1 SMALLER ENTITY AUDITS

1.1 THE ISSUES

There is a bigger difference between smaller entity audits and larger ones than ISAs imply. Such audits are not given a great deal of coverage by standard-setters or regulators but practitioners know that they can be difficult to perform efficiently. Some practitioners are very comfortable with them; others are not, for a number of reasons. There are issues with the auditing standards themselves, which are supposed to accommodate audits of all sizes but whose length and complexity can cause problems. There are issues with the way auditors apply them – particularly if auditors are not familiar with them, with the way regulators approach them – which needs to be constructive, and with the quality of audit methodologies on which auditors are heavily reliant. Figure 1.1 summarises the challenges facing auditors of smaller entities.

Audit exemption in some jurisdictions has taken a very large number of entities out of the audit net, but there are still many that, for a variety of reasons, are required or chose to have an audit. In many jurisdictions, there remain well-established mandatory audit requirements for all entities, regardless of size.
1.1.1 **One-size-fits-all auditing standards**

ISAs are written to accommodate larger, more complex entities, as well as smaller ones. The rights and wrongs of this are a moot point but, for the foreseeable future, this is very unlikely to change. Auditors of smaller entities will continue to need to filter out the irrelevant standards and requirements. There are frequent references to internal control systems, for example. Some of these references are important – in understanding the design and implementation of the system, for example – but many are not, particularly where a substantive approach is taken. Auditors cannot, unfortunately, simply ignore all references to internal controls, even if they do take a wholly substantive approach.

1.1.2 **Auditor efficiency**

The issue is not exclusively one of size. Complexity is also relevant. Some smaller entity audits can be complex – entities operating in the biomedical or financial services sector, for example – and some larger entities can be relatively straightforward if they simply shift large volumes of manufactured goods, for example. Generally though, smaller entities are less complex than larger ones. A smaller entity should be easier to understand, it should be more straightforward to assess the risk of error, and audit procedures to detect those errors should be easier to design and perform. Just as importantly though, there is much less room for inefficient auditing where smaller, less complex entities are concerned, simply because of fee constraints.

This means that firms need to be clear about how they apply ISAs to smaller audits, and they need to be particularly clear about what does not need to be done and what can be done more simply on smaller audits by comparison with larger audits. It also means that some practitioners are finding it harder than ever to justify conducting just one or two audits.

1.1.3 **Regulatory attitudes**

Regulator behaviour drives auditor behaviour and if regulators take a compliance approach and get bogged down in the detail, auditors follow suit. The regulatory approach to audits of all sizes varies enormously. Some regulators take the view that they have been appointed to police auditor behaviour and impose sanctions where auditors fail to comply with the rules. They keep their distance from the auditors they regulate. Others take the view that they and the auditors they regulate have congruent goals in terms of improved audits, and that their job is to help auditors improve audit quality and only impose sanctions as a last resort. Both are valid approaches and most regulators fall somewhere in-between these two extremes. Auditors the world over complain that regulators are overly concerned with compliance with the detail of auditing standards, and that they pay insufficient attention to the bigger picture. Regulators point out the fact that documented evidence of compliance with ISAs is also necessary. They are both right.

1.1.4 **The quality of audit methodologies**

Methodologies are critical. A good auditor will perform a good audit even with a mediocre methodology, and a poor auditor a poor audit even with a good
methodology, but a good quality, up-to-date methodology makes a substantial qualitative difference to most audits. The availability and quality of methodologies varies. Some methodologies are provided by professional bodies, some are provided by training consortia and some are commercially available. Many are tied into paper-based or electronic audit systems. One problem for firms that have embedded poor quality methodologies, or methodologies that have deteriorated over time, is that they cannot contemplate the logistics involved in a major overhaul, or replacing the methodology, rather than simply patching it up. Going forward though, firms may well get better at keeping systems up to date, with the increased involvement of younger people with better quality IT skills who are more accustomed and less resistant to constant change.

