

IFAC
International
Auditing
and Assurance
Standards Board

March 2003
Exposure Draft

Response Due Date June 30, 2003

The Special Considerations in the Audit of Small Entities

Proposed Amendments to
International Auditing Practice Statement 1005

Issued for Comment
by the International
Federation of
Accountants



REQUEST FOR COMMENTS

This exposure draft and accompanying explanatory memorandum of the International Auditing and Assurance Standards Board (IAASB) were approved for publication in March 2003. The exposure draft may be modified in the light of comments received before being issued in the form of an International Auditing Practice Statement (IAPS).

Commentators' Guide and Consideration of Specific Issues

The IAASB welcomes comments on the exposure draft. In responding to the exposure draft, commentators are requested to refer to the relevant paragraphs within the IAPS. The responses should include the reasons for the comments, including specific suggestions for any proposed changes to wording.

The IAASB is seeking comments only on the modifications proposed to the existing IAPS. In particular, the IAASB is interested in the completeness and appropriateness of the proposed new guidance.

Comments should be submitted so as to be received by **June 30, 2003**, preferably by e-mail or on a computer disk, or in writing. All comments will be considered a matter of public record. Comments should be addressed to:

Technical Director
International Auditing and Assurance Standards Board
535 Fifth Avenue, 26th Floor
New York, New York 10017 USA

E-mail responses should be sent to: EDComments@ifac.org

The approved text of this exposure draft of the IAASB is published in the English language. In order to achieve maximum exposure and feedback, IFAC encourages the reproduction of this publication in any format.

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EXPLANATORY MEMORANDUM

Background

At the September 2002 meeting of the International Auditing and Assurance Standards Board (IAASB) it was agreed that International Auditing Practice Statement (IAPS) 1005, “The Special Considerations in the Audit of Small Entities,” should be revised to take account of International Standards on Auditing (ISAs) issued since March 1999.

In addition, the IAASB agreed that for revised and new ISAs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities should be included in the body of those ISAs. For example, considerations in the audit of small entities will be dealt with in the proposed Audit Risk Standards, which is currently being exposed for public comment. IAPS 1005 will be eliminated over time.

The IAASB did not consider the existing guidance on the application to small entity audits of ISAs issued before March 1999. Commentators are requested to comment on the application of ISAs issued since March 1999 to small entity audits (i.e. proposed changes highlighted by way of mark-up text), and not on the existing guidance.

Proposed Changes

Commentary on the Application of International Standards on Auditing

IAPS 1005 is not intended to be a “how to” guide for audits of small entities, nor is it intended to be a guide for small practitioners on how to carry out audits. Rather, it is intended to be used by practitioners who already know how to conduct an audit in accordance with ISAs, but who need guidance on how audits of the financial statements of small entities differ from audits of the financial statements of other entities. Accordingly, explanatory information and guidance that might be helpful but does not relate only to small entities is not included.

The following revised and new ISAs have been issued since March 1999:

- ISA 100, “Assurance Engagements”
- ISA 200, “Objective and General Principles Governing an Audit of Financial Statements”
- ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements”
- ISA 260, “Communications of Audit Matters With Those Charged With Governance”
- ISA 505, “External Confirmations”
- ISA 545, “Auditing Fair Value Measurements and Disclosures”
- ISA 570, “Going Concern”
- ISA 700, “The Auditor’s Report on Financial Statements.”

ISA 100 deals with the principles of assurance engagements and their application to high level assurance engagements. These principles do not change when the subject matter of the engagement originates with a small entity. For these reasons, no change is proposed to IAPS 1005 in respect of ISA 100.

A change was made to paragraph 6 of ISA 200, requiring the auditor to exercise professional skepticism. IAPS 1005 does not discuss ISA 200 directly, but it does refer to professional skepticism. The discussion in IAPS 1005 is in line with the thoughts expressed in the revised paragraph 6 of ISA 200, and no change is proposed.

ISA 505 replaced and expanded part B of ISA 501, “Audit Evidence—Additional Considerations.” IAPS 1005 has no paragraphs dealing with ISA 501. No points raised in ISA 505 should cause any problems with small entities, and there do not seem to be any particular difficulties in the use of confirmations that arise in audits of small entities. No change is proposed.

