

Auditing and Assurance Guidance Statement

AGS 1048

(March 2004)

The Special Considerations in the Audit of Small Entities

Prepared by the **Auditing & Assurance Standards Board** of the
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Australian Accounting Research
Foundation
Level 10,
600 Bourke Street
Melbourne Victoria 3000
AUSTRALIA

Phone: (03) 9641 7433
Fax: (03) 9602 2249
E-mail: standard@aarf.asn.au
Website: www.aarf.asn.au

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AUDITING AND ASSURANCE GUIDANCE STATEMENT
AGS 1048 “THE SPECIAL CONSIDERATIONS IN THE AUDIT OF
SMALL ENTITIES”

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² AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and AUS 406, “The Auditor’s Procedures In Response to Assessed Risks” issued in February 2004 contain small entity audit considerations and are applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .54 to .65 of this AGS will be withdrawn when these new AUSs become effective.

³ See footnote 3.

⁴ AUS 502, “Audit Evidence,” which was revised and issued in February 2004, contains small entity audit considerations and is applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .66 to .70 of this AGS will be withdrawn when the revised AUS becomes effective.

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MAIN FEATURES

This Auditing and Assurance Guidance Statement (AGS):

- (a) describes the characteristics commonly found in small entities;
- (b) provides guidance on the application of AUSs issued until March 2003 to the audit of small entities;
- (c) contains a commentary on the application of AUSs when the auditor also prepares the accounting records and financial report of small entity clients.

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Introduction

- .01 Auditing and Assurance Standards (AUSs) contain basic principles and essential procedures together with related guidance that apply to the audit of the financial report of any entity, irrespective of its size, its legal form, ownership or management structure, or the nature of its activities. The Auditing & Assurance Standards Board (AuASB) recognises that small entities give rise to a number of special audit considerations. This Auditing and Assurance Guidance Statement (AGS) does not establish any new requirements for the audit of small entities; nor does it establish any exemptions from the requirements of AUSs. All audits of small entities are to be conducted in accordance with AUSs.
- .02 The objective of this AGS is to describe the characteristics commonly found in small entities and indicate how they may affect the application of AUSs. This AGS includes:
 - (a) Discussion of the characteristics of small entities; and
 - (b) Guidance on the application of AUSs issued until March 2003 to the audit of small entities.
- .03 The owner-manager of a small entity often needs assistance with the preparation of accounting records and a financial report. Professional Statement F1 “Professional Independence” deals with independence, and auditors considering rendering other services to small entity audit clients are to refer to this statement. The appendix to this AGS contains a commentary on the application of AUSs when auditors also prepare the accounting records and financial report of small entity audit clients.
- .04 In determining the nature and extent of the guidance provided in this AGS, the AuASB 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 AUSs. 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.

The Characteristics of Small Entities

- .05 The auditor of any entity adapts the audit approach to the circumstances of the entity and the engagement. The audit of a small entity differs from the audit of a large entity as documentation may be

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unsophisticated, and audits of small entities are ordinarily less complex and may be performed using fewer assistants.

- .06 The meaning of “small entity” in this context gives consideration not only to the size of an entity but also to its typical qualitative characteristics. Quantitative indicators of the size of an entity may include balance sheets totals, revenue and the number of employees, but such indicators are not definitive. Therefore it is not possible to give an adequate definition of a small entity solely in quantitative terms.
- .07 For the purposes of this AGS, 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 individual⁵); and
 - (b) One or more of the following are also found:
 - Few sources of income;
 - Unsophisticated record-keeping;
 - Limited internal controls together with the potential for management override of controls.
- .08 The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purposes of this AGS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

Concentration of Ownership and Management

- .09 Small business entities ordinarily have few owners; often there is a single proprietor. The owner may employ a manager to run the entity but is in most cases directly involved in running the entity on a day-to-day basis. Likewise, in the case of small not-for-profit organisations and public sector entities, although there are often several individuals charged with formal responsibility for the entity, there may be few people involved in managing the entity on a day-to-day basis.

⁵ The word “individual” denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a “small entity” for the purpose of this AGS if the owner exhibits the relevant characteristics.

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- .10 This AGS uses the term “owner-manager” to indicate the proprietors of entities who are involved in the running of the entity on a day-to-day basis. Where proprietors are not involved on a day-to-day basis, the term “owner-manager” is used to refer to both the proprietors, and to any managers hired to run the entity.

Few Sources of Income

- .11 Small entities often have a limited range of products or services and operate from a single or limited number of locations. Such characteristics may make it easier for the auditor to acquire, record, and maintain knowledge of the entity than would be the case with a larger entity. The application of a wide range of audit procedures may be straightforward in such circumstances. For example, effective predictive models for use in analytical procedures can sometimes be constructed. Analytical procedures may provide useful evidence, sometimes reducing the need for other substantive procedures. In addition, in many small entities, accounting populations are often small and easily analysed.

Unsophisticated Record-Keeping

- .12 Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of a financial report. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:
- (a) All the transactions and other accounting information that should have been recorded have in fact been recorded;
 - (b) Assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and
 - (c) Fraud or error in processing accounting information will be detected.
- .13 Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated or poor, which results in a greater risk that the financial report may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.

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- .14 Small entities often find it convenient to use branded accounting software packages designed for use on a personal computer. Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

Limited Internal Controls

- .15 Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor desirable, the fact that there are few employees limits the extent to which segregation of duties is practicable. However, for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. Supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.
- .16 The owner-manager occupies a dominant position in a small entity. The owner-manager’s direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small entities. The exercise of this control can also compensate for otherwise weak internal control procedures. For example, in cases where there is limited segregation of duties in the area of purchasing and cash disbursements, internal control is improved when the owner-manager personally signs all cheques. When the owner manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.
- .17 While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager’s dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial report. For example, the owner-manager may direct personnel to make disbursements that they would otherwise not make in the absence of supporting documentation.
- .18 The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional

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scepticism. 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

- .19 The commentary that follows provides guidance on the application of AUSs to the audit of a small entity. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant AUS and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of AUSs, the auditor refers to the AUS concerned. Where an AUS is, in principle, applicable to the audit of the financial report 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 AUS.

