

GUIDANCE NOTE ON SPECIAL CONSIDERATIONS IN THE AUDIT OF SMALL ENTITIES*

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Foreword

As the members are aware, the Institute has issued a number of documents, for example, accounting and auditing standards, guidance notes on issues related to accounting and auditing, and number of other studies, monographs and background material etc., for the benefit of the members.

I am glad to note that, as another step towards guiding the members in efficient and effective discharge of their assignments, the Auditing and Assurance Standards Board of the Institute has taken an initiative to bring out this Guidance Note on Special Considerations in an Audit of Small Entities. The Guidance Note provides extensive guidelines to the members in understanding the peculiar features of small entities and also on application of the various Auditing and Assurance Standards to audits of small entities.

I am also glad to note that with the issuance of this Guidance Note, the gap between the documents issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants is further narrowed. I am sure that the members, at large will find this Guidance Note of immense use in discharging their professional responsibilities.

New Delhi
September 8, 2003

R. BUPATHY
President

Special Considerations in the Audit of Small Entities

Preface

Though principles of audit are universally applicable, whether the client is a large-sized multinational company or a small sole proprietary firm, the manner of their application might have to be varied to suit the facts and circumstances of each case. However, there are inevitable peculiarities when it comes to audit of entities due to the smallness of their size and operations.

The objective of this Guidance Note on Special Considerations in the Audit of Small Entities is, primarily, to provide an understanding to the members as to the peculiar features of small entities and how to apply the principles and procedures outlined in the various Auditing and Assurance Standards to small clients.

The members should, however, take note that the Guidance Note is not a substitute for the Auditing and Assurance Standards mentioned therein. Thus, the members are expected to adhere to the principles outlined in the Auditing and Assurance Standards. The Guidance Note is designed merely to help them in understanding and applying these Standards while discharging their attest functions in small entities.

At this juncture, I wish to place on record, my thankfulness to Shri Sanjay Jhanwar, convenor, Jaipur study group which prepared the basic draft of the Guidance Note and also Shri Kamlesh S Vikamsey, FCA, immediate past Chairman, Auditing and Assurance Standards Board, without whose untiring efforts and able guidance, it would have been difficult to bring out this Guidance Note in such a short time. I also wish to place on record my appreciation for all my colleagues at the Auditing and Assurance Standards Board (AASB), namely, Sarvashree Rajkumar S Adukia, Vice Chairman, R Bupathy, Sunil Goyal, N V Iyer, Shanti Lal Daga, P P Pareek, Vinod Jain, Sunil Bhargava, K B Sharma, Sushil Kumar Agarwal, K Prahalada Rao, G S Prakash, Antaryami Roy, Rajesh B Doshi, Anil Bhalla, S Ravindran, C N Gangadaran and Professor K K Ramesh, without whose contribution, the Guidance Note might not have seen the light of the day. I also wish to acknowledge the work done and strong support provided by the Secretariat of the Board, viz., Shri Vijay Kapur,

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*Secretary to the Board and Shri Lalit Kumar and Smt. Puja Wadhera,
Senior Technical Officers in bringing out this technical document.*

*I sincerely hope that, the members would find the Guidance Note
helpful in resolving any issues regarding auditing standards that might
have arisen in audit of small clients.*

New Delhi
September 5, 2003

N NITYANANDA
Chairman
Auditing and Assurance Standards Board

Special Considerations in the Audit of Small Entities

Introduction

1. Auditing and Assurance Standards (AASs) {*earlier known as Statements on Standard Auditing Practices (SAPs)*} 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 Council of the Institute recognises that audit of small entities gives rise to a number of special considerations. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant AAS and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of AASs, the auditor should refer to the AAS concerned. This Guidance Note does not establish any new requirements for the audit of small entities nor does it establish any exemptions from the requirements of AASs. All audits of small entities are to be conducted in accordance with AASs.

2. The objective of this Guidance Note is to describe the characteristics that are commonly found in small entities and indicate how they might affect the application of AASs. This Guidance Note, thus, includes:

- (a) discussion of the characteristics of small entities; and
- (b) guidance on the application of AASs to the audit of small entities;

3. In determining the nature and extent of the guidance provided in this Guidance Note, the Auditing and Assurance Standards Board (AASB) 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 judgement with respect to the application of AASs. However, detailed guidance of a procedural nature has not been provided as the issue of such guidance may undermine the proper exercise of professional judgement in auditing.