The only change made to ISA 700 was to require the auditor’s report to refer to the country of origin of the financial reporting framework. For financial statements of small entities this will usually be an easy matter to determine, and no change is proposed to the existing paragraphs in IAPS 1005 that deal with ISA 700.

The Provision of Other Services to Small Entity Audit Clients and Commentary on the Application of ISAs When the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity

Section 8 of the IFAC *Code of Ethics for Professional Accountants* (the Code) was revised and issued in November 2001. Section 8 of the Code provides a framework that establishes principles that auditors should use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level.

Although Section 8 of the Code is applicable to audit engagements when the auditor’s report is dated on or after December 31, 2004, earlier application is encouraged. As a result, the IAASB is of the opinion that it would be inappropriate not to change the IAPS to reflect the above principles, and auditors rendering other services to small entity audit clients are encouraged to apply these principles as early as possible.

Paragraphs 95 to 101 of IAPS 1005 revised and issued in March 1999, which provides guidance on the application of the existing Section 8 of the Code (currently in effect) is included in the appendix to the proposed revised IAPS 1005.

Specific Issues for Consideration

Commentators are requested to comment specifically on the completeness and appropriateness of the guidance on the application of ISAs issued since March 1999.

**PROPOSED AMENDMENTS TO
INTERNATIONAL AUDITING PRACTICE STATEMENT 1005
THE SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES
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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, and changes to Section 8 of the IFAC Code of Ethics for Professional Accountants issued in November 2001 (effective December 31, 2004) (earlier application is encouraged).

The purpose of this IAPS is to provide practical assistance to auditors in applying ~~International Standards on Auditing (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.

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 ~~IAPC-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 to the audit of small entities; ~~and~~
 - ~~(c) guidance on the impact on the auditor's work where the auditor also provides accounting services to the small entity.~~
3. ~~The provision of accounting services by auditors is prohibited by law in some jurisdictions. In others, the provision of accounting services by auditors is permitted both by law and professional ethics.² Section 3 of this IAPS deals with the special factors to be taken into account by auditors who also provide accounting services to small entities. The owner-manager of a small entity often needs assistance with the preparation of accounting records and financial statements, and may seek such assistance from the auditor. Section 8 of the IFAC *Code of Ethics for Professional Accountants* (the Code) deals with independence and auditors considering rendering other services to small entity audit clients refer to the Code and their national independence requirements. In addition to the guidance referred to in paragraph 2 above, this IAPS highlights ethical considerations relating to the provision of other services to small entity audit clients (in particular the preparation of accounting records and financial statements), as well as 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 ~~IAPC-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.

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), and the IAASB adopted the pronouncements issued by the IAPC.

² ~~The IFAC Code of Ethics permits the provision of accounting and other services to audit clients, provided that independence is safeguarded.~~

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 individual³); 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 a 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

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.

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. 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. It also requires the auditor to obtain written representations on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. ISA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements” and ISA 545, “Auditing Fair Value Measurements and Disclosures” specify representations to be obtained from management (refer paragraphs 37, 38 and 82 of this IAPS). As noted in paragraph 12 to 18 of this IAPS, limited accounting and internal control systems may exist and, as a result, the owner-manger may be reluctant to provide the required representations.
22. 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. The auditor is encouraged to discuss with the owner-manager (and include in the engagement letter) the types of management representation to be obtained, the reasons for obtaining such representations, and the impact on the auditor’s report should such representations not be obtained.
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.

- | 264. 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.
- | 275. 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.
- | 286. 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

- | 297. 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.
- | 3028. 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.
- | 3129. 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.
- | 320. 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.
- | 331. 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: Fraud and Error