AUS 204: Terms of Audit Engagements

- .20 In many cases, owner-managers of small entities are not fully aware of their own responsibilities or those of their auditors. In particular, owner-managers may not appreciate that the financial report is their responsibility, particularly where the owner-manager has outsourced the preparation of the financial report.
- .21 One of the purposes of an engagement letter is to communicate clearly the respective responsibilities of the owner-manager and the auditor. The Appendix to AUS 204 provides an example of an audit engagement letter.
- .22 Paragraph .06 of AUS 204 states that the auditor may wish to include in the engagement letter the auditor’s expectation of receiving written confirmation concerning representations made in connection with the audit. AUS 520, “Management Representations” requires the auditor to obtain evidence that management acknowledges its responsibility for the fair presentation of the financial report in accordance with the relevant financial reporting framework, and has approved the financial report. Other AUSs require certain specific representations. The auditor may consider including in the engagement letter an indication of the anticipated matters on which management representations will be obtained. This provides an opportunity for the auditor to discuss with the owner-manager at the outset of the engagement the reasons for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained, which

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may help to avoid a problem arising as the audit is nearing completion. It will also help the auditor consider audit and reporting implications if the owner-manager cannot make or refuse to make the necessary representations.

- .23 In some cases the auditor may determine that it will not be possible to obtain sufficient evidence to form an opinion on the financial report because of weaknesses that may arise from the characteristics of the small entity. In these circumstances, and where permitted by the relevant jurisdiction, the auditor may decide not to accept the engagement, or to withdraw from the engagement after acceptance. Alternatively, the auditor may decide to continue with the engagement but express an “except for” or an inability to form an opinion. The auditor has regard to paragraph .54 of AUS 702 “The Audit Report on a General Purpose Financial Report” which states that the auditor would not ordinarily accept an audit engagement in which the terms of the engagement are such that the auditor believes that an inability to form an opinion would be expressed.

AUS 206: Quality Control for Audit Work

- .24 The primary objective of quality control is to provide assurance that audits are conducted in accordance with AUSs. The auditor of a small entity keeps this objective in mind when determining the nature, timing, and extent of the policies and procedures appropriate to the circumstances.
- .25 Paragraph .05 of AUS 206 states: “The nature, timing and extent of an audit firm’s quality control policies and procedures depend on a number of factors such as the size and nature of the practice...” Many audits of small entities are undertaken by small audit firms. Such firms, in determining appropriate policies and procedures, consider the areas listed in paragraph .06 of AUS 206 which are:
- (a) Professional Independence;
 - (b) Employment;
 - (c) Assignment of Personnel to Engagements;
 - (d) Supervision;
 - (e) Guidance and Assistance;
 - (f) Client Evaluation; and

(g) Allocation of Administrative and Technical Responsibilities.

.26 With the possible exception of “assignment of personnel to engagements” and “supervision” (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.

.27 The requirements of AUS 206 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.

.28 The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with AUSs. 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. 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.

.29 The auditor may have an in-depth understanding of the entity and its business, because of the close relationship between the auditor and the owner-manager, the size of the entity being audited, or the size of the audit team and the audit firm. However, that understanding does not eliminate the need for the auditor to maintain adequate working papers. Working papers assist in the planning, performance, supervision and review of the audit, and they record the evidence obtained to support the audit opinion.

.30 The discipline imposed by the requirement to record the reasoning and conclusions on significant matters requiring the exercise of judgement can often, in practice, add to the clarity of the auditor's

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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.

- .31 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.
- .32 Paragraph .11 of AUS 208 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 judgement in determining the contents of working papers in any particular case.
- .33 Nevertheless, the auditor of a large or a small entity, records in the working papers:
 - (a) The audit planning;
 - (b) An audit program setting out the nature, timing, and extent of the audit procedures performed;
 - (c) The results of those procedures; and
 - (d) The conclusions drawn from the audit evidence obtained together with the reasoning and conclusions on all significant matters requiring the exercise of judgement.

AUS 210: The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report

- .34 Appendix 1 to AUS 210 contains examples of fraud risk factors. An example relevant to small entities is “management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.” Although the presence of a dominant owner-manager is an important factor in the overall control environment, as the need for management authorisation can compensate for otherwise weak control procedures and reduce the risk of employee fraud and error, it 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

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significant influence on the auditor’s approach. The auditor’s assessment of the effect of such matters is conditioned by knowledge of that particular entity and the integrity of its owner-manager. Examples of matters that auditors take into account in this assessment include the following:

- Whether the owner-manager has a specific identifiable motive (for example, dependence of the owner-manager on the success of the entity) to distort the financial report, combined with the opportunity to do so.
 - Whether the owner-manager makes no distinction between personal and business transactions.
 - Whether the owner-manager’s life-style is materially inconsistent with the level of his or her remuneration (this includes other sources of income of which the auditor may be aware by completing the owner-manager’s tax return, for example).
 - Frequent changes of professional advisers.
 - Whether the start date for the audit has been repeatedly delayed or there are unexplained demands to complete the audit in an unreasonably short period of time.
 - Unusual transactions around the year-end that have a material effect on profit.
 - Unusual related party transactions.
 - Payments of fees or commissions to agents and consultants that appear excessive.
 - Loan accounts, on which no payments are made, or which do not earn interest, and for which the owner-manager is unable to provide any satisfactory explanation.
 - Advances given to or taken from third parties for supply of goods and services against which no goods or services have been provided for an unreasonably long period.
 - Disputes with tax authorities.
 - Unusual delay in providing explanations or representations sought by the auditor for unusual transactions.
- .35 Paragraph .20 of AUS 210 requires the auditor, when planning the audit, to discuss with other members of the audit team the

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susceptibility of the entity to material misstatements in the financial report resulting from fraud or error. Many small entity audits are carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations this requirement is not relevant, but the audit engagement partner, who will be planning the conduct of the audit personally, considers whether, and where, errors may be more likely to occur or how fraud might be perpetrated when assessing the risks of material misstatement and designing further audit procedures to respond to those risks.

