Audit of a Small Entity

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AUDIT OF A SMALL ENTITY

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AN AUDIT TECHNIQUE STUDY

The Canadian Institute of Chartered Accountants
NOTICE TO READER

This audit technique study was commissioned by the CICA as part of its continuing research program. Its purpose is to help auditors keep abreast of the latest developments and advances in auditing standards and methods and to discuss the techniques involved in the audit of a small entity. The views and observations expressed in this study are those of the principal author and the study group. They have not been adopted, endorsed, approved, disapproved or otherwise acted upon by the Auditing and Assurance Standards Board or by any CICA board, committee, or the governing body or membership of the CICA or any provincial Institute/Ordre.

The study constitutes an “Other Auditing and Assurance Publication” under the hierarchy established in CICA Handbook – Assurance Section 5021.02(d). It has not been written as a stand-alone document, but rather to help practitioners understand and apply the Recommendations issued by the Auditing and Assurance Standards Board. The study has been written to reflect the Recommendations in the CICA Handbook – Assurance as of October 31, 2005 and any standards changes after that date should be considered separately. Also, Recommendation paragraph 5021.09 states “The practitioner applying the auditing and assurance guidance included in an other auditing and assurance publication should be satisfied that, in his or her professional judgment, it is both relevant to the circumstances of the assurance engagement and appropriate.” The auditing guidance in this audit technique study has been reviewed by the CICA Auditing and Assurance Standards staff and is presumed to be appropriate for the purpose of performing an audit engagement.

In addition, this study contains references to forms and other aids contained in the Professional Engagement Manual published by the CICA that may be helpful in conducting an audit. Materials in this Manual, and their location within the Manual, will change over time.
The “Introduction to the Assurance and Related Services Recommendations” section of the *CICA Handbook – Assurance* says that, when auditing financial statements, an auditor should comply with generally accepted auditing standards (GAAS). Along with the other auditing Recommendations in the *CICA Handbook – Assurance*, GAAS apply to audits of all types of entities, both profit and not for profit. As the unique characteristics of small entities will, however, often affect the conduct of an audit, certain *CICA Handbook – Assurance* Recommendations may be difficult to interpret in that context.

In February 1988, the CICA published its first audit technique study on small business audits. Its purpose was to discuss the issues relating to such audits and the problems that might be encountered, as well as to provide practical guidance on how to conduct an effective and efficient audit. The major conclusions of that study were based on a “substantive test only” approach, with little attention being given to an understanding of the control environment.

In March 1992, the Auditing Standards Board issued *Handbook* Sections 5200 to 5220 on “Internal Control in the Context of an Audit,” which required auditors, including those associated with small business audits, to obtain an understanding of the audited entity’s control environment. This meant that the study needed to be updated. Accordingly, the second edition was published in 1994.

During the past two years, the Auditing and Assurance Standards Board has released several major new and revised standards, notably those dealing with fraud, audit risk, understanding the entity, internal control and quality control. In addition, the provincial Institutes/Ordre issued new rules on independence. All of this has caused, and continues to cause, changes in the planning and execution of audits and raises important questions about how these changes affect the audits of small entities. The Auditing and Assurance Standards Board soon recognized the need for implementation guidance for the new standards, of which this new edition is one of the components.
The objective of this new edition is the same as the first: to discuss the issues relating to small business audits, as well as to provide practical guidance on how to conduct an effective and efficient audit. For this edition, however, the audit of small not-for-profit organizations was added because audits of such entities now comprise a very significant portion of the audits of small entities being undertaken and, while many of the issues are the same as the audits of profit oriented entities, there are some important differences. Therefore, the study deals with both small businesses and small not-for-profit organizations.¹

The study group’s terms of reference were to:
1. Discuss the characteristics of small businesses and not-for-profit organizations (small entities) and how they may have changed since the second edition of this study was published in 1994.
2. Consider how the new audit risk standards apply to the audit of a small entity.
3. Address the impact of the new independence rules on the auditor of a small entity.
4. Discuss how the proposed new internal control and quality control standards will affect the audit of a small entity.
5. Discuss common audit problems and auditor-client relationships in a small entity audit context.
6. Discuss the fraud standard and its implications for a small entity.
7. Provide practical guidance on auditing a small entity in the twenty-first century.
8. Produce a revised edition of the study to reflect the results of the discussion of these issues.

The CICA expresses its appreciation to Gerald D. Trites, FCA, principal author and to the members of the study group for producing this new edition.

Toronto
January 2006

CICA Research Studies

¹ Another CICA study of interest to auditors of not-for-profit organizations is *The Audit of Not-for-Profit Organizations* (Toronto: The Canadian Institute of Chartered Accountants, 1993).
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Illustration of Audit Process

Accept/Continue audit engagement after investigation of independence and engagement risk

Gain understanding of the entity and its environment, including its internal control

Evaluate materiality

Perform risk assessment procedures

Discussion of material misstatement, including fraud, with the audit team

Assess the risks of material misstatement, including risk of fraud, and complete an audit plan

Evaluate design of internal controls relevant to the audit, and determine if controls have been implemented

Consider whether the evidence from substantive procedures alone will provide sufficient appropriate audit evidence to reduce the risks of material misstatement at the assertion level

Does the auditor plan to reduce audit risk by testing the operating effectiveness of controls?

YES

Design and perform tests of the operating effectiveness of controls

Evaluate results of tests of the operating effectiveness of controls

Are controls effective?

NO

Design substantive tests

Perform substantive tests

Evaluate audit evidence

Complete documentation

Issue appropriate report

NO

YES
Chapter 1

INTRODUCTION

This chapter addresses:
• the traditional problems that auditors have experienced in applying GAAS to small entity audits and the significant changes in those standards that necessitated this revised study;
• the objective of this study; and
• the characteristics of a small entity and the related effect on the audit.

GAAS AND THE AUDIT OF SMALL ENTITIES

Applying GAAS to the Audit of Small Entities

Generally accepted auditing standards (GAAS) apply to all audits, regardless of size. They provide users of audited financial statements with some assurance that the same quality of audit work has been applied in all engagements. Nevertheless, auditors frequently have difficulty applying GAAS in the audit of small entities.

There are many reasons for this difficulty, ranging from a lack of detailed implementation guidance to a perception that auditing standards are designed primarily for larger companies and do not recognize the special characteristics of small entities. Whatever the reasons, the application of GAAS to audits of small entities is an important matter because, although the number of audits of small entities has been declining in recent years, they are still numerous, especially in the not-for-profit sector.

Developments Affecting the Audit of Small Entities

Several recent developments, which are addressed in this study, have had a particularly significant impact on the audit of small entities:
• Significant new and revised standards on audit risk were issued in 2005. These standards include several principles intended to lead to significant changes in the way audits are carried out. Essentially, these new standards seek to redefine

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1 The audit risk standards are effective for financial statements and financial reports relating to fiscal periods commencing on or after January 1, 2006.
the audit risk model by asking auditors to understand the business risks\textsuperscript{2} that affect a client’s financial statements. This means that an auditor must carry out additional procedures, using various sources, to obtain a broader understanding of the entity and its environment, including its internal control, and to evaluate the risk of material misstatement. The previous standards called for the auditor to gain an understanding of the control environment for all audits. The new audit risk standards call for more audit work on internal control, including a need to obtain an understanding of the design and implementation of controls and the entity’s risk assessment process and monitoring of controls. The new standards do not require the auditor to carry out tests of the operating effectiveness of controls, but do encourage that they be carried out more often. They also impose more rigorous documentation requirements, which are summarized in Chapter 9.

- The new standard “The Auditor’s Responsibility to Consider Fraud” was issued as Section 5135 of the \textit{CICA Handbook – Assurance} in 2004. Among other changes, it includes a requirement for the lead auditor to discuss, with members of the audit team, the susceptibility of the entity’s financial statements to material misstatement due to fraud. In addition, the standard requires the auditor to obtain an understanding of the internal control designed and implemented by management to prevent and detect fraud.\textsuperscript{3}

- New standards on quality control were also released in 2004. A new section designated GSF-QC, “General Standards of Quality Control for Firms Performing Assurance Engagements,” sets out the quality control policies and procedures that firms performing assurance engagements need to implement. Section 5030, “Quality Control Procedures for Assurance Engagements,” sets out the quality control procedures to be performed in individual assurance engagements. Some of the requirements pose issues for the auditors of small entities and, therefore, merit consideration in this study.

- The provincial institutes/ordre released new rules of conduct on independence in 2003/04. These new rules also pose issues for auditors of small entities.

- In addition, \textit{CICA Handbook – Assurance} Sections 5110, “Terms of the Engagement,” 5150, “Planning,” and 5370, “Management Representations” all contain new or amended standards that have an impact on small entities.

\textsuperscript{2} \textit{CICA Handbook – Assurance} paragraph 5141.030 includes the comment that “Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.”

\textsuperscript{3} As part of the issuance of the audit risk standards in June 2005, Section 5135 (which previously also addressed misstatements due to error) now deals solely with fraud. Misstatements due to error are now dealt with in the audit risk standards.
Finally, small entity use of technology has increased. Many small entities now rely heavily on technology, using increasingly complex systems. As well, most practitioners are now using audit software packages to automate working papers.

This edition of the study has been developed in collaboration with a current revision of the Professional Engagement Manual. To remove duplication, appendices containing forms are not included. Readers should obtain current versions of these forms from the Professional Engagement Manual.

OBJECTIVE OF THIS STUDY
The objective of this study is to discuss the application of GAAS to, and provide practical guidance on, the audit of small entities. The emphasis is on the need to conduct an effective audit and on how to deal with the unique problems encountered in audits of small entities. The study does not address reporting issues under Section 5600 of the CICA Handbook – Assurance, “Auditor’s report on financial statements prepared using a basis of accounting other than generally accepted accounting principles.” It also does not address the reporting aspect of audits. This is an area that would require a separate study. The Professional Engagement Manual does contain materials to assist the practitioner in this regard.