- ~~32. Paragraphs 13 and 14 of ISA 240 illustrate certain conditions or events that may increase the risk of fraud or error. Examples of these conditions or events are given in Appendix 1 to the ISA. A relevant example applicable to small entities is “management is dominated by one person (or a small group) and there is no effective oversight board or committee...” Although this situation applies to most small entities, the guidance in ISA 240 is not intended to imply that all small entities are to be regarded by the auditor as necessarily involving a higher risk of fraud or error than larger entities.~~
343. 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. However, this 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. 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.
 - Disputes with tax authorities.
35. Paragraph 20 of ISA 240 requires the auditor, in 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 and 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, having personally conducted the planning of the audit, considers whether errors may be more likely to occur or how fraud might be perpetrated.
36. Paragraph 22 of ISA 240 requires the auditor, when planning the audit, to make inquiries of management *inter alia* 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 accounting and internal control systems may exist. Nevertheless, the auditor still considers conducting enquiry in order to obtain an understanding of the owner-manager’s attitude towards fraud and error, and of any actions the owner-manager has taken to prevent and detect 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 accounting and internal control systems may exist. As a result, the owner-manger 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 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 impact thereof on the auditor’s report.

39. ISA 240 requires the auditor to communicate specified matters to management and those charged with governance. With regard to reporting to those charged with governance, reference is made to the guidance provided in paragraph 42 of this IAPS.

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

4034. 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.

4135. 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

42. 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. Governance structures in small entities are often not well defined. The auditor determines who are entrusted with the supervision, control and direction of the small entity. Where management and those charged with governance are the same individuals and audit matters of governance interest have been communicated to those individuals in their

capacity as management of the small entity, the auditor is not required to re-communicate those matters to the same individuals in their capacity as individuals charged with governance.

ISA 300: Planning

4336. 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.

4437. 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

4538. The Appendix to ISA 310 gives a list of matters that the auditor may consider in relation to knowledge of the business. This list is illustrative only, it is not exhaustive, nor are all the matters listed relevant to every audit. In particular, the auditor of a small entity will often find that many of the points in this list are simply not relevant. It would therefore be inappropriate to regard this Appendix as a form of checklist to be applied routinely in all audits. It may, however, be sufficient for the auditor to use a checklist that has been appropriately tailored to the particular small entity; such a checklist can be reviewed and updated in subsequent years.

4639. The auditor of a small entity is often in a position to have a wide and up-to-date knowledge of the business by virtue of the fact that there may be regular close contact with the owner-manager. This relationship often provides information on matters such as the following:

- The activities of the small entity, its main products and services, and the industry in which it operates.
- The management style, aims, and attitudes of the owner-manager.
- Any plans for changes to the nature, management or ownership of the entity.
- Trends in profitability or liquidity and the adequacy of working capital.
- Legal or regulatory issues facing the entity, including its relationship with the taxation authorities.
- The accounting records.
- The control environment.

479. Documenting the auditor’s knowledge of the business is equally important in all audits, irrespective of the size of the entity. However, the extent of the documentation depends on the complexity of the entity and the number of persons who will be engaged on the audit. Small entities are ordinarily not complex and their audit rarely involves large teams of assistants. In many cases the audit may be performed by the partner and, perhaps, a single assistant. Therefore, whilst the auditor of a small entity will prepare documentation to a level sufficient to:

- (a) Facilitate proper planning of the audit; and
- (b) Provide for any change of responsibility within the audit firm, such as changes of audit engagement partner or the departure, illness or incapacity of assistants.

Such documentation will ordinarily be unsophisticated in format and as brief as circumstances allow.

ISA 320: Audit Materiality

481. “Materiality” is defined in the International Accounting Standards ~~Committee’s 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

492. 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.

5043. 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.

5144. 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

- 5245.** 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.
- 5346.** 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.
- 5447.** 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

Inherent Risk

- 5548.** In the audit of a small entity, control risk is often assumed or assessed as high, at least for certain financial statement assertions. The assessment of inherent risk for those assertions takes on a particular significance, as it has a direct impact on the extent of substantive procedures. There are difficulties in the assessment of the inherent risk of a small entity, for example there may be increased risk as a result of the concentration of ownership and control. However, the auditor's assessment of inherent risk in a small entity depends on its particular characteristics. A careful assessment of inherent risk for material financial statement assertions, rather than an assumption that it is high, may enable the auditor to conduct a more efficient and effective audit.