4. Normally, in the case of small entities, the auditors provide advisory services on accounting matters. It may be noted that with a view to ensure the independence of auditor, the Council of the Institute of Chartered Accountants of India has clarified that the members are not permitted to write the books of accounts of their auditee clients. Therefore, although the auditor may provide advisory services on accounting matters, he should refrain from writing the books of accounts of the auditee. Also, while providing the advisory services, the auditor must ensure that:

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- (a) he does not land in a situation where there could be conflict of interests and duty;
- (b) the client accepts the responsibility for the financial statements; and
- (c) provision of advisory services does not result into breach of any provisions of the Chartered Accountants Act, 1949 and Rules and Regulations framed thereunder.

The Characteristics of Small Entities

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

6. The meaning of "small entity" in this context gives consideration not only to the size of an entity but also to its typical qualitative characteristics. Quantitative indicators of the size of an entity may include balance sheet totals, revenue and the number of employees, but such indicators are not definitive. Therefore, it is not possible to give an adequate definition of a small entity solely in quantitative terms.

7. For the purposes of this Guidance Note, 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 individual¹); and
- (b) one or more of the following are also found:
 - ◆ few sources of income and uncomplicated activities;
 - ◆ simple and personalized 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

¹ The word "individual" denotes ownership by a natural person, rather than by other entity. An entity owned by other enterprises may, however, be regarded as a "small entity" for the purpose of this Guidance Note, if the owner exhibits the relevant characteristics.

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display all of those characteristics. For the purposes of this Guidance Note, small entities will ordinarily display characteristic 7(a) and one or more of the characteristics included mentioned at 7(b). These characteristics need to be examined in every audit period and if an entity doesn't display these characteristics in the period, the entity would not be categorized as small entity in such period.

Concentration of Ownership and Management

9. Small entities usually have few owners, often there is a sole proprietor. Many owner-managers adopt a 'hands on' approach to internal control issues by personally exercising supervisory controls. The owner may employ a manager to run the business but in most cases is directly involved in running the business on a day-to-day basis. As the proprietor, the owner-manager has a personal interest in safeguarding the assets of the business, measuring its performance and controlling its activities, but may be unable to divert limited management time to such matters as formal internal control procedures. However, the lack of formality does not of itself indicate circumstances giving rise to a high risk of fraud or error, the auditors of a small entity make their assessment of risk in the light of its particular circumstances.

10. This Guidance Note 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 and Uncomplicated Activities

11. Small entities typically have a limited range of activities and often specialize in a single product or service and operate from a single location.

12. Uncomplicated activities can make it easier for the auditors to acquire, record and maintain knowledge of the business. In addition, in many small entities, accounting populations are often small and easily analysed; the application of a wide range of audit procedures can often be straightforward in such circumstances. For example, effective predictive models for use in analytical procedures can sometimes be constructed.

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Simple Record-Keeping

13. Most small entities employ few, if any, personnel who are solely engaged in record keeping. Consequently, the book keeping functions and accounting records are often simple. Record keeping may be simple, customised or personalised, 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. Small entities often find it convenient to use branded accounting software packages designed for use on a personal computer. Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:

- (a) all the transactions and other accounting information that should have been recorded have in fact been recorded;
- (b) assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and
- (c) Fraud or error in processing accounting information can be detected.

Limited Internal Controls

14. 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.

15. 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

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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 cheques. When the owner-manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

16. 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.

17. 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 Auditing and Assurance Standards

18. The commentary that follows provides guidance on the application of AASs to the audit of a small entity. It is reiterated that this guidance is a supplement to, and not a substitute for, the guidance contained in the relevant AAS and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of AASs, the auditor should refer to the AAS concerned. Where a AAS is, in principle, applicable to audit of 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 AAS.

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AAS 3, Documentation

19. Paragraph 5 of AAS 3 states:

“The form and content of working papers are affected by matters such as:

- ◆ The nature of the engagement.
- ◆ The form of the auditor’s report.
- ◆ The nature and complexity of the client’s business.
- ◆ The nature and condition of the client’s records and degree of reliance on internal controls.
- ◆ The need in particular circumstances for direction, supervision and review of work performed by assistants.”