In general, this study is intended as a practical, but conceptual, guide to the conduct of an audit of a small entity. It is intended to be read in conjunction with the CICA Handbook – Assurance for an understanding of the underlying standards and in conjunction with the Professional Engagement Manual for the detailed guidance and forms that are required to carry out an audit.

CHARACTERISTICS OF A SMALL ENTITY
Need to Consider Characteristics
At least some of the difficulties in applying GAAS to small entity audits stem from the special characteristics of such entities. For example, certain of these characteristics are said to, or are perceived to, render internal control ineffective. As a result, the desired level of audit assurance in a small entity audit is often obtained primarily from the use of substantive procedures. It follows that an understanding of the issues pertaining to a small entity audit first requires an understanding of the characteristics of a small entity.

Moreover, the term “small entity” is best defined by its characteristics, rather than by size or sales volume. Agreement on what constitutes a small entity based on dollars is difficult to obtain because what represents few dollars to one person may well be substantial to another. This study, therefore, defines a small entity according to its characteristics.
Various publications have attributed characteristics such as the following to small entities:

- concentration of decision-making power;
- non-complex operations;
- lack of formal systems and authorization procedures; and
- limited segregation of duties.

This list is not exhaustive. Related or secondary characteristics that have caused difficulties for the auditor include:

- the potential for management to override internal control policies and procedures; and
- personnel having only limited knowledge of accounting and financial reporting.

Whether an entity should be considered small depends on the particular circumstances. An entity might meet only some of these characteristics and still qualify as small. Some public companies qualify, if they are managed by their majority shareholders and have some of the other characteristics. A more complete discussion of the characteristics follows.

Concentration of Decision-making Power

Normally, in a small entity, only a very small management group participates in decision making; in some cases, decisions are made by a sole manager in the case of a business or by a lead administrator in the case of a not-for-profit organization. Indeed, a small business entity often depends entirely on the skills of a single entrepreneur, who acts as a sole manager or as the leader of a small management group. For effective decision making, management relies on “hands-on” management and on obtaining effective outside advice when necessary. Since some entities have just a sole manager or an administrator to manage them, while others have a small management team, this study refers to managers or administrators of small entities simply as “management.”

Many small profit-oriented entities do not have a policy-making body, such as an active board of directors, to add expertise to management’s decision making. The impact of this on the quality of management will depend on the circumstances, such as the strength of management, the complexity of the business, and similar factors.

The involvement of an owner-manager in a profit oriented business sometimes compensates for an otherwise weak internal control system, so the lack of an owner-manager in a not-for-profit organization may tend to mean weaker internal control. On the other hand, small not-for-profit organizations are more likely to have an active board of directors, which may in some circumstances offset any weaknesses arising from the lack of an owner-manager.
The type of influence that management of a small entity exerts on internal control depends to a great extent on the control environment and, in particular, management attitudes about the importance of internal control. Management normally plays an important role in the internal control system in a small entity, so the honesty and integrity of management is an important issue. It is important to note that Section 5135 of the CICA Handbook – Assurance, “The Auditors Responsibility to Consider Fraud,” incorporates new professional scepticism standards that have an impact on the audit of small entities. Paragraph .024 of that section states:

The auditor should maintain an attitude of professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience with the entity about the honesty and integrity of management and those charged with governance.

This requirement effectively removes the presumption of management’s good faith that previously existed for assurance engagements. This does not mean that the auditor must presume management to be dishonest; rather, it means that the auditor must strive to maintain an objective attitude and, when performing audit procedures, cannot accept less-than-persuasive evidence by assuming that management is honest and acting in good faith.

Non-complex Operations
Generally, small entities are less complex in organization, operations and activities than larger ones. Moreover, the population of accounting data is smaller and variables such as product or service mix are limited. This is an advantage when the auditor needs to gain the necessary knowledge and understanding of the entity and its environment and when conducting audit procedures such as analytical review.

On the other hand, the availability of increasingly sophisticated technology at lower costs has increased complexity in some small entities. Small entities are now using information systems of a complexity and capability that previously was reserved for large entities. Also, all entities are now able to use the Internet for marketing, selling and purchasing, and this has also increased the complexity of their systems. For example, small entities routinely use point-of-sale systems, are beginning to make greater use of electronic cash transfers and comprise a significant segment of the e-business community. Small not-for-profit organizations are learning to effectively use the Internet for fund-raising purposes.

Increased use of technology has an impact on the complexity of information systems in use and, therefore, has an impact on audit risk. This matter is discussed further in Chapter 7.
Lack of Formal Systems and Authorization Procedures

Although often adequate for operational purposes, small entity systems and authorization procedures are frequently informal and flexible. Because management is closely involved, formal reporting systems to monitor financial activity may not always be necessary. This point is made in several auditing standards set out in the CICA Handbook – Assurance, as shown in the excerpts included in Appendix A.

Limited Segregation of Duties

A further characteristic common to many small entities is the limited segregation of duties. It is quite common to find one or two employees having responsibilities for day-to-day clerical operations and accounting routines and also for the custody of assets. In a small entity environment, it may be impractical to ensure that all incompatible duties are segregated.

Limited segregation of duties tends to be a pervasive weakness that could increase the risk of material misstatement in the financial statements. This applies especially if the inadequate segregation places individuals in a position where their errors can go undetected (unintentional misstatements) or they can perpetrate and conceal irregularities (intentional misstatements). If the segregation of duties is too limited, the auditor may determine through performance of risk assessment procedures that the controls are not likely to be effective and therefore may be forced to rely entirely on substantive tests of transactions and balances.

These concerns do not mean that there can be no effective controls in a small entity; on the contrary, strong supervisory controls exercised by management, based on direct personal knowledge of all aspects of the entity, can sometimes offset the limited segregation of duties. Moreover, it is frequently possible to establish some limited degree of segregation of the most important incompatible duties.

Management Override

While the involvement of management in running a small entity can strengthen internal control by offsetting a lack of segregation of duties, management involvement can also have a negative side if it is used to override established internal control policies and procedures. Management often has this authority, sometimes without question. The potential for management override is often viewed as a limitation that increases the difficulty of auditing a small entity. Much depends on the attitude of management and the board of directors towards the importance of internal control and the control environment they foster. If the attitude is poor and the control environment lacking, then it is unlikely that the auditor will be able to make use of tests of the operating effectiveness of controls in designing the audit strategy.
Under GAAS, the auditor needs to consider “the potential for management override of controls and recognize[s] the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud.”

The auditor needs to assess the nature of management involvement in the entity and make a judgment in the particular circumstances as to whether management appears to be overriding internal control. In many cases, this becomes a judgment call as to management’s integrity and managerial ability.

**Limited Knowledge of Accounting and Financial Reporting Among Personnel**

Usually, the entrepreneurial tendency of small entity management is to focus on sales, marketing, product development and growth rather than on financial reporting and accounting systems. Nor do many small entities have the benefit of qualified accounting staff, although accounting software has helped by including basic input controls, such as not allowing unbalanced journal entries to be posted and automation of the bank reconciliation process.

Similarly, small not-for-profit organizations tend to operate with scarce resources and have to focus on their financial and service objectives. Moreover, they often tend to rely on volunteers to provide financial reports and advice. While the volunteers can be highly skilled professionals, they frequently have other heavy time commitments and, consequently, may have limited time to devote to the needs of the entity.

**Who Relies on the Audit?**

Traditionally, the audit of a small business is performed for the benefit of creditors and prospective investors. Current investors — the shareholders — usually do not need an audit because there is no division between ownership and management and they are very close to the day-to-day operations of the business. Ongoing creditors, such as banks providing operating loans, are the largest external users of small business financial statements, but long ago ceased to demand audits for their continuing clients. Rather, they are content to rely on review engagements performed by competent public accountants. Audits of small businesses tend to be reserved for situations where new investors or creditors are being sought or when a business has grown in size and complexity to a point where the bank feels more comfortable with audited financial statements. Other than creditors and prospective creditors, the main users of the annual audited financial statements of small businesses are the owners themselves. Owner-managers tend not to use the audited financial statements to determine how the business is doing, but rather to rely on their own understanding of the business and of other informal performance

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indicators. Owners who are not actively involved in the management of the business may also require audited financial statements.

For not-for-profit organizations, it is more common to have a requirement for an audit under legislation, by-laws or agreements with donors or other stakeholders, making audits more common for such organizations. The stakeholders rely on the audited financial statements to gain some assurance that the funds entrusted to the organization are being managed properly and spent on programs that conform with the requirements of the donors and any government agencies that may be providing funding.

**Small Public Companies**

Small companies listed on exchanges, or whose shares are otherwise traded publicly, are subject to legislation pertaining to public companies. This means the auditors must be registered with the Canadian Public Accountability Board (CPAB).\(^5\) Legislation requires that such companies have a board of directors and an audit committee. If they do not appoint an audit committee, then the entire board of directors will be deemed to also be the audit committee.

The primary role of CPAB is to oversee the work of the auditors of public companies. In that capacity, CPAB organizes regular inspections of the work of such auditors, which means that the auditors must meet the CPAB’s requirements. The additional legal requirements for small public companies and their auditors pose an additional burden for auditors, which must be recognized in the planning and execution of their audit work.

This study does not cover the additional requirements of auditing reporting issuers,\(^6\) as this is a specialized area. The study is likely, however, to be helpful in applying GAAS to such audits.