1.2 WHAT THE REGULATORS SAY

Regulators should recognise that smaller entity audits are different. In particular, they need to recognise that smaller entity audit documentation can be significantly simpler. Regulatory observations on specific aspects of the conduct of smaller entity audits are provided in each section of this publication, but there are a few common strands to the observations made by regulators everywhere. Auditors:

- who perform high quality risk assessments sometimes need to align these better with the work they actually perform;
- often perform a good audit but fail to document what they have done;
- sometimes try to cut corners and avoid the requirements of ISAs by making inappropriate assumptions in areas such as materiality and related party transactions;
- fail to challenge management assumptions in areas such as accounting estimates, and accept management explanations too readily without questioning them.

Many of the observations above are not exclusive to smaller entity audits, but it remains the case that all regulators are clear that all audits, large or small, complex or simple, should be performed to the same standard, using the same ISAs.

1.3 WHAT PRACTITIONERS SAY

Some practitioners have understandable concerns about ISAs. ISAs do not always seem appropriate for the audit of smaller entities. Significant effort is sometimes required to interpret and adapt ISAs to make smaller audits cost-effective and there are different views among practitioners about whether it is possible to perform smaller audits efficiently. Not very surprisingly, those who make their living out of them, and do more of them, seem to have a more positive approach.

Practitioners who do achieve a degree of efficiency in small entity audits tend to use good quality audit methodologies specifically designed for smaller entity audits, or have taken the bolder step of developing their own methodologies.
Bought-in methodologies that try to address the audit of a wide range of entities do not always scale down easily. *The very best methodologies for smaller audits tend to be written in-house, by firms.* This is not always possible, but firms with poor bought-in systems that derive a significant proportion of their revenue from audit clients, and who intend to stay in that market, may do well to consider developing their own methodology. At the very least they might consider commissioning one, adapted to the firm’s needs. Staff experienced in performing efficient smaller audits may not be the right staff to write the methodologies but they can certainly be used to provide input to the staff selected to perform the development work. Staff performing the development work may be a mix of junior staff who have a detailed and up-to-date knowledge of ISAs, any IT specialists, and senior staff and partners who have the experience to adapt ISAs to smaller audits.

### 1.4 WHAT THE STANDARDS SAY

Rightly or wrongly, there is no ‘smaller entity ISA’. Standard-setters have repeatedly made it clear that they believe that ‘an audit is an audit’, meaning that all audits, regardless of size, must be performed under the same standards.

The IAASB’s staff Q&A *Applying ISAs proportionality with the size and complexity of an entity*\(^1\) brings together many of the smaller entity-specific references in the application material in ISAs, under headings such as:

- ‘How might the work effort in an SME audit differ from that in a larger entity audit?’; and
- ‘Does the auditor have to comply with all ISAs when performing the audit of an SME?’

At the end of the day though, ISAs do not include much specifically directed at smaller entities, hence the need for books such as these.

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**Proportionality**

Draft EC legislation and many other regulatory documents increasingly refer to ‘proportionality’, and the ‘proportionate application’ of ISAs to smaller entity audits. It is easier to say what this does not mean than what it does.

The proportionate application of ISAs does not mean that auditors can:

- ignore relevant ISAs or ISA requirements;
- make arbitrary decisions such as ‘materiality in a smaller audit is always £n’ or ‘petty cash is always immaterial’, or ‘no work will be performed on internal controls in smaller audits’.

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\(^1\) [www.ifac.org](http://www.ifac.org).
1.4.1 Defining a smaller entity

The glossary of terms in ISAs and ISA 200 on overall objectives define a smaller entity as an entity that typically has the following qualitative characteristics:

- a concentration of ownership and management, i.e., it is owned and managed by a single person or a small number of people; and
- one or more of the following features:
  - uncomplicated transactions
  - simple record keeping
  - relatively few internal controls
  - simple management structures
  - a limited number of staff and management with a broad range of responsibilities.