Control Risk

- 5649.** An understanding of the control environment is essential to the understanding of control risk. The auditor considers the overall influence of the owner-manager and other key personnel. For example, the auditor considers whether the owner-manager displays a positive control consciousness and considers the extent to which the owner-manager and other key personnel are actively involved in day-to-day operations.
- 570.** After obtaining an understanding of the accounting and internal control systems, the auditor makes a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions. Substantive procedures may be reduced if reliance on these controls is warranted after investigation and testing. However, many internal controls relevant to large entities are not practical in the small entity, and as a result it may not be possible to rely on internal control to detect fraud or errors. For example, segregation of duties may be severely limited in small entities because accounting procedures may be performed by few persons who may have both operating and custodial responsibilities. Similarly, when there are few employees, it may not be possible to set up a system of independent checking of their work.
- 581.** Inadequate segregation of duties and the risk of error may, in some cases, be offset by other control procedures such as the exercise of strong supervisory controls by the owner-manager means of direct personal knowledge of the entity and involvement in transactions. However this, in itself, may introduce other risks such as the potential for management override and fraud. Particular difficulties include the possible understatement of income by the non-recording or misrecording of sales. In circumstances where segregation of duties is limited and evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

- | [592](#). The auditor of a small entity may decide, based on the auditor’s understanding of the accounting system and control environment, to assume that control risk is high without planning or performing any detailed procedures (such as tests of controls) to support that assessment. Even where there appear to be effective controls it may be more efficient for the auditor to confine audit procedures to those of a substantive nature.
- | [6053](#). The auditor makes management aware of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor’s attention. Recommendations for improvement may also be made in this communication. Such recommendations are particularly valuable for the development of the small entity’s accounting and internal control systems.

Detection Risk

- | [6154](#). The auditor uses the assessments of inherent and control risk to determine the substantive procedures that will provide the audit evidence to reduce detection risk, and therefore audit risk, to an acceptable level. In some small entities, such as those where most transactions are for cash and there is no regular pattern of costs and margins, the available evidence may be inadequate to support an unqualified opinion on the financial statements.

ISA 401: Auditing in a Computer Information Systems Environment

- | [6255](#). The increasing availability of computer-based accounting systems that are capable of meeting both functional and economic circumstances of even the smallest entity impacts on the audits of those entities. Small entities’ accounting systems often make use of personal computers. International Auditing Practice Statement 1001, “~~CIS-IT~~ Environments—Stand-Alone MicrocomputersPersonal Computers” gives additional guidance regarding the special considerations of such an environment.
- | [6356](#). Small entities are likely to use less sophisticated hardware and software packages than large entities (often “packaged” rather than developed “in house”). Nevertheless, the auditor has sufficient knowledge of the computer information system to plan, direct, supervise, and review the work performed. The auditor may consider whether specialized skills are needed in an audit.
- | [6457](#). Because of the limited segregation of duties, the use of computer facilities by a small entity may have the effect of increasing control risk. For example, it is common for users to be able to perform two or more of the following functions in the accounting system:
 - Initiating and authorizing source documents.
 - Entering data into the system.
 - Operating the computer.
 - Changing programs and data files.
 - Using or distributing output.
 - Modifying the operating systems.
- | [6558](#). The use of computer information systems by small entities may assist the auditor in obtaining assurance as to the accuracy and appropriateness of accounting records by reducing control risk. Computerized information systems may be better organized, less dependent upon the skills of people using them, and less susceptible to manipulation than non-computerized systems. The ability of the auditor to obtain relevant reports and other information may also be enhanced. Good computerized systems facilitate accurate double entry and the reconciliation of subsidiary ledgers with control accounts. Report generation and the production of bank reconciliations may be more disciplined and effective, and the availability of reports and other information to the auditor is often improved. The assurance provided by such features,

providing they are properly evaluated and tested, may permit the auditor limit the volume of substantive testing of transactions and balances.

6659. The general principles outlined in International Auditing Practice Statement 1009 “Computer-Assisted Audit Techniques” (CAATs) are also applicable in small entity computer environments and give additional guidance regarding the special considerations in such an environment. However, in many cases where smaller volumes of data are processed, manual methods may be more cost-effective.

ISA 500: Audit Evidence

670. ISA 500 recognizes that, although audit evidence may be obtained in a number of ways, including from an appropriate mix of tests of control and substantive procedures, in some circumstances evidence may be obtained entirely from substantive procedures. A typical example of such circumstances would be where segregation of duties is limited and evidence of supervisory control is lacking, as is the case in many small entities.