**AUDITABILITY OF A SMALL ENTITY**

**Can Small Entities be Audited?**

It has sometimes been argued that the characteristics of small entities make them unauditable. In practice, however, most auditors feel comfortable providing audit opinions for the majority of small entities. The fact is, many of the stated reasons for considering small entities unauditable could make any entity unauditable, such as:

- accounting records are so inadequate that recorded transactions are not supported by source documents and/or source documents are not recorded;
- controls do not exist;

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\(^5\) The CPAB website is at www.cpab-ccrc.ca.

\(^6\) “Reporting Issuers” are entities listed on a stock exchange and have a market capitalization or total assets of more than $10 million.
there is a basic disregard for sound business practices; and
the integrity of management is questionable.

These situations can exist in any entity and an auditor needs to be alert to their existence by performing investigative procedures prior to accepting an engagement. The audit risk standards also require the auditor to be vigilant for these situations after accepting the engagement and to undertake a careful review at least each year to determine whether the client relationship should be continued. If such situations are encountered during an engagement, the terms of the engagement should be re-evaluated and the auditor should consider whether an opinion on the financial statements can be expressed and, if necessary, seek legal advice.

While not necessarily rendering a small entity unauditable, a lack of formal systems and authorization procedures and the limited segregation of incompatible duties in a small entity do present the auditor with some challenges. These include:
- difficulty in obtaining audit assurance with respect to the completeness assertion for financial statement items; and
- the risk that management may override established controls and procedures.

**Completeness**

As with other assertions, audit evidence for completeness may be gathered by taking a substantive or a combined approach. An effective substantive approach usually depends on finding some originating record of the revenue generated from outside the organization or involving an outside party. Such records would be traced through the accounting records to the general ledger. Cash registers, for example, are based on the principle of involving the customer in the recording of the sale and can be used for substantive testing or, sometimes, tests of the operating effectiveness of controls.

Internal control for completeness includes policies and procedures designed to:
- identify transactions the entity has executed; and
- provide reasonable assurance that all identified transactions have been recorded.

For example, completeness controls over sales would include a reconciliation of all pre-numbered shipping orders to recorded sales invoices, followed by an investigation of missing sales orders.

Many auditors assume that completeness must be audited substantively. It would seem to be a mistake, however, to assume that all small entities lack controls over completeness. Intuitively, it is much more reasonable to assume that the effectiveness of control procedures over completeness varies from one entity to another. In most entities, there is some procedure to ensure the capture of revenue — whether it be cash registers, activity logs or appointment books — because no entity wants to risk losing revenue. Under the new risk standards, the auditor is required to evaluate the design of controls and assess the likelihood of their effectiveness, so the auditor will be armed with more information about the controls in particular audits. This information will be helpful in designing the tests of the effectiveness of controls or substantive tests, whichever the auditor may
choose. It is often efficient to test the effectiveness of controls in auditing completeness.

Where there are no potentially effective controls over completeness, substantive tests must be used to audit the completeness assertion. The auditor must consider whether, in the absence of potentially effective controls, it is possible to obtain sufficient appropriate audit evidence. The file should document the factors considered and the conclusions reached. If appropriate substantive tests cannot be designed, the auditor faces a scope limitation and needs to consider the expression of a reservation of opinion, as discussed in Section 5510 of the CICA Handbook – Assurance, “Reservations in the Auditor’s Report.”

Management Override

In some cases, the controls in place may be overridden by management concerned about taxes — income taxes, provincial sales taxes (PST), harmonized sales taxes (HST) or goods and services taxes (GST) — or coping with issues such as personal financial problems, marital problems or other personal difficulties. A desire to minimize taxes increases the incentive of management to understate revenues, thus aggravating the completeness problem. This occurs either:

• when an owner-manager or administrator takes money out of the till for personal purposes, which has an effect on net income; or
• when barter transactions are carried out for entity purposes that are not likely to have an effect on net income. An example of such a transaction might be an accountant doing a tax return in exchange for legal services.

All of these issues have a bearing on the integrity of management and highlight the need for continuing vigilance as to acceptance and continuance of the client relationship. A “New Engagements Checklist” is set out in the Professional Engagement Manual.

Although the potential for management override exists in entities of all sizes, management override may be easier to initiate and more difficult to detect when there are only a few employees. Management’s ability and willingness to establish and exercise control are crucial to the auditability of a small entity. Without good management control, an entity may well be unauditable. On the other hand, strong management control provides the potential for management to override established controls and procedures and, thus, weaken internal control.

The ability of management to override established controls or procedures does not mean that a small entity is unauditable; rather, it means that this ability would be considered in the assessment of audit risk and in obtaining an understanding of the design and implementation of internal control, as discussed in Chapters 4 and 6 respectively.
EFFECT ON THE AUDIT
Many characteristics of small entities pose challenges for their auditors. Yet, some of the commonly held views as to the nature of these challenges may, in fact, be misconceptions. Auditors need to clearly define and understand the link between the characteristics of small entities and the nature of small entity audits. This is the focus of the chapters that follow.

The study group believes that a small entity is as auditable as any other entity. While the issues of completeness and management override exist, often to a greater extent than in larger entities, these issues can be effectively addressed by applying the auditing standards as discussed in this study. Moreover, the closeness of management to operations can often be a positive influence on the control environment and on the audit.
INDEPENDENCE AND THE PROVISION OF ADVISORY SERVICES

This chapter discusses two significant issues relating to the audit of small entities:
- the independence issues arising from current Rules of Professional Conduct and Council Interpretations; and
- the impact of advisory services on the audit.

The material in this chapter is not intended to replace, but should be read in conjunction with, the rules, interpretations and guides issued by the CICA and the provincial institutes/ordre.

INDEPENDENCE

Independence is the cornerstone of all audits. The provincial institutes adopted new independence rules in 2003 (2004 for the Ordre des Comptables Agréés du Québec) that pose new and, sometimes difficult, issues for auditors of small entities. The rules contain a requirement for auditors to identify and evaluate all threats to independence before accepting an audit and to reduce any threats to an acceptable level by applying certain safeguards. This “threats and safeguards” approach requires the exercise of professional judgment in particular circumstances.1

The rules set out the types of threats to independence.2 In some cases, the rules and interpretations suggest some safeguards. It is up to each auditor, however, to identify the threats and consider what safeguards to apply and whether the threats can be reduced to an acceptable level. The rules also note that, in some

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1 Two guides on the independence rules will be of interest to practitioners: Guide to New Canadian Independence Standard (Toronto: CICA, 2003) and Guide sur les nouvelles règles sur l’Indépendance (Montréal: L’Ordre des Comptables Agréés du Québec, 2004). In addition, the CICA’s Professional Engagement Manual and Quality Assurance Manual contain helpful guidance on the rules.

2 The rules apply to all assurance engagements, which include audits and review engagements. This study focuses on the audit of small entities, but much of what is said would also apply to review and any other type of assurance engagements. The rules also have relevance to compilation engagements because the rules for those engagements require the disclosure of situations leading to a lack of independence.
circumstances, no such safeguards are available and, accordingly, certain interests and relationships are prohibited.

Provincial institute council interpretations refer to five categories of independence threats:

(a) A Self-Interest Threat arises when an auditor stands to benefit in some financial or non-financial way from an arrangement with a client. An obvious example of a self-interest threat is an audit team member owning shares in a client. The receipt of professional fees for performing the audit does not constitute a self-interest threat.

(b) A Self-Review Threat arises when auditors are placed in the position of auditing their own work as part of the engagement. It may arise, for example, when an auditor provides bookkeeping services or prepares journal entries. This threat is most relevant to the provision of advisory services.

(c) An Advocacy Threat arises when an auditor promotes a client’s position to an extent that independence will be impaired.

(d) A Familiarity Threat arises when an auditor becomes too close to a client.

(e) An Intimidation Threat arises when an auditor has difficulty in acting objectively and exercising professional scepticism because of actual or perceived threats from a client’s directors, officers or employees.

Because many small entities have only limited accounting and financial expertise, they are likely to view their auditor as an expert in accounting, tax and various other areas and, accordingly, expect the auditor to provide the needed expertise as well as an effective audit. Similarly, small not-for-profit organizations often rely on their auditor to provide a variety of advice, including such matters as income tax, payroll questions and, sometimes, controls over systems.

Provision of these additional services can give rise to one or more threats to independence. The following discussion explores the relationship between the additional services and the threats to independence.

Maintaining Accounting Records and Financial Statement Preparation

The independence rules prohibit auditor maintenance of the accounting records of defined reporting issuers (under the independence rules, reporting issuers are listed on a stock exchange and have a market capitalization or total assets of more than $10 million). The maintenance of accounting records is not prohibited for other entities, although it will pose a self-review threat that needs to be addressed and offset with safeguards. An auditor cannot create records or systems and then audit them with independence.

An underlying principle is that maintenance of the records is a management function for which management must be responsible, even though a client may ask the auditor for assistance. As a practical matter, this principle can limit the extent to which an auditor can provide bookkeeping services without applying appropriate safeguards. This principle also underlies the rule with respect to journal entries and source documents or originating data, which states:
A member or firm shall not perform an audit or review engagement for an entity if, during either the period covered by the financial statements subject to audit or review or the engagement period, a member of the firm or a network firm:

(i) prepares or changes a journal entry, determines or changes an account code or a classification for a transaction or prepares or changes another accounting record without obtaining the approval of management of the entity; or

(ii) prepares a source document or originating data, or makes a change to such a document or data.\(^3\)

The degree of self-review threat arising from the preparation of, or changes to, journal entries is also influenced by the complexity of the entries. If the entries are complex, in addition to obtaining the approval of management, it may be necessary for the auditor to consult with another professional accountant for a second opinion. As noted, auditors cannot prepare, or make changes to, source documents or originating data. There is nothing in the independence rules at the time of publication, however, to prevent an auditor from providing typing services, such as, for example, typing cheques for signature by the client. The distinction is that it is the client’s signature on the cheque and not its initial preparation that makes the cheque an official document.