20. 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, or because of 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.

21. 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.

22. 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.

23. Paragraph 11 & 12 of AAS 3 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

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judgement in determining the contents of working papers in any particular case.

24. Nevertheless, the auditor of a large or a small entity, records in the working papers:

- (a) the audit planning;
- (b) an audit programme 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 judgement.

25. In the audit of a small entity, the nature and extent of the auditor's procedures and, consequently, of the documentation needed, are likely to be influenced by the following characteristics of small entities:

- (a) Simple ownership and management structures;
- (b) Uncomplicated activities with few products and services (and few locations);
- (c) Few, if any, employees;
- (d) Simplified accounting records;
- (e) Packaged accounting software; and
- (f) Few, if any, internal controls.

AAS 4, The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements

26. Paragraph 10 of AAS 2, "Objective and Scope of the Audit of Financial Statements", states as follows:

"In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk

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that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions."

27. Paragraph 2 of AAS 4 (Revised) states:

"Where planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatement in the financial statements resulting from fraud and error."

28. 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 on such matters is conditioned by knowledge of that particular entity and the integrity of its owner-manager. Matters that auditors may 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).

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- ◆ Whether there are frequent changes of professional advisors.
- ◆ 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.
- ◆ Whether there are unusual transactions around the year- end that have a material effect on profit.
- ◆ Whether there are unusual related party transactions.
- ◆ Whether the payments of fees or commissions to agents and consultants appear excessive.
- ◆ Whether there are disputes with tax authorities.
- ◆ Whether parts of the detailed accounting records are unavailable or have been lost for implausible reasons;
- ◆ Whether there is a significant level of cash transactions without adequate documentation;
- ◆ Whether there are many transactions without adequate documentation.
- ◆ Whether numerous unexplained aspects of audit evidence (such as differences between the accounting records and third-party confirmations, or unexpected results of analytical procedures);
- ◆ Whether there is inappropriate use of accounting estimates;
- ◆ Whether the owner-manager or key personnel have not taken annual leave for a long period of time.
- ◆ Whether there is lack of sufficient working capital.
- ◆ Whether weaknesses reported earlier are continued.
- ◆ Whether there is non-maintenance of year ending inventory and stock registers.

AAS 5, Audit Evidence

29. Paragraphs 1 to 5 of AAS 5 state:

“1. Statement on Standard Auditing Practices (AAS) 1, *“Basic Principles Governing an Audit”*, states (paragraphs 15–17):

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“The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

They are of two types:

- (a) Tests of details of transactions and balances;
- (b) Analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

Sufficient Appropriate Audit Evidence

2. Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability. Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. He may often seek evidence from different sources or of different nature to support the same assertion.

3. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The audit evidence should, in total, enable the auditor to form an opinion on the financial information. In forming such an opinion, the auditor may obtain audit evidence on a selective basis by way of judgmental or statistical sampling procedures. For example, the auditor may select only certain account receivables for confirmation purposes, or make a selection of personnel records for the purpose of testing that changes in payroll rates have been properly authorised.

4. The auditor's judgement as to what is sufficient appropriate audit evidence is influenced by such factors as:

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- (a) The degree of risk of misstatement, which may be, affected by factors such as:
 - (i) The nature of the item;
 - (ii) The adequacy of Internal Control;
 - (iii) The nature or size of the business carried on by the entity.
 - (iv) Situations which may exert an unusual influence on management;
 - (v) The financial position of the entity.
- (b) The materiality of the item.
- (c) The experience gained during the previous audits.
- (d) The results of the auditing procedures, including fraud and error which may have been found.
- (e) The type of information available.
- (f) The trend indicated by accounting ratios and analysis.

5. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence	that the internal control exists.
Effectiveness	that the internal control is operating effectively.
Continuity	that the internal control has so operated throughout the period of reliance."

30. 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.

31. 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.

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32. 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.

33. 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.