681. In the audit of small entities, there are particular problems in obtaining audit evidence to support the assertion of completeness. There are two principal reasons for this:

- (a) The owner-manager occupies a dominant position and may be able to ensure that some transactions are not recorded; and
- (b) The entity may not have internal control procedures that provide documentary evidence that all transactions are recorded.

692. The auditor plans and conducts the audit with an attitude of professional skepticism. In the absence of evidence to the contrary, the auditor is entitled to accept representations as truthful and records as genuine.

7063. The auditor of a small entity need not assume that there will be limited internal controls over the completeness of important populations such as revenue. Many small entities have some form of numerically based system to control the dispatch of goods or the provision of services. Where there is such a system to ensure completeness, the auditor may obtain audit evidence of its operation, by means of tests of control, to assist in determining whether control risk can be assessed at less than high in order to justify a reduction in the extent of substantive testing.

7164. Where there are no internal controls relevant to the assertion, the auditor may be able to obtain sufficient evidence from substantive procedures alone. Such procedures may include the following:

- Comparing recorded amounts with amounts calculated on the basis of separately recorded data, for example, goods issues recorded in physical stock records may be expected to give rise to sales income, and job sheets or time records may be expected to give rise to charges to clients.
- Reconciling total quantities of goods bought and sold.
- Analytical procedures.
- External confirmation.
- A Review of transactions after the balance sheet date.

ISA 520: Analytical Procedures

Analytical Procedures in Planning the Audit

7265. 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

- | [7366](#). 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.
- | [7467](#). 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.
- | [7568](#). 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.
- | [7669](#). 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

- | [770](#). 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

- | [781](#). 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.

792. 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.

8073. 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

81. 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 also is 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. 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. In the case of complex fair value measurements, the owner-manager of a small entity may not have the expertise and experience necessary to fulfill these responsibilities and the auditor considers recommending to the owner-manager the use of an expert, such as an independent valuer. Any assistance provided by the auditor may create threats to the independence of the auditor and the auditor refers to the relevant section of the Code.

82. 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 impact thereof on the auditor's report.

ISA 550: Related Parties

8374. 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.

- | [8475](#). 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.
- | [8576](#). 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

- | [8677](#). 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.
- | [8778](#). 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.
- | [8879](#). 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.
- | [890](#). 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

- | [9081](#). 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 ~~to~~ require any separate consideration by the auditor as it is so short.
- | [9182](#). 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

9283. The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but their lack of reserves limits their ability to sustain operations.

9384. ISA 570 requires that auditors consider whether there are any events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. the risk that the going concern assumption may not be appropriate. Risk factors Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the risk-possibility of the loss of a major customer or key employee, and the risk of the possible loss of the right to operate under a license, franchise or other legal agreement.

9485. ISA 570 gives guidance on additional audit procedures that may be relevant the evidence to be obtained when a question arises as to the appropriateness of the events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern basis. Such evidence-procedures may include a review of documentation such as budgets, cash flow and profit forecasts In the audit of a small entity, the auditor does not ordinarily expect to find detailed budgets and 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 considers the need to obtain written management representations.

9586. 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

9687. 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.

9788. 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.

9889. 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.

ISA 700: The Auditor's Report on Financial Statements

990. 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

10091. 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.

10192. 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

10293. 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

10394. 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.

The Provision of ~~Accounting-Other~~ Services to ~~The Small Entity Being-Audited~~ Clients⁴

104. This section is relevant to jurisdictions in which auditors are legally and professionally permitted to provide other services to their audit clients. This section is to be read in conjunction with Section 8 of the Code. Section 8 of the Code provides a framework that establishes principles that auditors use to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. Judgment is needed to determine which safeguards are to be applied. Some safeguards may eliminate the threat while others may reduce the threat to an acceptable level.

105. Auditors often provide other services, such as the preparation of accounting records and financial statements, to their small entity audit clients. The provision of such other services may, however, create threats to the independence of these auditors. Consequently, the auditor evaluates the significance of any threat created by the provision of other services to small entity audit clients. In some cases, it may be possible for the auditor to eliminate or reduce the threat created by application of safeguards. In other cases, no safeguards may be available to reduce the threat to an acceptable level and the auditor declines rendering such other service to the small entity audit client.