A similar analysis can be applied to the question of the auditor providing bookkeeping services. If an auditor takes source documents that originate from other sources independent of the auditor, such as suppliers, customers or the client itself, and simply records those documents in the books, this does not pose an independence problem. Therefore, an auditor can provide basic bookkeeping services as long as management takes full responsibility for the accounting records being audited and, if any threats to independence do arise, they are reduced to an acceptable level.

How can this position be reconciled with the rule that an auditor who prepares adjusting journal entries must have the client approve the entries as an indication of management’s taking responsibility for them? The difference is that, in the case of the journal entries, the auditor often derives or calculates the content of the entry rather than simply recording the entry in the accounting records. For example, the auditor might prepare an entry for amortization and actually calculate the amount. In this case, it is important to make sure the client agrees with, and takes responsibility for, the entry by, for example, the auditor obtaining the client’s signature to denote approval.

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\(^3\) Institute of Chartered Accountants of Ontario Council Interpretations, Rule 204.4(23). Ontario is used as an example although all other provinces have similar rules and interpretations.
In summary, auditors must exercise judgment in assessing their independence when offering services involving bookkeeping and preparation of journal entries. Such services can create a self-review threat that requires adequate safeguards for protecting independence. Where a self-review threat is considered serious, the auditor and or the client should consider hiring a contract bookkeeper or establishing a clear separation between the audit personnel and bookkeeping personnel.

The new independence rules do not prohibit providing advice on accounting policies and issues, the treatment of particular financial statement items or the wording of notes to the financial statements. The auditors of entities that are not reporting issuers may also prepare the financial statements and draft notes to the financial statements. The basic principle remains, however, that an entity’s management must make the decisions.

Because financial statements are the representations of management, and management has to accept responsibility for them, an auditor must be satisfied that small entity management has sufficient understanding of the financial statements and underlying entries to be able to accept this responsibility. This can be accomplished by reviewing the financial statements with management and discussing the management representation letter with them. The engagement letter also can be a useful vehicle for reminding small entity management of their responsibility for the financial statements.

Operations

Recruiting and training personnel

Auditors are prohibited from performing management functions, as this creates self-interest, familiarity and intimidation threats. Depending on the circumstances, management functions may include some recruiting activities, such as interviewing candidates, determining which candidate should be hired and negotiating with the applicants. There is no reason, however, why an auditor cannot offer training services for an entity’s personnel, provided they are not so extensive as to create a threat to independence that cannot be reduced to an acceptable level by the application of safeguards.

Improving accounting and management information systems and assisting in the design of computerized systems

For entities other than reporting issuers, an auditor may perform IT services related to the design and implementation of financial information systems. Such systems could subsequently become the subject of an audit engagement, raising a self-review threat. Accordingly, certain safeguards should be in place to require management to take responsibility for the systems. As with other situations,

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4 Institute of Chartered Accountants of Ontario Council Interpretations, Rule 204.4(32).
judgment is needed in determining the nature and extent of safeguards required to reduce the threat to an acceptable level.

**Tax**

*Preparation of tax returns, both personal and business, information returns for not-for-profit organizations and tax planning*

Preparation of tax returns does not generally pose a threat to independence. The provision of such services, however, is a good example of a situation where an advocacy threat can arise. The auditor must avoid taking a strong advocacy position for an audit client in dealings with, for example, the Canada Revenue Agency (CRA) or a court. Preparation of a Notice of Objection Form and presentation of the form to the CRA should not be a problem. If a case proceeds to tax court, however, and the auditor is expected to provide technical expertise, then the likelihood of an advocacy threat would be increased.

**Financial and General Advice**

*Assisting in the preparation of budgets, cash flows and forecasts*

An auditor can prepare budgets, cash-flows and forecasts provided the results of these services are not subject to review in any audit engagement.

*Assisting in obtaining financing*

An auditor may assist clients in obtaining financing, provided safeguards are in place to adequately offset any advocacy threat. This, again, is a matter of judgment. An auditor could accompany a client’s management to a meeting with the bankers to provide objective financial advice. It would be important, however, to avoid taking a strong advocacy position. An auditor must maintain a clearly objective viewpoint during the provision of such services.

*Interpreting financial information*

Services related to the interpretation of financial statements are not prohibited under the rules, provided that the principles of management responsibility for decisions are met.

**Valuations**

*Provision of valuation services*

An auditor may provide valuation services to reporting issuers under the new independence rules, but only if the results of those services are not subject to audit and do not have a material impact on the valuation of financial statement items. Again, the rules take a “threats and safeguards” approach and provide guidance on the factors that would increase the significance of the threats, which depend on characteristics such as the materiality of the valuation.
Client Familiarity

While becoming too close to the client is not necessarily an issue unique to the audit of a small entity, it can pose significant problems for an auditor, particularly in a local community. Under the current rules, some auditors have felt a need to revisit their policies with regard to such activities as playing golf and having lunch with clients. Some firms have limited or even banned such activities in some circumstances.

It is not generally considered necessary to ban such activities, but they may need to be controlled. A guiding principle is the perception that might be created in the minds of others observing such events. If an auditor plays golf with a client perhaps once or twice a year, that should not create a familiarity threat. If an auditor plays on the same team as a client every week, however, questions may well be raised. This is clearly a question of judgment. In most cases, there will be no need for significant change in behaviour. Sometimes, however, the perception and/or reality of an independence threat could be significant, and auditors need to be sensitive to this possibility.

Additional Considerations by the Auditor of a Small Entity

Several of the above constraints on practice under the independence rules raise particularly difficult challenges for sole practitioners and small firms. Under the new rules, the safeguards for reducing the level of a particular threat to independence include various forms of consultation with other professional accountants, as well as a division of duties between assurance services and advisory services. These measures are much more difficult for small firms. The Council Interpretations released in conjunction with the rules recognize this:

The size and structure of the firm and the nature of the assurance client and the engagement will affect the type and degree of threats to independence and, consequently, the types of safeguards appropriate to eliminate such threats or reduce them to an acceptable level. For example, it is understood that not all the safeguards noted in paragraphs 47 – 51 will be available to the sole practitioner or small firm or within the smaller clients such as owner-managed entities. Smaller clients often rely on members to provide a broad range of accounting and business services. Independence will not be impaired provided such services are not specifically prohibited by Rule 204.4 and provided safeguards are applied to reduce any threat to an acceptable level. In many circumstances, explaining the result of the service and obtaining client approval and acceptance for the result of the service will be an appropriate safeguard for such smaller entities. Similarly, such clients often have a long-standing relationship with an individual who is a sole practitioner or partner from
Independence will not be impaired provided safeguards are applied to reduce any familiarity threat to an acceptable level.\(^5\)

The Council Interpretations point out that consultation, where appropriate, may often reduce any threats to independence to an acceptable level.

**ADVISORY SERVICES FOR A SMALL ENTITY**

Providing advisory services is a positive aspect of public accounting, because an entity can be well served by relying on its auditor's training and skills. An additional positive aspect of advisory services is that each additional service gives an auditor more information about the entity's activities and management practices. Indeed, an auditor's understanding of the entity is often both extended and updated on a regular basis whenever additional services are performed. An auditor who has developed a close working relationship with management can obtain, relatively easily, the understanding of the entity necessary for the audit. It is essential, however, to document this understanding to provide proper support for the audit opinion.

Specifically, an auditor providing special services is likely in a good position to obtain understanding of the following areas:

- reliability of the record keeping;
- preparation of financial statements;
- adjusting entries;
- the entity's control environment;
- information that can be used for analytical review purposes; and
- integrity of management.

**Reliability of the Recordkeeping**

Because the new independence rule may well affect an auditor's ability to provide recordkeeping services, some auditors prefer to have their staff carry out the bookkeeping function. They will, of course, have to maintain a separation between the staff who do the bookkeeping and staff involved in the audit. This may give the auditor some degree of comfort about the recordkeeping function that is useful in the audit.

An auditor might also be able to assess the reliability of the recordkeeping when performing special assignments. There is, however, still a need to obtain sufficient appropriate audit evidence to support the assertions embodied in financial statement items.

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\(^5\) Institute of Chartered Accountants of Ontario Council Interpretations to Rules 204.1 to 204.6, Interpretation #52.
Preparation of Financial Statements and Adjusting Entries

In conjunction with the audit, as mentioned above, an auditor of a small entity that is not a reporting issuer will often provide adjusting entries or prepare the financial statements. In addition, the auditor will often advise on the computation of accounting estimates. This would include setting up accruals, the allowance for doubtful accounts and the provision for inventory obsolescence. It is important to note that this involvement does not in any way reduce the amount of audit work and documentation required. The additional involvement may, in fact, increase the documentation required, because the auditor would need to document the advice given, the support for any resulting adjustments and the safeguards taken to reduce the threats to independence to an acceptable level.

Control Environment of the Entity

Although controls are often limited in a small entity, controls of at least a supervisory nature are normally exercised. Close management-auditor relationships and frequent contact enable an auditor to become at least generally familiar with the overall control environment. The auditor can then recognize areas where the supervisory controls exercised by small entity management may detect or prevent the occurrence of a material misstatement in the financial statements.

Information that Can be Used for Analytical Review Purposes

In a small entity, the management-auditor relationship, the volume of transactions, the lack of complexity and the limited number of variables in the financial information often combine to enhance the effectiveness of analytical procedures. On the other hand, the effectiveness of analytical procedures, especially in a risk assessment context, is often impaired by the lack of solid financial information. There is a role for analytical procedures in an audit of a small entity, but the role must be assigned with due regard for the individual circumstances.