AAS 6, Risk Assessments and Internal Control

34. Paragraph 2 of AAS 6 requires that the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.

Inherent Risk

35. Paragraph 12 of AAS 6 requires that in developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions at the level of assertions made in the financial statements, or assume that inherent risk is high for the assertion, taking into account factors relevant

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both to the financial statements as a whole and to the specific assertions. When the auditor makes an assessment that the inherent risk is not high, he should document the reasons for such assessment.

36. 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

37. Paragraph 22 of AAS 6 requires that after obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

38. 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.

39. 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 error. 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

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few employees, it may not be possible to set up a system of independent checking of their work.

40. 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 by 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.

41. 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.

42. 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

43. Paragraph 43 of AAS 6 (Revised) states:

"The auditor should consider the assessed levels of inherent and control risks in determining the nature, timings and extent of substantive procedures required to reduce the audit risk to an acceptably low level. In this regard the auditor would consider:

- (a) The nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or

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using tests of details for a particular audit objective in addition to analytical procedures;

- (b) The timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and
- (c) The extent of substantive procedures, for example, using a larger sample size.”

44. The auditor uses the assessments of inherent and controls 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.

Accounting and Internal Control Systems

45. Paragraph 14 of AAS 6 states:

“Internal controls relating to the accounting system are concerned with achieving the following objectives:

- ◆ Transactions are executed in accordance with management’s general or specific authorisation.
- ◆ All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.
- ◆ Assets and records are safeguarded from unauthorized access, use or disposition.
- ◆ Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Audit Risk in the Small Business

46. Paragraph 49 of AAS 6 states –

“The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both

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small and large entities. However, many internal controls, which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore, segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit 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."

AAS 8, Planning

47. Paragraph 1 of AAS 8 states:

"Statement on Standard Auditing Practices 1, "Basic Principles Governing an Audit", states (paragraphs 12-14):

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

Plans should be made to cover, among other things:

- (a) Acquiring knowledge of the client's accounting systems, policies and internal procedures;
- (b) Establishing the expected degree of reliance to be placed on internal control;
- (c) Determining and programming the nature, timing and extent of the audit procedures to be performed; and
- (d) Coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit."

48. Paragraph 16 of AAS 8 states, "the audit planning ideally commences at the conclusion of the previous year's audit, and alongwith the related

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programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

49. Many audits of small entities are conducted by the audit engagement partner (or sole practitioner) working with one audit assistant (or without audit assistants). These circumstances will affect the auditor's approach to planning: planning can be performed on a less formal scale. With a smaller team, co-ordination and communication between team members is less complicated.

50. Planning the audit of a small entity need not be a complex or time-consuming exercise. Planning 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.

51. Planning the audit can, however, start at the completion of the previous year's audit as the auditor will be well placed to plan ahead for the next year. A file note prepared at this time, based on a review of the working papers and highlighting issues identified in the audit just completed that will have some bearing on the next year, can be particularly helpful. This file note, amended for changes arising during the subsequent year, could then be the initial basis for planning the next audit.

52. 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.

53. 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 should be tailored to the particular circumstances of the client.

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AAS 11, Representations by Management

54. Paragraphs 2, 3, 5 & 6 of AAS 11 state –

“2. The auditor should obtain representation from management, where considered appropriate.

3. The auditor should obtain evidence that management acknowledges its responsibility for the appropriate preparation and presentation of financial information and that management has approved the financial information.”

“5. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific enquiries. When such representations relate to matters which are material to the financial information, the auditor should:

- (a) seek corroborative audit evidence from sources inside or outside the entity;
- (b) evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and
- (c) consider whether the individuals making the representation can be expected to be well-informed on the matter.

6. Representation by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the quantity, existence and costs of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.”

55. 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.

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The auditor assesses the representation 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. In view of specific characteristics of small entities described in paragraph 6, while assessing the evidentiary value of management representation it may be viewed with circumspection. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.

AAS 13, Audit Materiality

56. Paragraph 3 of AAS 13 states:

“Information is material if its misstatement (i. e., omission of erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.”

57. 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.

58. 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

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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.

59. 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.

60. Whatever basis may be used to assess materiality for audit planning purposes, when the auditors assess 'the aggregate of uncorrected misstatements', their conclusion as to whether the financial statements give a true and fair view is based on a re-assessment of materiality. 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.

61. 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.

62. 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.