106. In accordance with paragraph 8.156 of the Code, the following activities generally create threats that are so significant that only avoidance of the activity or refusal to perform the small entity audit reduces the threats to an acceptable level:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the small entity audit client, or having the authority to do so;
- Determining which recommendation of the auditor is to be implemented; and
- Reporting, in a management role, to those charged with governance.

107. In accordance with paragraph 8.158 of the Code, the following activities may also create threats:

- Having custody of the assets of a small entity audit client;
- Supervising employees of the small entity audit client in the performance of their normal recurring activities; and

⁴ Paragraphs 104 to 103 are based on Section 8 of the Code, which was revised and issued in November 2001 and becomes effective December 31, 2004 (earlier adoption is encouraged). The appendix to this IAPS contains guidance based on the existing Section 8 of the Code (currently in effect), reflecting the text of paragraphs 95 to 101 of IAPS 1005 revised and issued in March 1999.

- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).
108. Safeguards that may be particularly relevant in reducing to an acceptable level threats created by the provision of other services to small entity audit clients include the following:
- Policies and procedures to prohibit the audit engagement partner and, where applicable, the professional staff from making management decisions for the small entity audit client, or assuming responsibility for such decisions;
 - Discussing independence issues related to the provision of other services with the owner-manager and those charged with governance (if not the same individual(s) as management);
 - Obtaining the owner-manager's acknowledgement of responsibility for the results of the other services performed by the auditor; or
 - Making arrangements so that professional staff providing the other services does not participate in the audit of the small entity.
109. Although Section 8 of the Code applies to all other services rendered to a small entity audit client, the remainder of this section focuses on the preparation of accounting records and financial statements, as (except for taxation services) these services are rendered most frequently to small entity audit clients and have a significant impact on the audit of the small entity's financial statements. Auditors refer to Section 8 of the Code with regard to other services rendered to their small entity audit clients.
110. It is the responsibility of the owner-manager to ensure that accounting records are kept and financial statements are prepared, although the owner-manager may request the auditor to provide assistance. If the auditor makes management decisions, the threat created cannot be reduced to an acceptable level by any safeguards. Consequently, the auditor does not make such decisions. Examples of such decisions include the following:
- Determining or changing journal entries, or the classifications for accounts or transactions or other accounting records without obtaining the approval of the owner-manger;
 - Authorizing or approving transactions; and
 - Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.
111. The audit process involves extensive dialogue between the auditor and the owner-manager. During this process, the owner-manager may request and receive significant input regarding such matters as accounting principles and financial statement disclosure, the appropriateness of internal control systems and the methods used in determining the stated amounts of assets and liabilities. Technical assistance of this nature and advice on accounting principles for small entity audit clients are an appropriate means to promote the fair presentation of the financial statements. The provision of such advice does not generally threaten the auditor's independence. Similarly, the audit process may involve assisting the small entity audit client in resolving account reconciliation problems, analyzing and accumulating information for regulatory reporting, drafting disclosure items and proposing adjusting journal entries. These services are considered to be a normal part of the audit process and do not, under normal circumstances, threaten independence.
112. An auditor may provide a small entity audit client *that is not a listed entity* with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any threat created is reduced to an acceptable level. Examples of such services include:

- Recording transactions for which the owner-manager has determined or approved the appropriate account classification;
- Posting coded transactions to the small entity's general ledger;
- Preparing financial statements based on information in the trial balance; and
- Posting owner-manager approved entries to the trial balance.

The significance of any threat created is evaluated and, if the threat is other than clearly insignificant, safeguards are considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards include:

- Making arrangements for such services to be performed by someone other than a member of the audit team (however, this would not be possible where the auditor is a sole practitioner);
- Implementing policies and procedures to prohibit the auditor providing such services from making any managerial decisions on behalf of the owner-manger;
- Requiring the source data for the accounting entries to be originated by the owner-manager;
- Requiring the underlying assumptions to be originated and approved by the owner-manager; or
- Obtaining owner-manager approval for any proposed journal entries or other changes affecting the financial statements.