It is fair to say that ISAs do not do as much as they might with this definition. The paragraphs specific to smaller entities that appear in the application material usually consist of just a few sentences. Those that are most useful are in the risk ISAs, but there is a need for more guidance to enable auditors to extract better value from the work they are required to perform on internal controls as part of understanding the entity, particularly when they go on to take a substantive approach. Nevertheless, the definition of a smaller entity demonstrates what is different about auditing a smaller entity. The following example illustrates this point.
1.4.2 Practice Note 26: smaller entity audit documentation

The definition of a smaller entity above was also used by the UK’s Financial Reporting Council (FRC) when it produced its Practice Note 26 Guidance on Smaller Entity Audit Documentation (PN 26). The appendix to PN 26 contains a number of practical and helpful examples of smaller entity audit documentation, including planning memoranda and work programmes.

1.4.3 The building blocks of the right approach to smaller entity audits

One thing that all audits have in common, regardless of size, is that to do them well firms need the right audit methodology and audit teams with the right expertise and attitude. Having the right audit approach and people is the key to efficiency and effectiveness.

ISA 200 and what smaller entity auditors do and don’t have to do

Paragraph 22 of ISA 200 on overall objectives requires auditors to comply with every requirement of each ISA unless:

- the entire ISA is irrelevant; or
- the individual requirement is irrelevant because it is conditional and the condition is not present.

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2 www.frc.org.uk.
At first sight, this appears to be glaringly obvious. Auditors will not attempt to comply with the requirements of ISA 402 on service organisations if there is no service organisation, and they will not attempt to attend an inventory count if there is no inventory. The more subtle and important point is that most auditors use a structured audit methodology that is very likely to have sections with requirements that are irrelevant to a particular audit.

The right audit methodology Because smaller entities tend to be less complex, standard checklists can cause problems. Pages of checklists listing the requirements of ISAs tend to lead to point after point marked ‘not applicable’, rather than a useful record of work performed. In short, many audit methodologies are over-engineered for smaller entities. They often need a great deal of tailoring, but they do not always get it. Is it better to take the time to write one paragraph justifying the deletion of a section, or to write ‘not applicable’ 25 times over two pages?

A checklist-heavy approach to a smaller audit is not only inefficient, it can also lead to poor audit quality. When faced with pages of irrelevant issues on audit programmes and checklists, the audit team can easily miss something that is relevant.

An audit methodology that will work for a smaller entity audit needs to be flexible enough to be scaled up for audits where there are more complex issues, and scaled down for simpler audits. The ‘blank piece of paper’ approach is the ultimate in scalable audit documentation, but some auditors fear that the lack of structure could mean that something gets missed.

Nevertheless, the firms that tend to achieve the most cost-effective approach to smaller audits use very few mandatory checklists or standard programmes. They tailor their audit approach to the individual needs of the entity, which leads to a higher quality of
audit as well as a more efficient one. The success of this approach is hugely dependent upon well trained audit staff with a good knowledge of ISAs. The approach is more dependent on audit teams knowing what they are required to do under ISAs and how to properly document their work to demonstrate compliance.

In jurisdictions in which there are low thresholds for audit exemption, many audit firms have small company audit working paper packs that work well. But in jurisdictions in which audit exemption thresholds have risen, these packs have not always been updated and some firms now use a ‘one-size-fits-all’ pack, with extensive sections of material that are not applicable to smaller entities.

In fairness, the over-engineering of audit packs is sometimes motivated by a genuine, albeit misdirected, desire to help auditors. Designers sometimes produce audit packs to ‘hand-hold’ auditors through the audit process with the best of intentions, often at the request of auditors themselves. An unfortunate side-effect of this is that such packs sometimes constrain auditors to a single, narrow and inefficient path through the audit, and the widespread use of electronic audit working papers in some jurisdictions has done little to help. Automated systems are sometimes worse because they force auditors to go through superfluous checklists before they can proceed to the next stage for the audit. These checklists can be every bit as over-engineered as the manual systems, but when it is automated you cannot throw it in the bin and ignore it!

It is essential that if firms use bought-in methodologies, regardless of whether they are manual or automated, they should recognise that for many smaller entity audits, it is possible that between a half and two-thirds of the requirements will not apply and that the audit approach the auditors will adopt needs to be tailored accordingly. The investment in this type of tailoring is worthwhile, to avoid being distracted by irrelevancies.