- .36 Paragraph .22 of AUS 210 requires the auditor, when planning the audit, to make inquiries of management *inter alia* to obtain:
- (a) An understanding of management’s assessment of the risk that the financial report may be materially misstated as a result of fraud, and the accounting and internal control systems management has put in place to address such risk; and
 - (b) Knowledge of management’s understanding regarding the accounting and internal control systems in place to prevent or detect error.

In small entities the owner-manager’s assessment may be less formal and less frequent, or the owner-manager may not conduct an assessment at all. Also, as noted in paragraphs .12 to .18 of this AGS, limited or more informal accounting and internal control systems may exist. Nevertheless, the auditor still makes the inquiries, as they provide a basis for obtaining an understanding of the actions the owner-manager has taken to prevent and detect fraud and error, and are also important in obtaining an understanding of the owner-manager’s attitude towards fraud and error.

- .37 Paragraph .51(a) of AUS 210 requires the auditor to obtain written representation from management that it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error. As noted in paragraph .12 to .18 of this AGS, limited or more informal accounting and internal control systems may exist. As a result, the owner-manager may be of the opinion that it is not possible to provide the required representation. The primary responsibility for the prevention and detection of fraud and error rests with management, irrespective of the size of the entity. It therefore is important to obtain the owner-manager’s acknowledgement of this responsibility. Such acknowledgement could be expanded to cover

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compensating controls (refer paragraph .16 of this AGS). If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses an “except for” or an inability to form an opinion.

- .38 Paragraph .51(d) of AUS 210 requires the auditor to obtain written representations from management that it has disclosed to the auditor the results of its assessment of the risk that the financial report may be materially misstated as a result of fraud. As noted in paragraph .36 of this AGS, the owner-manager of a small entity may not have conducted such assessment and therefore may be of the opinion that it is not possible to provide the required representation. The auditor requests the owner-manager to reflect in a written representation that such assessment was not conducted, as well as any actions that the owner-manager has taken to prevent or detect fraud and error. If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses an “except for” or an inability to form an opinion.

AUS 218: Consideration of Laws and Regulations in an Audit of a Financial Report

- .39 AUS 218 requires the auditor to obtain a general understanding of the legal and regulatory framework to which the entity is subject. Apart from those laws and regulations that relate directly to the preparation of the financial report, there may also be laws and regulations that provide a legal framework for the conduct of the entity and that are central to the entity’s ability to conduct its business. As most small entities have uncomplicated activities, the legal and regulatory environment to which they are subject is less complicated than the environment in which larger more diversified entities operate.
- .40 Once the auditor of a small entity has identified any relevant industry-specific laws and regulations, this information is recorded as permanent information as part of the knowledge of the entity and is reviewed and updated as necessary in subsequent years.

AUS 710: Communicating with Management on Matters Arising from an Audit

- .41 AUS 710 requires the auditor to communicate significant matters relating to the audit, or identified as a result of audit procedures performed, to an appropriate level of management on a timely basis. The auditor uses professional judgement to evaluate the significance of matters, to determine the appropriate level of management with

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whom to communicate, and to select the appropriate method of communication. ‘Management’ could range from an owner/manager to a governing body. In a small entity, the governing body may consist of the same individuals as those charged with management of the entity. It may also include spouses or other relatives, who may not be involved in the supervision or control of the entity on a day-to-day basis. The auditor determines who are entrusted with the supervision, control and direction of the small entity.

AUS 302: Planning

- .42 Audits of small entities are conducted by very small audit teams, many involve the audit engagement partner (or sole practitioner) working with one audit assistant (or without audit assistants). With a smaller team, co-ordination and communication between team members is easier. Planning the audit of a small entity need not be a complex or time-consuming exercise, it varies according to the size of the entity and the complexity of the audit. For example, on some small audits, planning may be carried out at a meeting with the owner-manager of the entity or when the entity’s records become available to the auditor for audit. Planning the audit can, however, start at the completion of the previous period’s audit as the auditor will be well placed to plan for the next period. A brief file note prepared at this time, based on a review of the working papers and highlighting issues identified in the audit just completed can be particularly helpful. This file note, amended for changes arising during the subsequent period, could then be the initial basis for planning the next audit. Discussion with the owner-manager is a very important part of planning, especially in a first-year audit. Such discussions do not need a special meeting they can often take place as a part of other meetings, conversations or correspondence.
- .43 In principle, planning comprises developing a general strategy (reflected in an overall audit plan) and a detailed approach for implementing the strategy in terms of the nature, timing and extent of the audit work (reflected in an audit program). However, a practical approach to the audit of a small entity need not involve excessive documentation. In the case of a small entity where, because of the size or nature of the entity, the details of the overall plan can be adequately documented in the audit program, or vice versa, separate documentation of each may not be necessary. When standard audit programs are used, these are appropriately modified and tailored to the particular client circumstances.