It is important to recognize the difference between high-assurance and low-assurance analytical review procedures. High-assurance analytical procedures, such as calculating revenue of an apartment building based on rental rates, number of rooms and vacancy rates, are extremely effective and can reduce, or even eliminate, the need for other verification of a particular item. Low-assurance techniques, such as calculating and comparing gross profit percentages, often provide little or no audit assurance, although they can be used to corroborate other audit evidence. To be effective, an auditor must recognize any abnormal or unexpected relationships in financial results. This means that, to reasonably predict financial results, the auditor needs to be familiar with the client’s activities, based on an understanding and analysis of past results.
Integrity of Management

In the past, auditors have normally designed audit procedures on the presumption of management’s good faith. As mentioned in Chapter 1, however, the standard on “Fraud” effectively removes this presumption. In a small entity, an auditor can often better assess management’s good faith in a relationship that has developed through the provision of a wide range of business and tax advice. The auditor would quickly become aware of any factors that might motivate small entity management to materially misstate the financial statements.

Whenever an auditor suspects that management is intentionally misstating the financial statements, procedures should be performed to confirm or dispel that suspicion. When the auditor is unable to dispel the suspicion, or obtains evidence indicating that management has, in fact, intentionally misstated the financial statements, management representations lose credibility. In such circumstances, CICA Handbook – Assurance Section 5136, “Misstatements — Illegal Acts,” paragraph 24, indicates that:

If management, particularly at the highest level, is involved in an illegal act, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements. In such circumstances, the auditor would consider obtaining legal advice about his or her contractual or statutory responsibilities and the appropriate course of action.

CONCLUSIONS

The new independence rules effectively reduce the extent to which auditors can provide advisory services unless they implement adequate safeguards to control any threats to independence.

There can be advantages to both parties in a close management-auditor relationship. An auditor’s advisory services assist small entities by making expert advice readily available on a wide range of accounting, business, tax and financial matters. The broadening of the auditor’s understanding of the entity’s activities may be of significant assistance in the conduct of an effective audit, as long as objectivity is maintained.

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6 CICA Handbook – Assurance, Section 5135, “The Auditor’s Responsibility to Consider Fraud.”
The new independence rules require auditors to document their consideration of independence. This would include a description of the engagement, threats identified, safeguards that have been applied to reduce the threat to an acceptable level and an explanation of how, in the auditor’s professional judgment, the safeguards eliminate the threats or reduce them to an acceptable level. Examples of documentation that would be appropriate in certain circumstances are provided in Appendix B to this study.
Chapter 3

UNDERSTANDING THE ENTITY AND PLANNING THE AUDIT

This chapter discusses several significant aspects of planning the audit of a small entity, including:

- preliminary engagement activities;
- obtaining an understanding of the entity and its environment, including internal control;
- developing an audit strategy; and
- administrative aspects of planning.

Generally accepted auditing standards require that “the auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.” It is just as important in a small engagement as in a larger one to plan carefully so that the audit will be focused on the essential audit areas. As with all audits, time and fee pressures, together with client expectations, provide incentives to do the work efficiently, but the pressures on the audit profession over the last few years have meant that the need to perform careful, high quality audits has never been higher.

“Planning,” Section 5150 of the CICA Handbook – Assurance, discusses the requirement for the auditor to develop an “overall audit strategy” and an “audit plan.” These concepts reflect the need for the auditor to make strategic audit decisions relating to the scope and timing of, and approach to, the audit and then develop detailed work plans consistent with the overall audit strategy. The audit plan describes the nature, timing and extent of risk assessment procedures, further audit procedures to respond to assessed risks and any other procedures required to comply with CICA Handbook – Assurance Recommendations.

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1 CICA Handbook – Assurance, “Generally Accepted Auditing Standards,” paragraph 5100.02 (i).
PRELIMINARY ENGAGEMENT ACTIVITIES

3 Planning encompasses those steps carried out early in the engagement, including the auditor's consideration of acceptance/continuance of the audit and the ethical and independence requirements. These considerations need to be documented. Planning continues throughout the audit, and is adjusted for changing conditions and circumstances. For continuing audits, planning ideally begins with the completion of the previous audit.

4 Once a decision is made to accept or continue the audit, the auditor should establish an understanding with the client of the terms of the engagement. This would normally be documented in an engagement letter, which should be in place in advance of the audit.

OBTAINING AN UNDERSTANDING OF THE ENTITY

Purpose

5 The CICA Handbook – Assurance guidance on obtaining an understanding of the entity states that:

The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.2

To meet this standard, an auditor needs to understand the industry in which a client competes, as well as its operations, strategy and position within the industry.

6 A thorough understanding of the entity is intended to make the audit effective. This understanding can help an auditor decide on the nature, timing and extent of audit procedures and whether balances and explanations of changes make sense in light of current operations and the industry. The auditor needs to be satisfied that the current year’s audit environment is adequately documented and communicated to any assistants working on the audit.3

7 To obtain a proper understanding of the current year’s audit environment, the understanding of the entity, as documented during previous audits, is usually updated by enquiry and, where necessary, by observation. The “Understanding the Nature of Entity” form in the Professional Engagement Manual is suggested for documenting information about the entity’s operations and the environment in which it operates.

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2 CICA Handbook – Assurance, “Generally Accepted Auditing Standards,” paragraph 5100.02(ii) and “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” paragraph 5141.002.

3 This is covered more fully in Chapter 9.
Previous Year’s Audit Working Papers
Planning for an audit should really have begun when the previous year’s audit was completed.\(^4\) That is the time when all the inefficiencies and ideas for improvement are fresh in the auditor’s mind. If these ideas were documented at that time, a review of the previous year’s working papers will be particularly useful in planning this year’s audit.

While the audit approach used in the previous year should not be adopted automatically, for reasons of efficiency, parts of that approach and certain of the working papers will always be carried forward. Where working papers are carried forward, or do not require many changes year to year, it is particularly useful to have them in electronic form.

An auditor often is asked to act as an advisor during the year. As a result, the auditor could become oriented to the goals and objectives of management. This orientation, as previously discussed, could impair or be seen to impair the auditor’s independence. A review of the previous year’s working papers provides an opportunity to regain an “auditing perspective” on the activities of the client entity.

Using a Strategic Approach: Initial Discussions with Management
The relative importance of individual characteristics of small entities will vary from one entity to another. This means that an auditor requires an understanding of how the characteristics apply to each particular entity before deciding on how best to approach the audit. To gain an understanding at the outset of what an entity is all about, it is best to go directly to management. The auditor can ask management how the entity is controlled and what its mission is. This information can then be used to plan the audit; it has been called “the strategic approach to an audit.”

Understanding management’s perspective is particularly useful for identifying controls on which to rely and for applying analytical techniques. For example, many small entities are franchise operations and are subject to control procedures laid down by the franchisor. The auditor should look for evidence of these controls in any manuals supplied by the franchisor and ask management whether the controls have been implemented. This information can then be used in performing the evaluation of the design and implementation of controls that the auditor is required to do. As well, the franchisor would probably make available statistics on other franchisee operations, which would be useful for analytical techniques.

\(^4\) For first-time audits, please see the CICA Audit Technique Study *The First Audit Engagement* (Toronto: CICA, 1996).
Several types of small entities attempt some reconciliation of input to output, thus providing controls over the completeness of revenues. Quite often, management has a feel for these controls, or even maintains some informal control records that can be used in the audit. For example, a gravel pit operator might compare the tonnage removed from the pit to the sales that are recorded. Similarly, a plastics processor who buys plastics and converts it to another form would often be able to match quantities purchased to quantities sold. There are many similar situations where an auditor can find out how management determines that all sales are recorded and thereby discover a new control procedure to evaluate.

Management controls can also be useful in auditing payroll. In most small entities, management is intimately familiar with staff salaries, and management’s review and approval of payrolls can be a useful control, provided there is an audit trail. It is important to note that management’s review and approval is not sufficient audit evidence for payroll. Audit procedures still have to be carried out.

In many small entities, management uses certain “rules of thumb” to manage the business. Sometimes, an auditor can use those rules as guidelines in the analytical review. For example, in the audit of a not-for-profit service provider, a central part of the audit will be to review the grants received and receivable. An analysis of the grants will provide audit assurance on revenues and deferred revenue, which usually comprise the larger items in the financial statements. Through discussion with management, the auditor can gain an understanding of the entity’s grant programs. Then the results of the individual grants will become easier to understand and anomalies will stand out more readily.

If an auditor begins with management’s perspective, this also improves the chances of meeting the entity’s expectations about the audit. Management may have specific concerns that should be addressed in the audit, or particular expectations about the audit that should be considered. Sometimes, these expectations need to be managed, so a discussion early in the engagement can be beneficial from this point of view.

Once a thorough discussion has been held with management, understanding the current year’s audit environment normally involves:

- establishing whether there have been any changes of audit significance in the entity’s operations and activities beyond what was learned from the discussions with management;
- analysis of entity and industry trends and future plans; and
- obtaining an understanding of the control environment.

Identifying Significant Changes

Since the last audit, there may have been changes in regulations, the industry, the environment or the entity’s operations that will affect the audit of the financial statements. The auditor’s written record of advisory services provided to the entity during the past year should be reviewed during the planning stage to identify significant changes that might affect the current year’s audit. For example, the
auditor might have given advice on financing an expansion, improving the management information system or negotiating with a significant funding provider. Of course, this would only be possible where the *Rules of Professional Conduct* concerning independence are not violated.