**The right audit team** Thorough, appropriate audit training as well as on-the-job coaching are needed to ensure that audit teams can perform the audit to an acceptable standard. If audit teams understand the detailed requirements of ISAs they can adapt their audit approach to the requirements of the individual assignment and document their work briefly to record what they have done to demonstrate that they have followed ISAs, without relying on checklists.

Auditors without a proper understanding of the ISAs have no choice but to use checklists to ensure that they do not miss anything. This makes it much more difficult to flex an audit approach to cater for smaller and less complex entities. It is even possible that auditors may be encouraged by a checklist to do something superfluous, because they do not know that the procedure does not apply.

Understanding ISAs involves reading them, reading about them, training, coaching and experience. The sheer volume of ISAs can be daunting but a co-operative approach within a firm that requires regular meetings of staff who each take an ISA and prepare a short presentation on it, on a weekly basis for a few months, can be very effective.
1.4.4 Ten top tips for cost-effective smaller and less complex audits

Figure 1.2 summarises our ten top tips for cost-effective smaller and less complex audits.

1. Make better use of the prior year audit file! Audit trainers are often heard imploring audit staff not to blindly follow last year’s file: it leads to a thoughtless audit approach, it does not take into account current year changes and it might well repeat last year’s mistakes. But there is a balance to be struck between taking account of new circumstances and ignoring the important resource that is last year’s file. The reality is that smaller and less complex entities tend to change very little from year to year. With appropriate updating, much of last year’s documentation can be reused, particularly for understanding the entity, risk assessment and the design of audit procedures.

Make better use of the prior year audit file!
- strike a balance between starting from scratch and blindly following last year’s file

Avoid excessive documentation of risks
- list the risks and the intended response, rather than listing the same risk repeatedly

Use more narrative notes
- they are a great deal easier to understand than checklists and produce better quality audits

Focus on what matters from the outset
- drive documentation by understanding the entity, assessing risks and designing tests, not vice versa

Avoid over-documentation of audit evidence
- recording a unique identifying feature of each item selected that would enable the test to be repeated – such as an invoice number – is sufficient. More detail is often superfluous

Non-audit service work
- properly recorded non-audit service work can provide audit evidence

Simplify the approach to internal controls
- focus on information systems and controls over the books and records, and use walkthroughs to confirm implementation

Document planning and completion together when little has changed
- where the documentation of planning and completion are aligned, issues identified in the planning are clearly linked to their resolution and duplication is avoided

Minimise unnecessary documentation
- keep copies of extracts rather than full documents and use an overflow file

Don’t forget to budget
- work will expand to fill the time available.

Figure 1.2 Ten top tips for cost-effective smaller and less complex audits
Auditors clearly need to make inquiries to make sure that this documentation is still relevant and up to date, and they will need to re-perform risk assessment procedures and reassess the appropriateness of last year’s tests. To make the best use of work in subsequent years, documentation of the understanding of the entity and the risk assessment can be placed on a permanent file or a permanent section of the current file. Audit programmes can be carried forward for editing in future years.

2. Avoid excessive documentation of risks  The risks of material misstatement tend to be fairly obvious to the auditors of smaller entities. This is not to say that they should be complacent, but where an entity is simple to understand the risks really are more readily apparent. Auditors should still perform all of the appropriate risk assessment procedures, but care should be taken not to record the same risk over and over again in the checklist or programme for each procedure.

Many audit methodologies use programmes and checklists in the planning section that mirror the requirements of ISAs. It is common for each checklist to cover a series of related procedures, such as understanding the entity, understanding internal controls, preliminary analytical procedures, and the inherent and fraud risk assessments. On a smaller audit, this degree of formality is unlikely to be necessary to identify risks. There is a real concern that the same risk of error is identified when each different risk assessment procedure is performed and that it gets recorded again and again, every time a new procedure identifies it. When auditing a smaller entity it may be better simply to list the risks of misstatement, together with how auditors intend to respond to them. A separate list can then be made of the procedures that auditors undertook in performing the risk assessment. This requires more of a ‘blank sheet of paper’ approach to the documentation of risk and is suitable for more experienced staff.