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*AUS 304: Knowledge of the Business*⁶

- .44 The Appendix to AUS 304 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.
- .45 The auditor of a small entity is often in a position to have a wide and up-to-date knowledge of the business by virtue of the fact that there may be regular close contact with the owner-manager. This relationship often provides information on matters such as the following:
- The activities of the small entity, its main products and services, and the industry in which it operates.
 - The management style, aims, and attitudes of the owner-manager.
 - Any plans for changes to the nature, management or ownership of the entity.
 - Trends in profitability or liquidity and the adequacy of working capital.
 - Legal or regulatory issues facing the entity, including its relationship with the taxation authorities.
 - The accounting records.
 - The control environment.
- .46 Documenting the auditor’s knowledge of the business is equally important in all audits, irrespective of the size of the entity. However, the extent of the documentation depends on the complexity of the entity and the number of persons who will be engaged on the audit. Small entities are ordinarily not complex and their audit rarely

⁶ AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” issued in February 2004 contains special considerations in the audit of small entities and is applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .44 to .46 of this AGS will be withdrawn when AUS 402 becomes effective.

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involves large teams of assistants. In many cases the audit may be performed by the audit engagement partner and, perhaps, a single assistant. Therefore, whilst the auditor of a small entity will prepare documentation to a level sufficient to:

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

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

AUS 306: Materiality and Audit Adjustments

- .47 “Materiality” means, in relation to information, that information which if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by the management or governing body of the entity. Materiality is discussed in Accounting Standards AASB 1031/AAS 5 “Materiality”, Accounting Standards AASB 1001/AAS 6 “Accounting Policies” and Statement of Accounting Concepts SAC 3 “Qualitative Characteristics of Financial Information”

Planning Stage

- .48 For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgement about materiality is to focus the auditor’s attention on the more significant financial report 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 judgement 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 report 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.

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- .49 Often in the case of small entities, a draft financial report is not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year’s trial balance may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgement of materiality is to calculate materiality on the previous year’s audited financial report as amended for known circumstances in relation to the year subject to audit.
- .50 Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method, for example, to revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to considering materiality at the overall financial report level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.

Assessment of Materiality When Evaluating the Results of Audit Procedures

- .51 Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial report, incorporating all agreed adjustments and information obtained during the course of the audit.
- .52 Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgement. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.
- .53 In addition, although planning may have been based on a quantitative assessment of materiality, the auditor’s opinion will take into account not only the amount but also the qualitative nature of individual misstatements and the aggregate of unadjusted misstatements within the financial report.

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*AUS 402: Risk Assessments and Internal Controls*⁷

Inherent Risk

- .54 In the audit of a small entity, control risk is often assumed or assessed as high, at least for certain financial report 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 report assertions, rather than an assumption that it is high, may enable the auditor to conduct a more efficient and effective audit.

Control Risk

- .55 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.
- .56 After obtaining an understanding of the accounting and internal control systems, the auditor makes a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions. Substantive procedures may be reduced if reliance on these controls is warranted after investigation and testing. However, many internal controls relevant to large entities are not practical in the small entity, and as a result it may not be possible to rely on internal control to detect fraud or errors. For example, segregation of duties may be severely limited in small entities because accounting procedures may be performed by few persons who may have both operating and custodial responsibilities. Similarly, when there are few employees, it may not be possible to set up a system of independent checking of their work.

⁷ AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and AUS 406, “The Auditor’s Procedures In Response to Assessed Risks” issued in February 2004 contain small entity audit considerations and are applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .54 to .65 of this AGS will be withdrawn when these new AUSs become effective.

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- .57 Inadequate segregation of duties and the risk of error may, in some cases, be offset by other control procedures such as the exercise of strong supervisory controls by the owner-manager means of direct personal knowledge of the entity and involvement in transactions. However this, in itself, may introduce other risks such as the potential for management override and fraud. Particular difficulties include the possible understatement of income by the non-recording or misrecording of sales. In circumstances where segregation of duties is limited and evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor’s opinion on the financial report may have to be obtained entirely through the performance of substantive procedures.
- .58 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.
- .59 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

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

*AUS 214: Auditing in a CIS Environment*⁸

- .61 The increasing availability of computer-based accounting systems that are capable of meeting both functional and economic circumstances of

⁸ See footnote 3.

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even the smallest entity impacts on the audits of those entities. Small entities’ accounting systems often make use of personal computers. AGS 1018, “IT Environments - Stand-Alone Personal Computers” gives additional guidance regarding the special considerations of such an environment.

- .62 Small entities are likely to use less sophisticated hardware and software packages than large entities (often “packaged” rather than developed “in house”). Nevertheless, the auditor has sufficient knowledge of the computer information system to plan, direct, supervise, and review the work performed. The auditor may consider whether specialised skills are needed in an audit.
- .63 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 authorising source documents.
 - Entering data into the system.
 - Operating the computer.
 - Changing programs and data files.
 - Using or distributing output.
 - Modifying the operating systems.
- .64 The use of computer information systems by small entities may assist the auditor in obtaining assurance as to the accuracy and appropriateness of accounting records by reducing control risk. Computerised information systems may be better organised, less dependent upon the skills of people using them, and less susceptible to manipulation than non-computerised systems. The ability of the auditor to obtain relevant reports and other information may also be enhanced. Good computerised systems facilitate accurate double entry and the reconciliation of subsidiary ledgers with control accounts. Report generation and the production of bank reconciliations may be more disciplined and effective, and the availability of reports and other information to the auditor is often improved. The assurance provided by such features, providing they are properly evaluated and tested, may permit the auditor to limit the volume of substantive testing of transactions and balances.

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- .65 The general principles outlined in AGS 1060, "Computer Assisted Audit Techniques" (CAATs) are also applicable in small entity computer environments and give additional guidance regarding the special considerations in such an environment. However, in many cases where smaller volumes of data are processed, manual methods may be more cost-effective.