Changes that may have an effect on the audit in terms of timing, risk and staffing would normally include the following:

- acquisition or disposal of a major item of equipment, outlets, service centres or branches, product lines, or segments of an entity;
- changes in major users of the financial statements, including owners, major suppliers, funding bodies, customers or related parties, bankers and other creditors;
- changes in key personnel or in the organizational structure;
- changes in the recording and processing of transactions, particularly if any applications have been computerized;
- changes or the need for changes in the entity’s accounting policies;
- changes in any government or regulatory legislation affecting the entity;
- changes in management’s personal circumstances; and
- changes in the composition of a board of directors.

Such changes would be noted when completing or updating documentation pertaining to the understanding of the entity. Planning reports, budgets or forecasts could also, to the extent practicable, be reviewed to identify matters affecting the current year’s audit. A change in a product line, for example, may mean that the auditor should give special consideration to the valuation of inventory on hand.

**Analysis of Trends**

GAAS require some analysis to be performed as part of the risk assessment procedures, but the analysis is not required to be extensive. The depth of analysis that is possible in a small entity audit at the planning stage depends to a considerable extent on what information is available. Often, there is no hard information to use and considerable reliance must be placed on discussions with management as to what has happened during the year. It is important, however, for the auditor to get a feel for the entity and what kind of financial results to expect.

If interim or monthly financial statements are available, the auditor could obtain copies to see if they reveal any major events or changes since the last audit. A few key techniques can be used on these statements to highlight possible changes (for example, gross profit ratios, inventory turnover, etc.). Although computerized accounting packages enable more frequent preparation of periodic financial statements, they may not be useful in trend analysis because key adjustments and accruals are often recorded only at year end.

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5 *CICA Handbook – Assurance*, Section 5301, "Analysis," paragraph .08.
In audits of very small entities, the analysis would likely be the first task on the job because it is unlikely that an auditor would pay a special planning visit for an audit that will be undertaken in a day or two. For these audits, it is unlikely that financial statements will be available at this stage. It may be possible, however, to obtain the trial balance before the visit. The information can then be entered into an audit software program and a draft brought along when the audit begins. This allows the auditor to do some analysis for planning purposes prior to arrival (for example, profit or loss for the year, comparison to last year, new accounts opened, etc.).

Reasonably accurate interim or monthly financial statements may be available for many small entities. It may also be necessary to briefly review the general ledger or other accounting records when visiting a client to update the understanding of the entity.

To gain an understanding of the industry and current trends, the Internet is an indispensable source of information and statistics. Other entities in the industry may have websites that can be scanned for trends. In addition, industry organizations may have websites with useful information in them. It is sometimes useful for the auditor to refer to published statistics, particularly when the industry is new to the auditor. Such statistics are available for drug stores, clothing retailers, restaurants and many other types of small businesses and not-for-profit entities. Reference to such statistics would simply reinforce the auditor’s general understanding of the entity’s activities and, perhaps, provide a frame of reference for identifying any changes or trends that may be important to the audit. This information might also be helpful in identifying significant events or areas requiring particular attention during the audit, in terms of investigating the reasons for unexpected variations and seeking evidence to corroborate the results.

Obtaining an Understanding of Internal Control

GAAS require that, in obtaining an understanding of an entity, the auditor needs to obtain sufficient understanding of its internal control to identify and assess the risks of material misstatement of the financial statements. This understanding is required regardless of whether the auditor has an expectation that the controls will be operating effectively and thus be considered for testing during the audit. Because of this requirement, the role of internal control is fundamental to developing an audit strategy in any audit of a small entity.

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6 For example, publications such as *RMA Annual Statement Studies 2005-2006* (Risk Management Association – www.rmahq.com) contain industry ratios.

The standards on fraud need to be taken into account in planning the audit. Certain characteristics of a small entity — such as the concentration of decision-making power, limited segregation of duties and management override — may lead to an increased risk of misstatement in the financial statements due to fraud. On the other hand, management may be able to exercise more effective oversight than in a larger entity, thereby compensating for the generally more limited opportunities for segregation of duties. The auditor would need to evaluate the approach and attitude of management on a case-by-case basis in identifying the risks of material misstatement due to fraud. If, for example, management insists on authorizing key transactions, this may compensate for otherwise weak controls and reduce the risk of employee fraud.

DEVELOPING AN OVERALL AUDIT STRATEGY

Types of Audit Strategy

During the planning stage, an auditor needs to identify the essential audit assertions and then to decide how to audit them. Significant balances or areas where there is a high risk of material misstatement must be identified. The audit work to be performed on these areas can then be determined relative to their importance when the detailed planning is carried out.

Two basic types of audit strategy may be developed:

- an audit strategy based on an expectation of the operating effectiveness of controls (a combined approach where tests of the operating effectiveness of controls would be used in conjunction with substantive procedures); and
- an audit strategy based on no expectation of the operating effectiveness of controls (where substantive tests are used).

In developing an overall audit strategy, the auditor would also take into consideration the results of the preliminary engagement activities. The auditor’s task is to ensure that the audit approach adopted is the most appropriate to satisfy the specific audit objectives. The audit strategy must be developed for each financial statement item on an assertion-by-assertion basis.

The auditing standards warrant some explanation as to what is expected of the auditor in developing the audit strategy. CICA Handbook – Assurance Section 5143, “The Auditor’s Procedures in Response to Assessed Risks,” paragraph 23, states:

*When the auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.*

To comply with this standard, the auditor would first conduct a review of the design and implementation of controls. This would include doing enough work on the implementation, such as walk-through testing, to develop an expectation as to whether or not the controls are likely to be effective. The auditor would then
perform an assessment of the risks of material misstatement, and in so doing, would make a judgmental decision as to whether or not to include the results of the controls work in this assessment. Therefore, it is up to the auditor’s judgment as to whether to carry out tests of controls. Under this standard, the auditor might well conclude that certain controls are likely to be effective, but then decide to proceed with substantive tests rather than tests of controls on grounds of efficiency or any other reason deemed appropriate, provided, of course, the auditor is satisfied that substantive tests alone will suffice.

This interpretation is supported by the wording in CICA Handbook – Assurance Section 5143, “The Auditor’s Procedures in Response to Assessed Risks,” paragraph .08, which states:

In other cases, the auditor may determine that performing only substantive procedures is appropriate for specific assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor’s risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient.

The end result of this standard is that the auditor is required to evaluate the design and implementation of internal controls, but is not required to test them. In some cases, however, having invested the time in evaluating internal control, the auditor may well find that it is more efficient to perform tests of the operating effectiveness of the controls. In any event, the understanding obtained of the controls and related processes may be helpful in designing substantive tests.

**Audit Team Meeting**

GAAS require that the audit team discuss the risks of material misstatement in the audit. This discussion places particular emphasis on the susceptibility of the entity’s financial statements to material misstatement due to fraud. A significant matter in this discussion would be the role of management and whether management is likely to increase or decrease the risk of fraud. Normally, it is advisable that such discussions take place at a meeting of the audit team during the planning stage of the audit. The purpose of this meeting is to draw upon the experience of the team members in conducting the audits of previous years of this particular entity to assist in directing team efforts to the areas with the greatest risk of material misstatement.

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Where a sole practitioner does the work, the team meeting could be replaced with the preparation of a memo for the audit file outlining the considerations that would have been discussed in a team meeting. That memo would indicate that those matters were specifically considered during the planning process, along with their impact, if any, on the audit strategy adopted. In certain circumstances, the practitioner would consult with a professional colleague in the planning phase of the audit to discuss relevant issues. If particularly contentious issues were to arise, it might be advisable to contact the local provincial institute/ordre.

Documentation
Adequate and proper documentation of audit strategy decisions is not only crucial to the proper planning of the audit but, if carried out systematically, can also assist the auditor in ensuring that the plan for gathering audit evidence is sound and efficient.

Documentation of the audit strategy is not straightforward, however, because of the many variables inherent in the decision making. Some auditors prefer to document the overall strategy in an overview working paper and then to develop the strategy for each major financial statement item, or each audit objective, or each financial statement assertion in supporting schedules.

The audit strategy should be communicated to the client, preferably in the form of an audit strategy letter and, of course, a copy of this letter should be retained in the file. Entities, including all not-for-profit organizations, that have public accountability are, therefore, required to communicate their audit strategy. Section 5751 does not require that the communication be in writing, but paragraph 5751.37 indicates that written communications are generally the preferred practice. While, strictly speaking, this Recommendation does not apply to entities without public accountability, the CICA Handbook – Assurance, in Section 5751, “Communications with Those Having Oversight Responsibility for the Financial Reporting Process” recommends that such communications be considered for such entities “whether or not in writing” (paragraph 5751.05).

DEVELOPING AN AUDIT PLAN
The development of the actual audit plan moves the planning to a greater level of detail than that involved with the development of overall audit strategy. Here, the work is focused at the assertion level and specific audit procedures are determined on an assertion-by-assertion basis.

Establishing Audit Objectives
The assertions set out in CICA Handbook – Assurance, “Audit Evidence,” Section 5300 need to be restated into audit objectives to assist in developing and documenting the audit strategy. Paragraph 5300.21 sets out descriptions that can be used as generic objectives related to each assertion. For example, the assertion of “occurrence” is followed by the description “Transactions and events that have
been recorded have occurred and pertain to the entity,” and the “completeness” assertion is followed by the description “All transactions and events that should have been recorded have been recorded.”

Establishing clear audit objectives assists the auditor in identifying audit evidence that satisfies more than one audit objective. For example, in addition to providing direct audit evidence on existence of accounts receivable, positive confirmation of accounts receivable also provides some audit assurance on the following audit objectives related to sales transactions:

- recorded sales represent goods shipped and/or services rendered — occurrence;
- sales amounts have not been overstated — accuracy;
- credit notes are complete and have been properly recorded, priced and issued — completeness and accuracy.