3. Use more narrative notes  The most flexible approach to audit documentation will always be narrative notes. Small, simple entities tend to have few internal controls, no internal auditors and they are not part of a group. Their financing is often simple and there are no complex assets or liabilities to be valued. Checklists tend to include something to address all of these eventualities, which is useful on larger or more complex audits but does not work so well for smaller entities because so many requirements are irrelevant.

Most file reviewers say that narrative notes tend to give the reviewer a much better picture than a checklist. Checklists can be completed without auditors really stopping to think about the audit. Writing narrative notes puts more pressure on them to think about what they have done and why. These
notes can be used as the basis for audit documentation in subsequent audits. It is harder for checklists to be used in this way.

4. **Focus on what matters from the outset** The focus in audit planning should always be on understanding the entity, assessing risk and designing appropriate audit procedures. Whilst ISAs have many specific requirements that relate to these processes that should not be forgotten, auditors must never lose sight of the purpose of the processes.

Completing standardised documentation can be a major distraction. Experienced auditors should do what they know they need to do, and then document what they have done, rather than reading through a checklist to find out what needs to be done next. Checklists can be completed later to make sure that everything has been covered.

5. **Avoid over-documentation of audit evidence** Audit teams sometimes document too much information when recording the results of a test. For example, when recording a sales test, auditors sometimes document the purchase order number, the date, the gross amount, VAT and net amount, the goods sold and the supplier. Much of this is often superfluous. The minimum required documentation is a unique identifying feature of each item selected, such as a purchase invoice number that would enable the test to be repeated should it be necessary to challenge its findings. Documenting any more than this may be superfluous.

File reviewers may want a little more documentation if the team member is inexperienced, to aid the review process. With inexperienced, junior auditors, fuller documentation can help with on-the-job coaching. In other cases, too much information is costly to produce, slows down the review process and results in superfluous schedules when a simple record of what was done on the audit programme might have sufficed.

6. **Non-audit service work** The provision of non-audit services presents threats to auditor independence. But auditors sometimes forget that it also brings significant benefits to the quality of the audit. Typically, auditors of smaller entities assist with the preparation of the statutory financial statements, tax computations and tax returns. Sometimes, auditors advise on a range of other matters such as funding, VAT and employment taxes.

If auditors have prepared the financial statements, the accountancy work can be used as audit evidence. If auditors have prepared the schedules for prepayments and accruals, for example, they need to document how they were prepared. If the entity’s records were used to prepare the figures, auditors should record that fact to demonstrate the quality of audit evidence obtained. If comparisons were made to prior periods, auditors should record this in the same way that audit evidence from analytical procedures would be recorded. With the right documentation, accountancy work can be used as audit evidence.
Providing non-audit services also enables auditors to obtain a much better understanding of the entity than they might otherwise. This makes the risk assessment easier. Again, this understanding of the entity needs to be documented if it is to be relied on. In practice this is a substantial benefit because auditors, as trusted advisors to management, have a very good insight into management’s thinking, making the audit much easier.

Nevertheless, auditors are always required to assess threats to independence, such as the self-review threat, and the self-interest and familiarity threats. Appropriate safeguards are needed but auditors should not ignore the beneficial effects of providing non-audit services on audit quality and efficiency.

7. Simplify the approach to internal controls  The application material in ISA 315 on risk assessment recognises that smaller entities tend to have fewer internal controls. This means that standardised checklists that take a formal approach to documenting internal controls are either less relevant or not relevant at all to smaller entities. ISA 315 has a five-fold categorisation of internal controls:

- the control environment;
- the entity’s risk assessment process;
- the information system, including the related business processes, relevant to financial reporting, and communication;
- control activities relevant to the audit;
- monitoring of controls.

The application of this categorisation to smaller entities is considered in detail in subsequent sections but in general, in a smaller entity audit, it is unlikely that there will be much for auditors to consider in terms of the control environment, risk assessment procedures and monitoring. For many smaller entities, these three issues can be summarised as one question: Are the directors honest and are they any good at running the business?

