
MMASA Summary ©

Some considerations pertaining to “smaller entities”

International Standards on Auditing (ISA) apply to an audit of historical financial information. How these standards are applied and the results of its application in respect of the audit of an identified set of financial statements is a matter of professional judgement of the auditor responsible and accountable for the audit, taking cognisance of the specific circumstances of the auditee concerned.

The ISA’s acknowledge the fact that the size and complexity of the auditee and the financial statements subject to audit have a primary influence on the planning and performance of the audit. In this regard various ISA’s emphasise considerations pertaining to smaller entities.

IAPS 1005 define a “small entity” as follows:

“Small entity” involves the consideration of the size of the entity, but also (and maybe more importantly) qualitative characteristics of the entity. Qualitative indicators include:

- There is concentration of ownership and management in a small number of individuals (often a single individual); and
- Few sources of income; or
- Unsophisticated record-keeping; or
- Limited internal controls together with the potential for management override of controls.

This document provides a summary of references in the following ISA’s in respect of considerations in the case of “smaller entities”: ISA 240, 300, 315 and 330 (Redrafted and issued in December 2006).

Furthermore, relevant small entity considerations and matters from IAPS 1005 pertaining to the following ISA’s are included: ISA 250, 320, 510, 560 and 570.

The following key applies to the summary:

- “C” Provides the context within which the specific ISA makes reference to considerations in the case of smaller entities.
- “S” Extract from the ISA concerned relating to smaller entities.

ISA 240: The auditor’s responsibilities relating to fraud in an audit of financial statements

- C The auditor shall make enquiries of management regarding management’s assessment of the risk of fraud.
- S 240.A13
In some entities, particularly smaller entities, the focus of management’s assessment may be on the risks of employee fraud or misappropriation of assets.
- C The auditor shall obtain an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the

risks of fraud (unless all of those charged with governance are involved in managing the entity).

S 240.A21

In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

C The auditor shall evaluate whether one or more fraud risk factors are present.

S 240.A27

In the case of a small entity, some or all of these considerations (*in respect of the evaluation of fraud risk factors*) may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

ISA 250: Consideration of laws and regulations in an audit of financial statements

Matters from IAPS 1005

- 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.
- 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 300: Planning an audit of financial statements

C The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit.

S 300.A12

In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period

based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement.

C The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

S 300.A16

When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. 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 performs 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.

C The auditor shall document the audit plan

S 300.A20

For the audit plan, standard audit programs or checklists drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

ISA 315: Identifying and assessing risks of material misstatement through understanding the entity and its environment

C The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances.

S 315.A14

Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

C The auditor shall obtain an understanding of certain key aspects of the entity and its environment as identified in ISA 315.11. Such key aspects include the measurement and review of the entity's financial performance.

S 315.A37

Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

C The auditor shall obtain an understanding of internal control relevant to the audit.

S 315.A41.

Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

- C The auditor shall obtain an understanding of internal control relevant to the audit.
S 315.A45
Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.
- C The auditor shall obtain an understanding of control environment (one of the components of internal control).
S 315.A72 – A74
The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.
- In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.
- Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.
- C The auditor shall obtain an understanding of an entity's risk assessment process (one of the components of internal control). If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or represents a material weakness in the entity's internal control.
S 315.A76
There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.
- C The auditor shall obtain an understanding of an entity's information system, including the related business processes, relevant to financial reporting (one of the components of internal control). Such understanding normally relates to the following areas: (a) Classes of transactions, (b) Procedures by which transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements, (c) Related accounting records and supporting information, (d) How the information system captures events and conditions, other than transactions,

that are significant to the financial statements, (e) The financial reporting process used to prepare the entity's financial statements, and (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

S 315.A81

Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

C The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting (one of the components of internal control).

S 315.A83

Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

C The auditor shall obtain an understanding of control activities relevant to the audit (one of the components of internal control).

S 315.A89 – A90

The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

C The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit (one of the components of internal control).

S 315.A96

Management's monitoring of control is often accomplished by management's or the owner manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

ISA 320: Audit materiality

Matters from IAPS 1005

- 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 is to use a percentage of a key figure in the

financial statements such as one of the following: (i) Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure), (ii) Revenue, (iii) Balance sheet total.

- The auditor uses the best information available at the time. This may include draft financial statements for the current year (if available), or the current year's trial balance (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.
- 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.
- 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.
- At the reporting stage 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.

ISA 330: The auditor's responses to assessed risks

C In designing the further audit procedures to be performed, the auditor shall consider the reasons for the risk assessment at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and whether the risk assessment takes account of relevant controls (i.e., the control risk).

S 330.A18

In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

ISA 510: Initial engagement – Opening balances

Matters from IAPS 1005

- No specific small entity considerations.

ISA 560: Subsequent events

Matters from IAPS 1005

- It is not common for small entities to be required to report shortly after their period-end. This means that more time passes between the balance sheet date and the date of the auditor's report, allowing more opportunity for the occurrence of subsequent events. ISA 560 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the auditor's report.
- When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant subsequent events procedures can take the form of inquiry of the owner-manager, recording the owner-manager's responses and inspection of available books and records, including bank statements.

ISA 570: Going concern

Matters from IAPS 1005

- The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but may lack reserves to sustain operations.
- Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the possibility of the loss of a principal supplier, major customer or key employee, and the possible loss of the right to operate under a license, franchise or other legal agreement.
- 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 favour 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.

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