(Refer paragraph 8.167 of the Code.⁵)

113. The provision of accounting and bookkeeping services to small entity audit clients in emergency or other unusual situations, when it is impractical for the owner-manager to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:

- (a) The auditor does not assume any managerial role or make any managerial decisions;
- (b) The owner-manager accepts responsibility for the results of the work; and
- (c) Professional staff providing the services are not members of the audit team (however, this would not be possible where the auditor is a sole practitioner).

(Refer paragraph 8.170 of the Code.)

~~95. This section is relevant to jurisdictions in which auditors are legally and professionally permitted to provide accounting services to their audit clients.~~

~~96. In some jurisdictions, auditors are permitted to provide accounting and other services to audit clients. The owner-manager of a small entity often needs assistance with the preparation of the financial statements, and other accounting services, and may seek such assistance from the auditor.~~

~~97. Examples of accounting services that the auditor may be engaged to perform include the following:~~

- ~~• Assisting with the keeping of accounting records.~~
- ~~• Advising on the selection and application of accounting policies.~~

⁵ It should be noted that national independence requirements may prohibit the auditor from rendering some or all of the services listed in this paragraph.

~~• Assisting with the preparation of financial statements.~~

~~98. In performing accounting services, 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 assistance provided to the entity does not relieve the auditor from obtaining sufficient and appropriate audit evidence.~~

Ethical Considerations

~~99. The auditor bears in mind the overriding ethical requirement for independence and objectivity when forming and expressing an opinion on the financial statements and exercises care to ensure that the relationship with the entity does not prejudice the ability to form an objective opinion.~~

~~100. Paragraph 8.5 of the IFAC Code of Professional Ethics for Public Accountants permits the provision of other services, but states:~~

~~—“When a professional accountant in public practice, in addition to carrying out an audit or other reporting function, provides other services to a client, care should be taken not to perform management functions or make management decisions, responsibility for which remains with the board of directors and management.”~~

~~101. The commentary on paragraph 8.5 states that the provision of other services does not mean that the professional accountant has ceased to be independent. However, with respect to the preparation of accounting records, the commentary provides further advice as follows:~~

~~—“The preparation of accounting records is a service which is frequently requested of a professional accountant in public practice, particularly by smaller clients, whose businesses are not sufficiently large to employ an adequate internal accounting staff...In all cases in which independence is required and in which a professional accountant in public practice is concerned in the preparation of accounting records for a client, the following requirements should be observed:~~

~~(a) The professional accountant in public practice should not have any relationship or combination of relationships with the client or any conflict of interest which would impair integrity or independence.~~

~~(b) The client should accept responsibility for the statements.~~

~~(c) The professional accountant in public practice should not assume the role of employee or of management conducting the operations of an entity.~~

~~(d) Staff assigned to the preparation of accounting records ideally should not participate in the examination of such records. The fact that the professional accountant in public practice has processed or maintained certain records does not eliminate the need to make sufficient audit tests.”~~

Commentary on the Application of International Standards On Auditing ISAs when the Auditor Also Provides Accounting Services To Prepares the Accounting Records and Financial Statements of the Small Entity

~~114. This section is relevant to Where the auditors who are legally and professionally permitted to provides accounting services to prepare accounting records and financial statements for their small entitysmall 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 audit client does not relieve the auditor from obtaining sufficient and appropriate audit evidence.~~

~~†The following~~ additional 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

~~11502~~. 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 ~~accounting~~ other services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.

~~11603~~. 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

~~11704~~. When the auditor ~~provides accounting services to~~ prepares the accounting records or financial statements for a small entity, such services are not audit work and ~~so~~ the requirements of ISA 230 do not ordinarily apply to, for example, documentation of the work done in ~~assisting with the preparation of~~ preparing the financial statements.

~~11805~~. 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

~~11906~~. 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

~~12007~~. 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

~~12108~~. When the auditor ~~assists in the preparation of~~ 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 ~~accounting services~~ 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 400: Risk Assessments and Internal Control

~~12209.~~ In ~~performing accounting services~~ preparing the accounting records or financial statements, the auditor may obtain an understanding of the accounting and internal control system. ~~This may indicate that~~ Consideration is given to whether there are certain internal controls ~~that~~ the auditor may wish to assess and test, which may ~~in turn~~ affect the nature, timing and extent of substantive procedures required for the audit.