Identifying audit objectives by assertion and financial statement item also provides some assistance in determining the appropriate direction of testing, based on the presumption that asset and expense balances are audited primarily for overstatement and liability and revenue balances are audited primarily for understatement. It is important in auditing accounts receivable, for example, to include tests to establish that the accounts exist and are properly valued. The direction of this testing will be, therefore, from the recorded balances to the underlying documents. On the other hand, the audit of accounts payable would include tests to establish that all liabilities are recorded. It would be of little value, therefore, to test from the recorded balances to the underlying documents. The direction of testing would more appropriately be from the underlying documents to the recorded balances.

Establishing an appropriate direction of testing does not mean that the auditor should avoid checking for the understatement of assets and the overstatement of liabilities. Considering the direction of testing simply provides for an efficient way to achieve these objectives. For example, audit satisfaction that accounts receivable are not understated is usually best obtained by testing revenues for completeness. In this way, the test addresses both revenue and accounts receivable. Similar reasoning applies to other relationships, such as purchases/expenses and inventory/cost of sales.

As audit work on recorded balances does not normally cover the completeness assertion, because a lack of completeness relates to that which is not recorded, other procedures are necessary to satisfy that audit assertion. In addition, there is a need for assurance on the measurement of transactions, such as sales, throughout the entire period and not just for the portion of the period reflected in receivables. Moreover, accounts receivable confirmation may address the possibility of overstated sales due to pricing or other mechanical errors, but will provide little or no assurance on the understatement of sales.
Conclusion

The development of an audit plan requires analysis and thought. While the process may be costly at first, there is significant benefit in the development of audit programs that provide assurance on areas that might otherwise have been missed or not properly audited. Care in the development of an audit plan also provides an opportunity to identify efficiencies in the testing process.

ADMINISTRATIVE ASPECTS OF PLANNING

Quality Control and Assigning Personnel

An essential step in good planning involves considering the technical requirements for the audit and other services provided to the client so that appropriate staff can be scheduled for the job. Also fundamental is the timing of the work, which should be coordinated with the client at the planning stage.

Assignment of personnel to an audit is an important element of planning. Assignment decisions are influenced by matching the skills of the personnel to the needs of the client, but also need to take into account the independence rules and the quality control standards. Additional guidance on the quality control standards is found in the CICA’s Quality Assurance Manual.

The independence rules, of course, prohibit assigning to an audit any personnel who might have a conflict under the rules.

The quality control standards, together with the independence rules, set out a number of matters, including:
- establishing a system of quality control;
- independent review requirements by a partner not connected with the audit.

System of quality control

The “General Standards of Quality Control for Firms Performing Assurance Engagements” in the CICA Handbook – Assurance require firms performing assurance engagements to establish a system to ensure that adequate quality control governs their audits. These standards include a variety of steps, including having a senior person assume responsibility for monitoring quality.

The General Standards recognize, however, that this may be applied in small firms in an informal way. The standards specify that:

The nature, extent, timing and documentation of the policies and procedures developed by firms to satisfy the requirements of these Recommendations will vary and will depend on many factors, including the size and the nature of the practice of the firm and its operating

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9 The term “independent review,” used here because it is the most common term, means the same as “engagement quality control review” in the Quality Control standards and “file quality review” in the Quality Assurance Manual and the Professional Engagement Manual.
characteristics. The policies and procedures need not be complex or time-consuming to be effective. These Recommendations describe responsibilities for several different roles and functions within the firm, including overall quality control and monitoring. For a small firm, it may be necessary for one person to perform more than one of these functions. In some circumstances, it may be appropriate to use the services of a suitably qualified external person. When a firm decides to use such a person, care would be taken to establish the legal responsibilities of the parties and to safeguard client confidentiality.10

Sole practitioners might consider making an arrangement with another practitioner or firm, perhaps one with specialized expertise, if needed. The Quality Assurance Manual provides some guidance on this point.

Independent reviewer

The quality control standards also call for the independent review of high-risk files. Again, the Quality Assurance Manual provides some guidance on this requirement for small firms, pointing out that:

Smaller firms may not have a person qualified to perform an objective FQ [File Quality] review. This may be due to a variety of factors ranging from a lack of suitably qualified personnel, familiarity with the client, involvement in engagement decision-making or the existence of independence issues.11

The manual goes on to state that “When an external FQ reviewer is required, the firm should search for a suitable firm or individuals who can perform the reviews required at the required times.”12 It also includes a number of requirements to look for in selecting a reviewer. These include competence, character, commitment, chemistry and other practical issues such as time and cost.

Engagement partner rotation

The Independence Rules (204.4) call for partner rotation on a five-year basis for reporting issuers. This rule does not apply to entities not listed on a stock exchange, but the Quality Assurance Manual, A3.4-1, suggests that it may be considered as a best practice for sensitive engagements, engagements involving a matter of public interest, or engagements where the same senior personnel have been involved for a significant number of years.

12 ibid.
The manual does recognize the difficulties that this idea might entail:

For smaller firms, the practice of partner or senior staff rotation may simply not be practical. There may not be enough assurance partners with the necessary knowledge and experience to serve as the lead engagement partner. In these circumstances the firm should involve an additional professional accountant (not otherwise associated with the assurance team) to review the work done or otherwise advise as necessary. This person will likely be someone from outside the firm.13

Impact of quality control standards on audit planning for small entities

The end result of the requirements is that there are quality control issues that an auditor of a small entity must consider in planning an audit. In particular, these issues will have an impact on the assignment of personnel to an engagement. There are several rules that could be onerous, but the standards do provide relief to recognize the practicalities for small audit firms. Nevertheless, the requirements warrant careful consideration, particularly for high-risk audits or those with a higher than normal public profile.

Time Budget and Fee Estimate

An auditor may prepare a time budget for the current year’s engagement together with a fee estimate. This is especially important on a small engagement where the time budget is tight. The degree of detail need not be onerous. On simple jobs, it might just be a global estimate of total time. On more complex assignments, it might be useful to allocate the time to individual items or groups of items. The important thing is to establish some control over the time, thereby adding a degree of discipline to the work.

Client Assistance

A key way to perform an efficient audit is to seek client assistance in preparing some of the working papers. During the planning stage, the auditor should prepare a list of working papers and any other assistance the entity could provide for the audit. With smaller entities, the accounting expertise available will usually be much less than with larger ones. As a result, the auditor may not be able to obtain a complete set of working papers and a set of financial statements prior to starting the audit. Even the smallest entity, however, may be able to prepare some working papers for the auditor.

Chapter 4

RISK ASSESSMENT

This chapter discusses engagement risk, as well as audit risk and its components, involved in the audit of small entities. It also addresses determination of appropriate risk levels and how an auditor might apply the audit risk model in a small entity audit.

ENGAGEMENT RISK
Any audit poses some degree of risk that the auditor’s reputation may later be damaged by litigation or adverse publicity. This risk, often called engagement risk, exists independently of the audit and the audit risk model. In assessing engagement risk, an auditor would ordinarily consider factors such as:

- the client's reputation and association risk;
- the effect on interested parties (for example, creditors and shareholders, etc.) of a material error occurring and being discovered after the audited financial statements are released;
- the risk of fraud occurring and remaining undetected;
- the risk of financial loss to the client, the auditor or a third party if such an error or fraud were discovered; and
- the auditor’s own skills and whether they are sufficient for the particular engagement.

Engagement risk should be assessed before an engagement is accepted. As well, in each subsequent year, the auditor should update the assessment and decide whether the engagement should be continued.

Compared to the engagement risk in the audit of a large, publicly traded corporation, the engagement risk arising from the audit of most small entities is often considered to be low. This presumption should be treated with some caution, but may apply if:

- the financial statements have limited circulation;
- the parties interested in the financial statements are limited to the entity’s single or few owner(s) or members and a few creditors;
- the financial strength and profitability record of the entity is strong;
- the absolute size of the amounts is small;
- the entity does not handle public money, such as trust account funds; and
- management integrity is high.
Other circumstances, however, may lead to higher engagement risk, including:
- an absentee owner;
- a low level of management integrity;
- the prospect of the entity being sold or going public;
- a not-for-profit organization that has a high degree of public exposure;
- a financial position or record of profitability that is weak;
- a plan for significant financial reorganization in the foreseeable future;
- a highly leveraged situation;
- a technical default (or near default) on a financing covenant such as maintenance of minimum working capital; and
- exposure to environmental issues.

For reasons outlined in Chapter 2, evaluating management’s integrity is a critical step in the audit of a small entity. In evaluating management integrity, an auditor would consider matters such as:
- past experience with the client;
- reliability of previous management representations;
- receptivity of management to correcting errors discovered during previous audits;
- difficulties in obtaining information and responses during previous audits.

An assessment of a high engagement risk could have a number of implications, including a decision to decline the engagement or a re-appointment. It might also result in having an independent partner review the files. Finally, it would result in an assessment of the effects, if any, on the evaluation of audit risk.

The CICA Handbook – Assurance, Section 5135, “The Auditor’s Responsibility to Consider Fraud,” contains expanded guidance and required procedures for assessing the risk of material misstatement due to fraud. It requires the auditor to identify and assess the risks of material misstatement due to fraud when identifying and assessing the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. It also requires the auditor to obtain written representations from management regarding its assessment of the risk of fraud.