*AUS 502: Audit Evidence*⁹

- .66 AUS 502 recognises that, although audit evidence may be obtained in a number of ways, including from an appropriate mix of tests of control and substantive procedures, in some circumstances evidence may be obtained entirely from substantive procedures. A typical example of such circumstances would be where segregation of duties is limited and evidence of supervisory control is lacking, as is the case in many small entities.
- .67 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.
- .68 The auditor plans and conducts the audit with an attitude of professional scepticism. In the absence of evidence to the contrary, the auditor is entitled to accept representations as truthful and records as genuine.
- .69 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,

⁹ AUS 502, "Audit Evidence," which was revised and issued in February 2004, contains small entity audit considerations and is applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .66 to .70 of this AGS will be withdrawn when the revised AUS becomes effective.

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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.

- .70 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.

AUS 512: Analytical Procedures

Analytical Procedures in Planning the Audit

- .71 The auditor applies analytical procedures at the planning stage of the audit. The nature and extent of analytical procedures at the planning stage of the audit of a small entity may be limited by the timeliness of processing of transactions by the small entity and the lack of reliable financial information at that point in time. Small entities may not have interim or monthly financial information that can be used in analytical procedures at the planning stage. The auditor may, as an alternative, conduct a brief review of the general ledger or such other accounting records as may be readily available. In many cases, there may be no documented information that can be used for this purpose, and the auditor may obtain the required information through discussion with the owner-manager.

Analytical Procedures as Substantive Procedures

- .72 Analytical procedures can often be a cost-effective means of obtaining evidence required by the auditor. The auditor assesses the controls over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor

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will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

- .73 An unsophisticated predictive model can sometimes be effective. For example, where a small entity has employed a known number of staff at fixed rates of pay throughout the period, it will ordinarily be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial report and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items. The extent of analytical procedures in the audit of a small entity may be limited because of the non-availability of information on which the analytical procedures are based.
- .74 Predictive analytical procedures can often be an effective means of testing for completeness, provided the results can be predicted with a reasonable degree of precision and confidence. Variations from expected results may indicate possible omissions that have not been detected by other substantive tests.
- .75 However, different types of analytical procedure provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can be a very persuasive source of evidence and may eliminate the need for further verification by means of tests of details. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may be a less persuasive source of evidence, but may provide useful corroboration if used in combination with other audit procedures.

Analytical Procedures as Part of the Overall Review

- .76 The analytical procedures ordinarily performed at this stage of the audit are very similar to those that would be used at the planning stage of the audit. These include the following:
 - Comparing the financial report for the current year to those of previous years.
 - Comparing the financial report to any budgets, forecasts, or management expectations.

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- Reviewing trends in any important financial report ratios.
- Considering whether the financial report adequately reflects any changes in the entity of which the auditor is aware.
- Inquiring into unexplained or unexpected features of the financial report.

AUS 514: Audit Sampling and Other Selective Testing Procedures

- .77 There are a variety of methods of selecting items for testing, the auditor’s choice of an appropriate method will be guided by considerations of effectiveness and efficiency. The means available to the auditor are:
- (a) Selecting all items (100% examination);
 - (b) Selecting specific items; or
 - (c) Audit sampling.
- .78 The small populations ordinarily encountered in small entities may make it feasible to test:
- (a) 100% of the population; or
 - (b) 100% of some part of the population, for example, all items above a given amount, applying analytical procedures to the balance of the population, if it is material.
- .79 When the above methods of obtaining audit evidence are not adopted, the auditor considers the use of procedures involving audit sampling. When the auditor decides to use audit sampling, the same underlying principles apply in both large and small entities. The auditor selects sample items in such a way that the sample can be expected to be representative of the population.

AUS 526: Auditing Fair Value Measurements and Disclosures

- .80 In accordance with paragraph .04 of AUS 526, management is responsible for making the fair value measurements and disclosures included in the financial report. Management is also responsible for establishing an accounting and financial reporting process for determining the fair value measurements and disclosures, selecting appropriate valuation methods, identifying and adequately supporting any significant assumptions used, preparing the valuation and ensuring

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that the presentation and disclosure of the fair value measurements are in accordance with the entity’s identified financial reporting framework.

- .81 According to paragraph .11 of AUS 526, in some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgement need to be made as part of the measurement process.
- .82 The owner-manager of a small entity may not have the expertise and experience necessary to fulfill the responsibilities referred to in paragraph .80 for fair value measurements other than those based on published price quotations. The auditor recognises that the use of an expert, such as an independent valuer, may represent a significant cost to the small entity. However, if considered necessary in the circumstances, the auditor recommends to the owner-manager the use of an expert.
- .83 Any assistance provided by the auditor may create threats to the independence of the auditor. The auditor is to refer to paragraphs 2.71 to 2.76 of Professional Statement F1 “Professional Independence” for guidance on valuation services that may pose a threat and the potential safeguards that can be considered.
- .84 Paragraph .63 of AUS 526 requires the auditor to obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures. Because of the reasons set out in paragraph .82, the owner-manager may be of the opinion that it is not possible to provide the required representation. The responsibility for making the fair value measurements and disclosures included in the financial report rests with the owner-manager. If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses an “except for” or an inability to form an opinion.