ISA 500: Audit Evidence

~~12310.~~ The auditor of a small entity when ~~providing accounting services~~ preparing the accounting records or financial statements, applies professional judgment in considering whether ~~the other those~~ services ~~rendered~~ result in a reduction in the audit work necessary to support the auditor's opinion. ~~Accounting services~~ 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, ~~accounting 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 ~~work is done~~. 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

~~12411.~~ In small entities where the auditor has been engaged to ~~perform accounting services~~ prepare accounting records or financial statements, analytical procedures carried out at the planning stage of the audit will be more effective if ~~some of the accounting those~~ services ~~to be performed by the auditor~~ have been completed before the audit planning is finalized.

ISA 540: Audit of Accounting Estimates

~~12512.~~ 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

~~126.~~ 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.

~~127.~~ 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

~~12813.~~ When assessing the risk of undisclosed related party transactions, the auditor ~~takes account of any related party~~ considers matters arising when ~~providing any assistance on matters such as the following~~ preparing the accounting records or financial statements of the small entity,

assistance provided in preparing personal and corporate tax matters, or review of the owner-manager's current accounts.

- ~~• Keeping the accounting records.~~
- ~~• Preparing the financial statements (in particular any statutory disclosures required concerning loans and other transactions with directors and connected persons).~~
- ~~• Personal and corporate tax matters.~~
 - Compiling and reviewing owner-manager's current accounts.

12914. 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.

13015. 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

13116. 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 budgets or 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

13217. 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 assisted in drafting 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**The Provision of Accounting Services to the Small Entity Being Audited**

Paragraphs 104 to 113 of this IAPS are based on Section 8 of the Code, which was revised and issued in November 2001 and becomes effective December 31, 2004 (earlier adoption is encouraged). This appendix contains guidance based on the existing Section 8 of the Code (currently in effect), reflecting the text of paragraphs 95 to 101 of IAPS 1005 revised and issued in March 1999.

1. This section is relevant to jurisdictions in which auditors are legally and professionally permitted to provide accounting services to their audit clients.
2. In some jurisdictions, auditors are permitted to provide accounting and other services to audit clients. The owner-manager of a small entity often needs assistance with the preparation of the financial statements, and other accounting services, and may seek such assistance from the auditor.
3. Examples of accounting services that the auditor may be engaged to perform include the following.
 - Assisting with the keeping of accounting records.
 - Advising on the selection and application of accounting policies.
 - Assisting with the preparation of financial statements.
4. In performing accounting services, 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 assistance provided to the entity does not relieve the auditor from obtaining sufficient and appropriate audit evidence.

Ethical Considerations

5. The auditor bears in mind the overriding ethical requirement for independence and objectivity when forming and expressing an opinion on the financial statements and exercises care to ensure that the relationship with the entity does not prejudice the ability to form an objective opinion.
6. Paragraph 8.5 of the IFAC Code of Professional Ethics for Public Accountants permits the provision of other services, but states:

“When a professional accountant in public practice, in addition to carrying out an audit or other reporting function, provides other services to a client, care should be taken not to perform management functions or make management decisions, responsibility for which remains with the board of directors and management.”
7. The commentary on paragraph 8.5 states that the provision of other services does not mean that the professional accountant has ceased to be independent. However, with respect to the preparation of accounting records, the commentary provides further advice as follows:

“The preparation of accounting records is a service which is frequently requested of a professional accountant in public practice, particularly by smaller clients, whose businesses are not sufficiently large to employ an adequate internal accounting staff...In all cases in which independence is required and in which a professional accountant in public practice is concerned in the preparation of accounting records for a client, the following requirements should be observed:

- (a) The professional accountant in public practice should not have any relationship or combination of relationships with the client or any conflict of interest which would impair integrity or independence.
- (b) The client should accept responsibility for the statements.
- (c) The professional accountant in public practice should not assume the role of employee or of management conducting the operations of an entity.
- (d) Staff assigned to the preparation of accounting records ideally should not participate in the examination of such records. The fact that the professional accountant in public practice has processed or maintained certain records does not eliminate the need to make sufficient audit tests.”