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AAS 14, Analytical Procedures

63. Paragraph 2 and 3 of AAS 14 state –

“2. The auditor should apply analytical procedures at the planning and overall review stages of the audit. Analytical procedure may also be applied at other stages.

3. “Analytical procedures” means the analysis of significant ratios and trend including the resulting investigation of fluctuations and relationships that are in consistent with other relevant information or which deviate from predicted amounts.”

Analytical Procedures in Planning the Audit

64. 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

65. 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.

66. 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

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the payroll. The use of widely recognized trade ratio (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.

67. 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.

68. However, different types of analytical procedure provide different levels of assurance. Analytical procedures 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

69. 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 with 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.

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AAS 15, Audit Sampling

70. Paragraphs 2-4 of AAS 15 state –

“2. When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.

“3. Audit sampling” means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

4. It is important to recognize that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population.”

71. 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.

72. The small population 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.

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73. 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. One choice to be made by the auditor is whether to use statistical or non-statistical sampling methods. Both methods involve the exercise of a high degree of judgement by the auditor. However, in the audit of small entities the required level of assurance can often be obtained in a cost-effective manner by the use of non-statistical methods of determining the sample size and selecting the sample items.

74. With non-statistical methods, auditors apply the auditing standards set out in the AAS when using their judgement to design the size and structure of the audit sample and to select the sample items. For example, they consider:

- ◆ the audit objective, to ensure the procedure is likely to achieve the objective;
- ◆ the population, to ensure it is appropriate and complete (a sample cannot provide evidence about the completeness of the population from which it is drawn).

The auditors select the sample items in such a way that they can reasonably be expected to be representative of the population in respect of the relevant characteristics. Three methods commonly used are random, systematic and haphazard selection: these are described in para 19 of the AAS. So-called 'block' testing methods (for example, examining all items of a particular type in one month) are not designed to be representative of the total population and are therefore not an application of audit sampling. (Block testing may, however, form part of other audit techniques, such as analytical procedures).

AAS 16, Going Concern

75. AAS 16 paragraphs 1 to 6 state as follows:

"1. The purpose of this Statement on Standard Auditing Practices (AAS) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going

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concern assumption as a basis for the preparation of the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in absence of information to the contrary. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the entity may not be able to realize its assets at the recorded amounts and there may be changes in the amount and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted.

5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.

6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

Financial Indications

- ◆ Negative net worth or negative working capital.
- ◆ Fixed term borrowing approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- ◆ Adverse key financial ratios.

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- ◆ Substantial operating losses.
- ◆ Substantial negative cash flows from operations.
- ◆ Arrears or discontinuance of dividends.
- ◆ Inability to pay creditors on due dates.
- ◆ Difficulty in complying with the terms of loan agreements.
- ◆ Change from credit to cash-on-delivery transactions with suppliers.
- ◆ Inability to obtain financing for essential new product development or other essential investments.
- ◆ Entering into a scheme of arrangement with creditors for reduction of liability.

Operating Indications

- ◆ Loss of key management without replacement.
- ◆ Loss of a major market, franchise, licence, or principal supplier.
- ◆ Labour difficulties or shortages of important supplies.

Other Indications

- ◆ Non-compliance with capital or other statutory requirements.
- ◆ Pending Legal Proceedings against the entity that may, if successful, result in judgements that could not be met.
- ◆ Changes in legislation or government policy.
- ◆ Sickness of the entity under any statutory definition.”

76. The assessment of going concern may be dependent on a particular assumption. For example;

- (a) if the entity's operations are largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn from the business. For example, the continuance of the small entity may be dependent on the owner-manager subordinating his loan account to the entity in favour of other creditors, bank, other financial institutions;
- (b) if the entity has, in effect, a single customer, it will be important that the trading relationship continues; or

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- (c) If aggregate contingent liabilities are more than net worth.

In such circumstances, the auditor considers the evidence available to support the assumption in question. For example, the auditor inspects appropriate evidence of the subordination. Where the entity is dependent on additional support from the owner-manager, the auditor needs to consider 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.

AAS 17, Quality Control for Audit Work

77. 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.

78. Paragraph 1 of AAS 17 states: "The purpose of this Statement on Standard Auditing Practices (AAS) is to establish standards on the quality control:

- (a) policies and procedures of an audit firm regarding audit work generally; and
- (b) procedures regarding the work delegated to assistants on an individual audit."