There are often few control activities, such as authorisation and approval controls, and those that there are may well not be good enough to be relied on by auditors. Smaller entities do have information systems though, in terms of books, records, computers and related business systems.

This approach to internal controls in smaller audits is very different to larger entity audits, so a firm’s standard audit methodology will need to be adapted. Narrative notes tend to be a better way to document the system of internal control in smaller entity audits.

Auditors are also required to understand the implementation of the internal control system. This is typically done through walkthroughs. In a smaller entity, the approach is straightforward. The main internal controls are the books and records and related business systems. Simple walkthroughs of transactions in the main business cycles, often sales, purchases and wages, may be sufficient to understand implementation.
8. Document planning and completion together when little has changed  This idea may seem radical to the many auditors who have always maintained separate documentation for planning and completion, but for smaller entities it can make sense. The issues that are considered during the planning of a smaller entity audit are often the same when they are considered again during completion – there are few if any changes.

For example, auditors may record the existence of certain financial difficulties during the preliminary consideration of a going concern. At the end of the audit, if nothing has changed, there is a possibility that duplicate documentation will be prepared, in the completion section of the file. This applies in many areas, such as appointment and reappointment, preliminary analytical procedures and overall analytical procedures, communications with management and materiality.

Documenting planning and completion together has the additional benefit that issues identified in the planning are clearly linked to their resolution in completion. This makes it difficult to miss something during the audit and not follow through properly on planning.

9. Minimise unnecessary documentation  Audit teams sometimes produce more documentation than necessary, including copies of invoices, and all of the accounts team’s spreadsheets, sales ledger and general ledger prints, for example.

Auditors might think it important to hold copies of documents such as articles of association, leases, valuations and minutes of meetings, but it may only be necessary to keep copies of extracts from such documents. Most auditors are only really interested in certain key parts of these documents, so why not hold a copy of the relevant extract? It makes the file thinner, easier to read, and the relevant part of the document is simpler to find.

A more radical idea is to keep an audio recording of meetings instead of written notes.

Excessive documentation creates a number of problems that are not conducive to audit quality or efficiency. Unnecessary documents make the file harder and slower to review, which has cost implications, and it is easy for reviewers to miss important points when there is excessive documentation, which compromises quality. There is a cost involved in the original preparation of unnecessary documentation and there are on-going file storage and archiving costs.

There are two common causes of excessive audit documentation. Firstly, audit staff generally – and junior staff in particular – keep documentation for safety. They do not want to ask management for it again and they do not want to be asked why they did not... it may only be necessary to keep copies of extracts ...

... Unnecessary documents make the file harder and slower to review, which has cost implications and it is easy for reviewers to miss important points ... which compromises quality.
keep a copy. Auditors and archivists are first cousins. Audit staff might be encouraged to reduce documentation by suggesting that they place documentation that will probably not be needed in an overflow file that can be disposed of shortly after the audit is completed.

The second cause of excessive documentation is more difficult to deal with. If file reviewers, such as audit managers and partners, lack trust in the audit team, they effectively re-perform parts of the audit by inspecting documents themselves, rather than the record of it being viewed by the audit team member. The reviewer's lack of trust might often be misplaced, but sometimes is not.

In all cases, audit teams need to be properly briefed, which includes trying to reduce excessive documentation over time.

10. Don’t forget to budget  At first sight this point might not seem to have anything to do with ISAs. However, ISAs do require auditors to prepare a time and fee budget. In the real world the most important thing to do with the budget is to use it to compare the actual time spent to the budget.

Work expands to fill the time available. Sticking to a time budget is therefore essential, but not at the expense of audit quality. Auditors the world over are subject to enormous fee pressures and regulators observe that cuts in budgets potentially compromise audit quality. Budgets need to be set by experienced members of the audit team. If the budget is realistic, the audit team can be encouraged to stick to it.

After every assignment a debriefing is needed to discuss within the team what went well and what needs to be improved on the next audit. Part of the debrief should be a discussion of performance against budget.