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AUS 518: Related Parties

- .85 Significant transactions are often entered into between the small entity and the owner-manager, or between the small entity and entities related to the owner-manager. Small entities seldom have sophisticated policies and codes of conduct on related party transactions. Indeed, related party transactions are a regular feature of many entities that are owned and managed by an individual or by a family. Further, the owner-manager may not fully understand the definition of a related party, especially where relevant accounting standards deem certain relationships to be related and others not. The provision of management representations in respect of the completeness of disclosure may entail some explanation by the auditor of the technical definition of a related party.
- .86 The auditor of a small entity ordinarily performs substantive procedures on the identification of related parties and related party transactions. However, if the auditor assesses the risk of undisclosed related party transactions as low, such substantive procedures need not be extensive. The auditor often acts as the auditor of other entities related to the small entity, which may assist in identifying related parties.
- .87 The auditor’s in-depth knowledge of the small entity may be of assistance in the identification of related parties, which in many instances, will be with entities controlled by the owner-manager. This knowledge can also help the auditor assess whether related party transactions might have taken place without recognition in the entity’s accounting records.

AUS 706: Subsequent Events

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

- .88 It is not common for small entities to be required to report shortly after their period-end. It is often the case that more time elapses between the period-end and the approval or signature of the financial report by the owner-manager in the case of small entities, than in the case of large entities. The period to be covered by the auditor’s subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunity for the occurrence of subsequent events that can affect the financial report. AUS 706 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the auditor’s report.

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- .89 The subsequent events procedures that the auditor of a small entity performs will depend on the information that is available and, in particular, the extent to which the accounting records have been written up since the period-end. When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant procedures can take the form of inquiry of the owner-manager, recording the owner-manager’s responses and inspection of bank statements. Paragraph .05 of AUS 706 gives examples of some of the matters that it may be appropriate for the auditor to consider in the course of these inquiries.
- .90 The auditor may, depending on the circumstances, consider that the letter of representation should cover subsequent events. The letter of representation is ordinarily dated on the same day as the auditor’s report, thus covering the entire period since the period-end.
- .91 Guidance on the auditor’s procedures relating to subsequent events (if any) in the period between the approval of the financial report and the date of the auditor’s report is given in the guidance provided in this AGS on AUS 702, “The Audit Report on a General Purpose Financial Report.”

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

- .92 Where, as in many small entities, the meeting at which the financial report is approved or signed is immediately followed by the annual general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.
- .93 If the auditor becomes aware of a fact that materially affects the financial report, the auditor considers whether the financial report requires amendment, discusses the matter with management, and takes action appropriate in the circumstances.

AUS 708: *Going Concern*

- .94 The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but may lack reserves to sustain operations.
- .95 AUS 708 requires that the auditor considers whether there are any events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. Conditions of particular relevance to small entities include the risk that banks and other

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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 licence, franchise or other legal agreement.

- .96 AUS 708 gives guidance on additional audit procedures that may be relevant when events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern. Such procedures may include a review of documentation such as cash flows and profit forecasts. In the audit of a small entity, the auditor does not ordinarily expect to find detailed forecasts relevant to the consideration of going concern. Nevertheless, the auditor discusses with the owner-manager the going concern status of the entity and, in particular, the financing of the entity in the medium and long-term. The auditor considers these discussions in the light of corroborative documentation and the auditor’s knowledge of the business. The auditor seeks written representation from the owner-manager of the matters identified.
- .97 Where the small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating his loan to the entity in 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.

AUS 520: Management Representations

- .98 Paragraph .07 of AUS 520 states that, when representations relate to matters that are material to the financial report, the auditor:
- (a) Seeks corroborative audit evidence from sources inside or outside the entity;
 - (b) Evaluates whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and

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- (c) Considers whether the individuals making the representations can be expected to be well-informed on the particular matters.
- .99 Paragraph .08 of AUS 520 states that representations from management cannot be a substitute for other audit evidence that the auditor expects to be available. If such audit evidence cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the auditor’s report. However, in certain instances, a representation by management may be the only audit evidence that the auditor can reasonably expect to be available.
- .100 In view of the particular characteristics of small entities, the auditor may judge it appropriate to obtain written representations from the owner-manager as to the completeness and accuracy of the accounting records and of the financial report (for example, that all income has been recorded). Such representations, on their own, do not provide sufficient audit evidence. The auditor assesses the representations in conjunction with the results of other relevant audit procedures, the auditor’s knowledge of the business and of its owner-manager, and considers whether, in the particular circumstances, it would be reasonable to expect other audit evidence to be available. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.
- .101 Due to the nature of small entities, owner-managers may be of the opinion that it is not possible to provide certain specific representations. This may particularly be the case for the specific representations in AUS 210, AUS 526 and AUS 708 (refer paragraphs .37, .38, .84, .96 and .97 of this AGS). The auditor is encouraged to discuss with the owner-manager the reasons for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained. As noted in paragraph .22 of this AGS, it may be useful to discuss these representations with management when agreeing the terms of engagement.

AUS 702: The Audit Report on a General Purpose Financial Report

- .102 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 report. In many cases the auditor will be able to express an unqualified opinion on the financial report of small entities. However

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there may be circumstances that necessitate a modification of the auditor’s report.

Scope Limitations

- .103 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 an “except for” 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 report, an inability to form an opinion.

- .104 The following illustrative paragraphs may be used for this purpose:

Example of paragraphs for an auditor’s report qualified when completeness of accounting records is not substantiated—scope limitation that does not prevent the auditor from expressing an opinion

The company’s recorded sales include \$X in respect of cash sales. There was no system of control over such sales on which we could rely for the purpose of our audit and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the completeness and accuracy of the accounting records in respect of sales, the financial report gives a true and fair view of (or ‘presents fairly, in all material respects,’) the financial position of the company as of ... and the results of its operations and its cash flows for the year then ended in accordance with ... (and complies with...).

Example of paragraphs for an auditor’s report with an inability to form an opinion when completeness of accounting records is not substantiated—scope limitation that is so significant that the auditor is unable to express an opinion

The company’s sales were made entirely on a cash basis. There was no system of control over such sales on which we could rely for the purpose of our audit and there were no satisfactory audit procedures that we could perform to obtain reasonable assurance that all cash sales were properly recorded.