79. Paragraph 6 of AAS 17 states that the objectives of quality control policies to be adopted by an audit firm will ordinarily incorporate the following:

- (a) professional requirements;
- (b) skills and competence;
- (c) assignment;
- (d) delegation;
- (e) consultation;
- (f) acceptance and retention of clients; and
- (g) monitoring

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80. 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.

81. The requirements of AAS 17 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.

82. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with AASs. 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 judgements made in the course of the audit can present practical problems when the same individual also performed the entire audit. It can often therefore be helpful for that individual to allow a short interval after performing the entire audit work before reviewing the working papers relating to any material issues with, so far as possible, a ‘fresh eye’. 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.

AAS 18, Audit of Accounting Estimates

83. Paragraphs 2 & 3 of AAS 18 state –

“2. The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.

3. “Accounting estimate,” means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

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- ◆ Allowances to reduce inventory and accounts receivable to their estimated realisable value.
- ◆ Provisions to allocate the cost of fixed assets over their estimated useful lives.
- ◆ Accrued revenue.
- ◆ Provision for taxation.
- ◆ Provision for a loss from a lawsuit.
- ◆ Insurer's liability for outstanding claims.
- ◆ Losses on construction contracts in progress.
- ◆ Amortization of certain items like goodwill and deferred revenue expenditure.
- ◆ Provision to meet warranty claims
- ◆ Provision for retirement benefits in the financial statements of employers.”

84. The steps ordinarily involved in reviewing and testing of the process used by management are:

- (a) Evaluation of the data and consideration of assumptions on which the estimate is based;
- (b) Testing of the calculations involved in the estimate;
- (c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and
- (d) Consideration of management's approval procedures.

86. Although the owner-manager is responsible for determining the amount of the estimate to be included in the financial report, the auditor of a small entity may often be 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 requirement of AAS 18. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding accuracy and the underlying assumptions used in arriving at the estimates.

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AAS 19, Subsequent Events

87. AAS 19, paragraphs 2 and 4 state as follows:

“2. The auditor should consider the effect of subsequent events on the financial statements and on the auditor’s report.

4. The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor’s report that may require adjustment of, or disclosure in, the financial statements have been identified.”

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

88. It is not common for small entities to be required to report shortly after their period end. It is often the case that more time elapses between the period end and the approval or signature of the financial statements by the owner-manager in the case of small entities than in the case of large entities. The period to be covered by the auditors’ subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunities for the occurrence of subsequent events that can affect the financial statement.

89. The subsequent event procedures that the auditor of small entities 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 upto date and minutes of the meetings of the directors have not been prepared, relevant procedures can take the form of enquiry of the owner-manager, recording the owner-manager’s responses and inspection of bank statements.

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

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

91. Where, as in many small entities, the meeting at which the financial statements are approved or signed is immediately followed by the annual

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general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.

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

AAS 20, Knowledge of the Business

93. Paragraph 2 of AAS 20 requires that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial statements or on the examination or audit report. Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.

94. The Appendix to AAS 20 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.

95. 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.

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- ◆ Legal or regulatory issues facing the entity, including its relationship with the taxation authorities.
- ◆ The accounting records.
- ◆ The control environment.

96. 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 which are being engaged in the audit. Small entities are ordinarily not complex and their audit rarely involves large teams of assistants. In many cases, the partner and perhaps, a single assistant may perform the audit. 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.

AAS 21, Consideration of Laws and Regulations in an Audit of Financial Statements

97. Paragraph 2 of AAS 21, 'Consideration of Laws and Regulations in an Audit of Financial Statements' requires that when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

98. 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

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to which they are subject is less complicated than the environment in which large or more diversified entities operate.

99. 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.

AAS 22, Initial Engagements—Opening Balances

100. Paragraphs 3 of AAS 22 states:

“For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- (a) the closing balances of the preceding period have been correctly brought forward to the current period;
- (b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and
- (c) appropriate accounting policies are consistently applied.”

101. AAS 22 gives guidance on circumstances in which the opening balances are derived from financial statements of the preceding period which were not audited.

