatory material provides further explanation of the requirements of an ISA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
  - Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. The application and other explanatory material may also provide background information on matters addressed in an ISA.”

3 ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph A4.

4 ISA 330, paragraph A18.

5 ISA 200, paragraph A23.

6 ISA 200, paragraph 23.

7 ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 11.

8 ISA 315, paragraph A45.

9 ISA 315, paragraph A85.

“Communication may be less structured and easier to achieve in a small entity than in a larger entity...”<sup>10</sup>

“The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary.”<sup>11</sup>

Thus, while obtaining an understanding of the entity’s internal control relevant to the audit is equally important in the audit of an SME, the auditor is also likely to be able to obtain the necessary understanding and document that understanding quite readily.

### Q3. *How do the ISAs help guide the auditor in their application to an SME audit?*

The ISAs specifically anticipate their application to an SME audit. For example, in relation to requirements:

- They specify alternative procedures regarding understanding the entity’s risk assessment process when the entity has not established such a process or it has an ad hoc process (a common occurrence in SMEs).<sup>12</sup>
- They specify a choice of audit procedures based on the particular circumstances (e.g., choice of responses to assessed risks for accounting estimates under ISA 540 where the option of using evidence arising from events occurring after the date of the financial statements is often an effective response in an SME audit, when such evidence is relevant to the accounting estimate and there is a long period between the date of the statement of financial position and the date of the auditor’s report).<sup>13</sup>
- They indicate if a requirement is conditional where those charged with governance and management are the same (a situation often seen in SMEs).<sup>14</sup>

Of particular relevance to the auditor of an SME is the fact that the ISAs also include useful guidance that assists the auditor in understanding or applying specific requirements in the ISAs in the context of an SME audit. Where appropriate, this guidance is included in sections of the application material in the ISAs under the subheading, *Considerations Specific to Smaller Entities*.<sup>15</sup> A few examples of the type of guidance provided are noted below:

- Standard audit programs or checklists drawn up on the assumption of few relevant control activities may be used for the audit plan of an SME audit provided that they are tailored to the circumstances of the engagement.<sup>16</sup>
- Because interim or monthly financial information may not be available in an SME for purposes of analytical procedures to identify and assess the risks of material misstatement, the auditor may need to plan to perform analytical procedures when an early draft of the entity’s financial statements becomes available.<sup>17</sup>
- Audit evidence for elements of the control environment in SMEs may not be available in documentary form. Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor’s understanding of an SME’s control environment.<sup>18</sup>

10 ISA 315, paragraph A87.

11 ISA 315, paragraph A93.

12 ISA 315, paragraph 17.

13 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 13.

14 ISA 260, *Communication with Those Charged with Governance*, paragraph 13.

15 While the guidance has been developed primarily with unlisted entities in mind, some of the considerations may be helpful in audits of smaller listed entities.

16 ISA 300, *Planning an Audit of Financial Statements*, paragraph A19.

17 ISA 315, paragraph A10.

18 ISA 315, paragraphs A77-A78.

Specific SME considerations also address how to apply the ISAs when there is only a one-person team, for example, in relation to the requirement for the engagement partner to take responsibility for the direction and supervision of an engagement team.<sup>19</sup>

In addition, other guidance indicates that specific aspects of the audit will vary with the size, complexity, and nature of the entity, for example, in relation to:

- The nature and extent of the auditor’s planning activities.<sup>20</sup>
- The auditor’s consideration of relevant fraud risk factors.<sup>21</sup>
- The communication process between the auditor and those charged with governance, and the form of that communication.<sup>22</sup>
- The level of detail at which to communicate significant deficiencies in internal control.<sup>23</sup>
- The judgment as to whether a control is relevant to the audit.<sup>24</sup>

#### **Q4. Does the auditor have to comply with all the ISAs when performing an audit of an SME?**

The basic obligations in the ISAs are as follows:

“The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist.”<sup>25</sup>

“The auditor shall not represent compliance with ISAs in the auditor’s report unless the auditor has complied with the requirements of this ISA [ISA 200] and all other ISAs relevant to the audit.”<sup>26</sup>

It is important to note, however, that not all of the ISAs may be relevant in every audit—that is, the circumstances in which an ISA applies may not exist in the engagement. Indeed, for an SME audit, several of the ISAs may not be relevant for this reason. For example, some of the ISAs that would not be relevant in an SME audit include:

- ISA 402,<sup>27</sup> if the SME does not use a service organization.
- ISA 510,<sup>28</sup> if the SME audit is a continuing, and not an initial, engagement.
- ISA 600,<sup>29</sup> if the SME audit engagement is not a group audit.
- ISA 610,<sup>30</sup> if the SME has no internal audit function.
- ISAs 800, 805, and 810<sup>31</sup> if the SME audit engagement is to report on general purpose financial statements.

19 ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 15 and ISA 300, paragraph A15.

20 ISA 300, paragraph A1.

21 ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph A26.

22 ISA 260, paragraphs A30 and A38.

23 ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A15.

24 ISA 315, paragraph A61.

25 ISA 200, paragraph 18.

26 ISA 200, paragraph 20.

27 ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

28 ISA 510, *Initial Audit Engagements—Opening Balances*.

29 ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

30 ISA 610, *Using the Work of Internal Auditors*.

31 ISA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*; ISA 805, *Special Considerations—*

Further, some ISAs, such as ISA 705<sup>32</sup> dealing with modifications to the auditor's opinion, may not be relevant in the circumstances.

The auditor need not be concerned with ISAs that are not relevant to the audit. Nevertheless, it is necessary that the auditor understands the scope of each ISA to determine whether it is relevant or not in the circumstances.

**Q5. *Does the auditor have to comply with all the requirements of every relevant ISA when performing an SME audit?***

Even if an ISA is relevant, not all of its requirements may be relevant in the particular circumstances of an audit. If a requirement is conditional and the condition does not exist, it is not necessary for the auditor to comply with the requirement.<sup>33</sup> Often, it is self-evident from the circumstances of the engagement whether a condition that determines the relevance of a conditional requirement exists. A few examples of requirements that need not be applied if the relevant conditions do not exist include:

- Holding an engagement team discussion as part of the risk assessment activities if it is only a one-person team.<sup>34</sup>
- Performing the specified substantive and other follow-up procedures if the auditor has not identified previously unidentified or undisclosed related parties or significant related party transactions.<sup>35</sup>
- Obtaining sufficient appropriate audit evidence to determine whether a material uncertainty exists if the auditor has not identified any event or condition that casts doubt on the entity's ability to continue as a going concern.<sup>36</sup>

There is a specific documentation requirement in those exceptional circumstances where the auditor judges it necessary to depart from a specific requirement. This documentation requirement applies only to a requirement that is relevant in the circumstances. The ISAs do not call for compliance with a requirement that is not relevant in the circumstances.<sup>37</sup>

**Q6. *How does audit documentation assist the auditor in an SME audit?***

At the basic level, audit documentation in an SME audit assists the auditor in planning and performing the audit. It facilitates supervision and review of the work performed by assistants, and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Also, by providing a record of matters of continuing relevance that can be simply updated, documentation provides a head start to the following year's audit.

Of particular importance, however, is that audit documentation can help to enhance the quality of the audit in terms of the quality of the auditor's judgments. The soundness of decisions is often higher when the auditor takes the time to document the facts of a significant matter and the rationale for the auditor's conclusions; the logic and clarity in thinking are generally enhanced.

*Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement; and ISA 810, Engagements to Report on Summary Financial Statements.*

32 ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

33 ISA 200, paragraph 22.

34 ISA 315, paragraph 10.

35 ISA 550, *Related Parties*, paragraph 22.

36 ISA 570, *Going Concern*, paragraph 16.

37 ISA 200, paragraph A74; and ISA 230, *Audit Documentation*, paragraph A19.

Audit documentation, therefore, assists the overall audit process while also providing a record that may assist audit oversight authorities and others when reviewing audit files.