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Because of the significance of the matter discussed in the preceding paragraph, we do not express an opinion on the financial report.

Date and Signature of the Auditor’s Report

.105 The auditor dates the auditor’s report as of the completion date of the audit. This date should not be earlier than the date on which the owner-manager approves or signs the financial report. Approval may be in the form of a management representation. In the audit of small entities, for practical reasons, the auditor may actually sign the report on a date later than that on which the owner-manager approves or signs the financial report. Prior planning by the auditor, and discussion with the management of their procedures for finalising the financial report, will often prevent this situation from arising. Where it cannot be avoided, there is a possibility that some event during the intervening period could materially affect the financial report. Therefore, the auditor takes such steps as are appropriate:

- (a) To obtain assurance that, on that later date, the owner-manager would have acknowledged responsibility for the financial report or the items appearing therein; and
- (b) To ensure that their procedures for reviewing subsequent events cover the period up to that date.

AUS 212: Other Information in Documents Containing Audited Financial Reports

.106 The auditor reads the other information to identify material inconsistencies with the audited financial report. Examples of “other information” often included with the financial report of a small entity is the detailed income and expenditure statement, that is often attached with audited financial report for taxation purposes, and the management report.

Operative Date

.107 This AGS is operative from the date of issue.

Compatibility with International Standards and Statements on Auditing

.108 The guidance provided in this AGS is consistent with IAPS 1005 “The Special Considerations in the Audit of Small Entities”.

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BACKGROUND TO REVISION

This section does not form part of the Guidance Statement. It is a summary of the reasons for the current revision to the Guidance Statement and of key issues which have been considered by the Auditing & Assurance Standards Board (AuASB) as part of this revision.

1. This Auditing and Assurance Guidance Statement AGS 1048 “The Special Considerations in the Audit of Small Entities” replaces the former AGS 1048, issued in July 2002.
2. The revised AGS 1048 describes the characteristics commonly found in small entities. It also provides guidance on the application of Auditing and Assurance Standards (AUSs) issued between March 1999 and March 2003. For AUSs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities are included in the body of those AUSs.
3. The revised AGS 1048 is operative from the date of issue.
4. The revised AGS 1048 is based on the revised International Auditing Practice Statement IAPS 1005 “The Special Considerations in the Audit of Small Entities”, issued in late 2003 by the International Auditing & Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). The revised IAPS 1005 takes account of International Standards on Auditing (ISAs) issued between March 1999 and March 2003.
5. Guidance contained in the revised AGS 1048 (IAPS 1005) will be withdrawn when revisions to related AUSs (ISAs) become effective.

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APPENDIX I

*COMMENTARY ON THE APPLICATION OF AUSs WHEN THE AUDITOR
ALSO PREPARES THE ACCOUNTING RECORDS AND FINANCIAL
REPORT OF THE SMALL ENTITY*

This appendix is relevant to auditors who are legally and professionally permitted to prepare accounting records and a financial report for their small entity audit clients. In preparing the accounting records and financial report, the auditor may obtain useful information about the entity and its owner-manager’s aims, management style, and ethos. The auditor also acquires an in-depth knowledge of the entity, which assists in planning and conducting the audit. The auditor nevertheless remembers that the preparation of accounting records and financial report for the small entity audit client does not relieve the auditor from obtaining sufficient and appropriate audit evidence. The matters set out below may be relevant in the application of the AUSs by the auditor who also prepares the accounting records and financial report for the small entity audit client.

AUS 204: Terms of Audit Engagements

1. Where the auditor has assisted with the preparation of the financial report, owner-managers of small entities may not be fully aware of their own legal responsibilities or those of the auditor. Owner-managers may not appreciate that the financial report is their responsibility, or that the audit of the financial report is legally quite distinct from any other services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.
2. Paragraph .03 of AUS 204 states that the auditor may agree terms of engagement for other services by means of separate letters of engagement. However, there is no requirement for separate letters and, in the case of a small entity, there may be practical reasons why a single combined letter may be more appropriate.

AUS 208: Documentation

3. When the auditor prepares the accounting records or financial report for a small entity, such services are not audit work and the requirements of AUS 208 do not ordinarily apply to, for example, documentation of the work done in preparing the financial report.

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4. A consideration when establishing a retention policy for the working papers of a small entity is that owner-managers often request copies of the working papers containing accounting information to assist them in the administration of their entity. Paragraph .14 of AUS 208 states that working papers are the property of the auditor. Although portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity's accounting records. It may be helpful for the engagement letter to set out these requirements regarding the accounting records.

AUS 210: The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report

5. The auditor may have obtained knowledge of the owner-manager's personal financial position and lifestyle through the provision of other services to the entity or the owner manager. This knowledge may enhance the quality of the auditor's assessment of the inherent risk of fraud. Unexplained demands to prepare the financial report and complete the audit in an unreasonably short period of time may also indicate that there is an increased risk of fraud or error occurring.

AUS 218: Consideration of Laws and Regulations in an Audit of a Financial Report

6. Most entities are subject to requirements relating directly to the preparation of financial report, including the relevant companies legislation. The accounting expertise of the auditor as regards the legislation relating to the preparation of the financial report helps the owner-manager ensure that the relevant statutory obligations have been complied with.

AUS 302: Planning

7. When the auditor prepares the accounting records or financial report, sufficient flexibility is required in the overall audit plan to take account of any areas of audit risk identified, and evidence obtained in performing those services. The auditor of a small entity therefore plans to take into consideration knowledge obtained from the preparation of the accounting records or financial report so that the approach to obtaining evidence is properly co-ordinated and that efficiency of work and cost can be secured.