102. The fact that the preceding period financial statements were not audited does not reduce the auditors’ need to obtain sufficient audit evidences regarding the opening balances and comparatives. Information about some of the opening balances may be readily available (for example, cash, debtors and creditors) and evidence may also be obtained through some of the audit procedures in the current period (for example, debtor write offs, stock obsolescence and fixed assets). Where the auditors cannot obtain such evidence by other means, they consider the implications for their report.

AAS 23, Related Parties

103. Paragraph 2 of AAS 23 states:

“2. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party

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transactions that are material to the financial statements. However, an audit cannot be expected to detect all related party transactions.”

104. 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.

105. 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. Where detailed substantive tests are required, the fact that the accounting populations in small entities are generally small may enable the auditor to examine all items.

106. 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. In this context, when performing audit procedures which may identify related parties and related party transactions, the auditor should consider the substance of the relationship and/ or transaction being tested and not merely the legal form.

AAS 25, Comparatives

107. Paragraph 2 and 3 of AAS 25 states:

“2. The auditor should determine whether the comparatives comply, in all material respects, with the financial reporting framework relevant to the financial statements being audited.

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3. The existence of differences in financial reporting frameworks results in comparative financial information being presented differently in each framework. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation that are referred to in this AAS are as follows:

- (a) corresponding figures where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures” for the purpose of this AAS). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures; and
- (b) comparative financial statements where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.”

AAS 26, Terms of Audit Engagement

108. AAS 26, paragraph 2 and 5 states:

“2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.”

“5. In the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoiding any misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor’s acceptance of the appointment, the objective and scope of the audit and the extent of the auditor’s responsibilities to the client.”

109. 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

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responsibility, particularly where the owner-manager has outsourced the preparation of the financial statements. 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 AAS 26 provides an example of an audit engagement letter.

AAS 28, The Auditor's Report on Financial Statements

110. AAS 28, paragraph 2 and 4, states:

“2. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.”

“4. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.”

111. 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.

112. 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.

AAS 29, Auditing in a Computer Information Systems Environment

113. AAS 29, paragraph 3 and 4, states:

“3. The auditor should consider the effect of a CIS environment on the audit. The auditor should evaluate, *inter alia*, the following factors to determine the effect of CIS environment on the audit:

- (a) the extent to which the CIS environment is used to record, compile and analyse accounting information.

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- (b) the system of internal control in existence in the entity with regard to:
 - (i) flow of correct and complete data to the processing centre;
 - (ii) processing, analysis and reporting tasks undertaken in the installation; and
- (c) the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

4. The auditor should have sufficient knowledge of the Computer Information Systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of CIS environment.”

114. When the CIS are significant the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risk. The nature of the risks and the internal control characteristics in CIS environments include the following:

- ◆ Lack of transaction trails
- ◆ Uniform processing of transactions
- ◆ Lack of segregation of functions
- ◆ Potential for errors and irregularities
- ◆ Initiation or execution of transaction.
- ◆ Dependence of other controls over computer processing
- ◆ Potential for increased management supervision
- ◆ Potential for use of computer-assisted audit techniques

Both the risks and the controls introduced as a result of these characteristics of CIS have a potential impact on the auditor’s assessment of risk, and the nature, timing and extent of audit procedures.

115. 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,

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116. 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 should have sufficient knowledge of the computer information system to plan, direct, supervise, and review the work performed. The auditor should consider whether specialized skills are needed in an audit.

117. 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.

Overall Review of Financial Statements

118. For the purpose of overall review of financial statements analytical procedures are to be carried out on the basis of considerations enumerated in Paragraphs 4 and of AAS 14.

119. The overall review of the financial statements is not primarily a matter of completion of checklists on compliance matters. In addition it requires the auditors to ‘stand back’ from the detail of accumulated audit evidence relating to individual components of the financial statements, so as to be able to express an objective opinion on the financial statements as a whole. The auditors’ consideration of whether the financial statement assertions are:

- (a) consistent with their knowledge of the business and the results of other audit procedures; and
- (b) fairly disclosed,

is a matter of the auditors’ judgement, requiring appropriate levels of experience and skill.

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120. The auditors' analytical procedures applied when completing the audit are designed to assist in arriving at an overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the business; the results of such procedures are therefore an important factor to be considered for this purpose.