**Q7. *How do the ISAs help guide the auditor in applying the documentation requirements in an efficient and effective manner?***

Appropriate audit documentation need not be burdensome. ISAs do much to encourage the auditor to prepare meaningful audit documentation while fostering an effective and efficient approach to it.

Firstly, the documentation requirements in the ISAs, which set out what is expected of the auditor, are designed to result in sufficient and appropriate audit documentation of the basis for the auditor's report and evidence that the audit was planned and performed in accordance with the ISAs and applicable legal and regulatory requirements.<sup>38</sup> For this purpose, ISA 230 requires the auditor to prepare audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand specific matters. This sets the benchmark in guiding the auditor in determining the content and extent of the audit documentation.

In this context, ISA 230 requires the documentation to include *significant* matters that arose during the audit and the *significant* professional judgments the auditor made in reaching conclusions on those matters.<sup>39</sup> The emphasis is on the *significant* matters and *significant* professional judgments. The ISA explains that an important factor in determining the form, content, and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.<sup>40</sup>

Secondly, the ISAs also recognize that it is unrealistic to expect every aspect of an audit to be documented. Accordingly, ISA 230 makes clear the following:

“... it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. ... it is [also] unnecessary for the auditor to document separately ... compliance with matters for which compliance is demonstrated by documents included within the audit file. ... For example, the existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.”<sup>41</sup>

Thirdly, the ISAs explicitly encourage the auditor to exercise professional judgment in determining the form and extent of documentation. They also acknowledge how the extent of audit documentation may vary depending on the circumstances. Examples, such as the following, are included in several places in ISA 230 and other ISAs:

- The manner in which specific requirements in ISA 315 are documented is for the auditor to determine using professional judgment.<sup>42</sup>
- The form, content, and extent of documentation depend on various factors, including the size and complexity of the entity,<sup>43</sup> and the audit methodology and technology used in the audit.

38 ISA 230, paragraph A6 states: “In principle, compliance with the requirements of this ISA will result in the audit documentation being sufficient and appropriate in the circumstances. Other ISAs contain specific documentation requirements that are intended to clarify the application of this ISA in the particular circumstances of those other ISAs. The specific documentation requirements of other ISAs do not limit the application of this ISA. Furthermore, the absence of a documentation requirement in any particular ISA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that ISA.”

39 ISA 230, paragraph 8.

40 ISA 230, paragraph A9.

41 ISA 230, paragraph A7.

42 ISA 315, paragraph A131.

43 ISA 230, paragraph A2; ISA 315, paragraph A131.

- The documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity.<sup>44</sup> Documentation may be simple and relatively brief.<sup>45</sup>

Finally, to further assist the auditor, the ISAs provide examples of how the documentation in an SME audit can be approached in an efficient and effective manner. For example, they suggest the following:

- It may be helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate.<sup>46</sup>
- The documentation of the understanding of the entity may be incorporated in the auditor's documentation of the overall strategy and audit plan. Similarly, the results of the risk assessment may be documented as part of the auditor's documentation of further procedures.<sup>47</sup>
- It is not necessary to document the entirety of the auditor's understanding of the SME and matters related to it.<sup>48</sup>
- A brief memorandum may serve as the documented audit strategy. At the completion of the audit, a brief memorandum could be developed and then updated to serve as the documented audit strategy for the following year's audit engagement.<sup>49</sup>

44 ISA 230, paragraph A16.

45 ISA 230, paragraph A17; ISA 315, paragraph A132.

46 ISA 230, paragraph A17.

47 ISA 315, paragraph A131.

48 ISA 315, paragraph A132.

49 ISA 300, paragraphs A11 and A19.

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