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AUS 402: Risk Assessments and Internal Controls

8. In preparing the accounting records or financial report, the auditor may obtain an understanding of the accounting and internal control system. Consideration is given to whether there are certain internal controls the auditor may wish to assess and test, which may affect the nature, timing and extent of substantive procedures required for the audit.

AUS 502: Audit Evidence

9. The auditor of a small entity when preparing the accounting records or financial report, applies professional judgement in considering whether those services result in a reduction in the audit work necessary to support the auditor's opinion. The preparation of accounting records or financial report will seldom provide all, and may not even provide any, of the audit evidence required by the auditor. In particular, those services will ordinarily do no more than provide *some* of the necessary evidence regarding the completeness of a population, or the value at which items are stated in the financial report. However, audit evidence can often be obtained at the same time that the accounting records or financial report are being prepared. Specific audit work will ordinarily be required, for example, on the recoverability of debtors, the valuation and ownership of inventories, the carrying value of fixed assets and investments and the completeness of creditors.

AUS 512: Analytical Procedures

10. In small entities where the auditor has been engaged to prepare accounting records or a financial report, analytical procedures carried out at the planning stage of the audit will be more effective if those services have been completed before the audit planning is finalised.

AUS 516: Audit of Accounting Estimates

11. 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 is often asked to assist with or advise on the preparation of any accounting estimates. By assisting with the process of preparing the accounting estimate, the auditor at the same time gains evidence relevant to meeting the requirements of AUS 516. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the

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reasonableness and appropriateness of the underlying assumptions used in arriving at the estimates.

AUS 526: Auditing Fair Value Measurements and Disclosures

12. Although the owner-manager is responsible for fair value measurements and disclosures, the auditor of a small entity may be asked to assist with the process of preparing the fair value measurements or disclosures. Management remains responsible for the reasonableness of the assumptions on which the fair value measurements and disclosures are based and, as a result, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgement of responsibility.
13. By assisting with the process of preparing the fair value measurements or disclosures, the auditor at the same time gains evidence relevant to meeting the requirements of AUS 526. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the measurements or disclosures.

AUS 518: Related Parties

14. When assessing the risk of undisclosed related party transactions, the auditor considers matters arising when preparing the accounting records or financial report of the small entity, assisting with the preparation of personal and corporate tax matters, or reviewing the owner-manager’s current accounts.
15. This, taken together with information obtained through discussion with the owner-manager, assists in the assessment of the risk in this area and may provide a reasonable basis for the risk to be assessed as low.
16. This assistance and the close relationship between the auditor and the owner-manager can assist in the identification of related parties, which, in most instances, will be with entities controlled by the owner-manager.

AUS 708: Going Concern

17. In some small entities, the auditor may be asked to assist the owner-manager with the assessment of going concern and sometimes with the preparation of any necessary cash flows or profit forecasts. In all

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cases, the owner-manager remains responsible for the assessment of going concern for any information prepared (even if the auditor assisted in its compilation), and for the reasonableness of the assumptions on which it is based. In such circumstances, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgment of responsibility.

AUS 520: Management Representations

18. In the audit of a small entity, it is particularly important for the auditor to obtain management representations in which the owner-manager acknowledges responsibility for the fair presentation of the financial report. This is particularly necessary where the auditor has prepared the financial report, because of the danger of the auditor’s role and responsibility in relation to the financial report being misunderstood. In order to ensure that the representations are meaningful, the auditor considers explaining these matters to management before the representations are obtained.

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APPENDIX 2

WHERE TO FIND SMALL ENTITY AUDIT CONSIDERATIONS

The table below lists the AUSs on which the AuASB has prepared small entity audit considerations, and provides an indication of where the considerations can be found.

AUS	Title	Where to Find Small Entity Considerations
204	Terms of Audit Engagements	AGS 1048
206	Quality Control for Audit Work	AGS 1048
208	Documentation	AGS 1048
210	The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report	AGS 1048
218	Consideration of Laws and Regulations in an audit of a Financial Report	AGS 1048
710	Communicating with Management on Matters Arising from an Audit	AGS 1048
302	Planning	AGS 1048
304	Knowledge of the Business	AGS 1048 AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” issued in February 2004 contains special considerations in the audit of small entities and is applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .44 to .46 of AGS 1048 will be withdrawn when the new

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AUS	Title	Where to Find Small Entity Considerations
		AUS becomes effective.
306	Materiality and Audit Adjustments	AGS 1048
402	Risk Assessments and Internal Controls	AGS 1048 AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and AUS 406, “The Auditor’s Procedures In Response to Assessed Risks” issued in February 2004 contain small entity audit considerations and are applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .54 to .60 of this AGS will be withdrawn when the new AUSs become effective.
214	Auditing in a CIS Environment	AGS 1048 AUS 402, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and AUS 406, “The Auditor’s Procedures In Response to Assessed Risks” issued in February 2004 contain small entity audit considerations and are applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .61 to .65 of this AGS will be withdrawn when the new AUSs become effective.
502	Audit Evidence	AGS 1048 AUS 502, “Audit Evidence,” which was revised and issued in February 2004, contains small entity audit considerations and is applicable for audits of a financial report for periods commencing on or after 15 December 2004. Paragraphs .66 to .70 of this AGS will be withdrawn when the

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AUS	Title	Where to Find Small Entity Considerations
		revised AUS 502 becomes effective.
512	Analytical Procedures	AGS 1048
514	Audit Sampling and Other Selective Testing Procedures	AGS 1048
526	Auditing Fair Value Measurements and Disclosures	AGS 1048
518	Related Parties	AGS 1048
706	Subsequent Events	AGS 1048
708	Going Concern	AGS 1048
520	Management Representations	AGS 1048
702	The Audit Report on a General Purpose Financial Report	AGS 1048
212	Other Information in Documents Containing Audited Financial Reports	AGS 1048