The risk of fraud in small entities must be evaluated in each individual case, as there is a wide variety of circumstances. In some entities, the manager will be involved in day-to-day procedures to the point that fraud by anyone else in the organization is almost impossible. Therefore, while the small entity is not likely to have any formal policies, much will depend on the auditor’s evaluation of the particular circumstances, as well as the role and ethical behaviour of management.
AUDIT RISK
The prime objective of an audit is to seek reasonable assurance that the financial statements contain no material misstatements. The term “reasonable assurance” indicates the existence of some risk that a material misstatement might remain undetected. This risk, known as audit risk, is defined in the *CICA Handbook – Assurance* as:

The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.¹

The quality control standards released in 2004 call for a consideration of audit risk before an audit is accepted and each year thereafter before the annual decision is made to continue with the engagement. This does not involve a complete risk assessment such as would be carried out during the audit, but simply that the knowledge the auditor would have about audit risk be taken into account. In addition, the standards call for a consideration of business risk to the extent that it is relevant to the financial statements. Although a good deal of work must be carried out before the engagement can even be accepted or continued, the work done during this phase is likely to be extremely useful in carrying out the rest of the audit. “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” Section 5141, paragraph .007 of the *CICA Handbook – Assurance* provides an indication of the type of procedures that should be carried out:

*The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:*

(a) enquiries of management and others within the entity;
(b) analytical procedures; and
(c) observation and inspection.

This process of enquiry, analytical procedures and observation and inspection is essential for understanding the level of audit risk and planning the audit. The remainder of this chapter and subsequent chapters explain what must be done to meet the audit risk standards in the audit of a small entity.

Factors Relating to Audit Risk
In a small entity, audit risk largely depends on the integrity of management, the attitude of management towards controls and the existence of factors that may motivate management to materially misstate the financial statements.

¹ *CICA Handbook – Assurance*, "Reasonable Assurance and Audit Risk," paragraph 5095.08.
These factors could include:

- a desire to minimize taxes by reducing income;
- an inclination to charge personal expenses to the entity;
- a significant strain on management’s personal finances;
- a pressure of outside financing that depends on presenting favourable operating results or an improved financial position;
- a difficulty in meeting financial obligations;
- a management propensity for risk taking; and
- a possibility of project funding being denied or having to be returned.

When there is an absentee owner, factors that might motivate an employee/manager to cause material misstatements also include:

- inadequate compensation (or compensation perceived as inadequate); and
- manager or employee bonus schemes geared to financial performance.

Among the several general factors that could affect the determination of business risk, and thus audit risk, are profitability, economic conditions, types of creditors and the potential uses of the financial statements. Much of this information is usually documented as part of the understanding of the entity.

The guiding principle as to how much audit risk is acceptable is found in the 
CICA Handbook – Assurance, which sets out examination standard #1 as follows:

_The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit._

The determination of the audit risk level requires the exercise of professional judgment. The audit risk level may or may not be expressed in quantitative terms. When it is, the most practical approach is to set a standard acceptable audit risk level that would be used for normal audit engagements, taking into account the considerations discussed above. A common approach is to set the standard acceptable risk level at no greater than 5% unless the presence of some of the factors that increase audit risk provide a strong reason to establish a lower level, say, 3%. This level has a direct and measurable impact on testing when statistical sampling is used, because a 5% risk level translates into a 95% confidence level (and 3% into 97%). When judgmental sampling is used, the level of audit risk still has a direct impact on the nature, timing and extent of testing. Although this impact, being judgmental, cannot be measured, a higher audit risk level would still result in a strategy where more reliable evidence is sought, the extent of audit procedures is expanded and work is performed closer to the year end.

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2 CICA Handbook – Assurance, "Generally Accepted Auditing Standards," paragraph 5100.02.
The approach that must be taken is to assess the level of audit risk at the assertion level and at the overall financial statement level by carrying out risk assessment procedures. The resulting evaluation is then used to determine the further audit procedures that must be performed to reduce audit risk to an acceptably low level. The further audit procedures carried out must be linked directly to the risk evaluation.

THE AUDIT RISK MODEL
Components of Audit Risk
The audit risk model does not distinguish between audits of large and small entities. Audit risk consists of two components: the risk of material misstatement and detection risk. The risk of material misstatement, in turn, is also comprised of two components: inherent risk and control risk.

Inherent risk is the susceptibility to misstatement of an account balance, class of transactions or disclosure that could be material when aggregated with misstatements in other balances, classes or disclosures, regardless of the existence of internal control. The risk of error is greater for some assets than for others, depending on the nature of the asset and its susceptibility to manipulation or inadvertent error. For example, manufactured inventory, with all its cost components and allocations, is often more susceptible to error than purchased inventory, where cost is more readily determinable.

Control risk is the risk that internal control will not prevent or detect, on a timely basis, potential misstatements in an account balance or class of transactions that could be material when aggregated with misstatements in other balances, classes or disclosures. Control risk is a function of the effectiveness of internal control. Some control risk will always exist because of the inherent limitations of any internal control system.

Detection risk is the risk that an auditor’s procedures will not detect misstatements in an account balance, class of transactions or disclosure that could be material when aggregated with misstatements in other balances, classes or disclosures. It is a function of the effectiveness of the audit procedures the auditor applies. This risk arises from uncertainties that exist from not auditing 100% of an account balance or class of transactions. Other uncertainties can arise through the application of inappropriate audit procedures, misapplication of audit procedures or misinterpretation of audit results. The auditor can often reduce the risk of failing to detect material errors by increasing the extent of substantive procedures (analytical review and detailed tests of balances and transactions) or by choosing more effective procedures.

Interrelationship of Risk Components
Inherent and control risk differ from detection risk in that they exist independently of the financial statement audit. Inherent risk exists as a function of the entity and control risk depends on how the entity operates. Detection risk, however, relates to
the audit procedures and can be modified at the discretion of the auditor. Accordingly, the auditor’s role is to assess the level of inherent and control risk and then to apply audit procedures to reduce detection risk to a level that will reduce overall audit risk to an acceptably low level.

Historically, this assessment involved assessing inherent and control risk separately. Under current standards, however, an auditor is encouraged to carry out the risk assessment on a combined basis, although separate consideration is still acceptable. In any event, an auditor must arrive at an assessment of the combined level of inherent and control risk, which is referred to as the risk of material misstatement, at the beginning of the audit. The assessment of the risk of material misstatement is carried out at both the overall financial statement level and the assertion level. This is accomplished by applying “risk assessment procedures” and by audit team members discussing the susceptibility of the financial statements to material misstatement.

RISK ASSESSMENT PROCEDURES

One of the major aspects of the audit risk standards in the CICA Handbook – Assurance relates to the extent of work an auditor must do in assessing audit risk. The standards explicitly require the auditor to acquire an understanding of the entity, its environment and its control systems in the risk assessment that must be carried out. Standards also require that the auditor’s procedures consist of enquiries of management and others, analytical procedures and observation and inspection. The enquiries of management must encompass the entity’s business risks (specifically those that affect the financial statements) and how those risks are being addressed. In a small entity, the responses to the risks being faced may not be well documented and may not be formally determined. In the audit of a small entity, however, the auditor may find more opportunities to observe the processes followed by management and the way in which business risks are addressed.

For a small entity audit, much of the enquiry will be directed to management, although this depends on the size of the entity. Some entities will have staff involved in the production of the financial statements, or key people who are involved in monitoring the environment and influencing the entity’s responses to that environment. For example, if one or two managers essentially decide everything that happens in an entity, then enquiry of those people will be sufficient. If, however, an entity is a business with a more sophisticated management structure, such as an automobile dealer, there may well be a management team that assists with the major decision making, as well as accounting staff (perhaps holding professional designations) to maintain the business records. In such a case, enquiries of these other key people would be necessary to assess the risk of material misstatement.
APPLYING THE AUDIT RISK MODEL

Risk Level Assessment

The relationship of the three components of audit risk may be expressed in the form of the following equation:

\[
\text{Audit risk} = \text{Risk of Material Misstatement} \times \text{Detection Risk}
\]

or

\[
\text{AR} = \text{RMM} \times \text{DR}.^3
\]

The relationship of the components to each other suggests a number of considerations for the auditor.

The auditor assesses the risk of material misstatement (IR x CR) to determine the level of detection risk required to reduce audit risk to an acceptable level. As the auditor’s assessment of the risk of material misstatement decreases, the acceptable level of detection risk increases. The higher the level of acceptable detection risk, the less audit effort is required.

Having established the acceptable level of audit risk, the auditor would determine how best to reduce detection risk to the point that audit risk is reduced to an acceptably low level for the assertions affecting specific financial statement items.

How the audit risk level for the statements as a whole relates to the risk levels for individual assertions is explained in the CICA Handbook – Assurance as follows:

Although the components of audit risk (inherent, control and detection risks) will vary from assertion to assertion, the audit risk attached to each assertion at the account balance or class of transactions level must ultimately be no greater than the acceptable level of audit risk for the financial statements as a whole. The way in which the auditor determines such risks and combines them involves professional judgment and is dependent on his or her audit approach.\(^4\)

This means that the audit risk level for the financial statements as a whole cannot be lower than the highest risk level of any of the assertions that relate to significant account balances or transactions. If, for example, there is a 4% risk of material error for inventory valuation, the risk of material error for the financial statements as a whole must be at least 4%.

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\(^3\) The equation has traditionally been expressed in terms of the components of risk. In this form it becomes AR = IR x CR x DR. If the components of IR and CR are to be recognized as comprising RMM, they should logically be shown as a group, such as in the form AR = (IR x CR) x DR.

Risk of Material Misstatement

Inherent risk

The evaluation of inherent risk in small entity audits often assumes particular importance. This is because controls are often limited, requiring an assessment of control risk as “high.” With audit risk established at a desired level (say 5%), this leaves inherent risk as the only remaining variable in the risk equation affecting detection risk. Therefore, the auditor’s evaluation of inherent risk will have a direct effect on the nature, timing and extent of substantive testing.

In assessing inherent risk at the assertion level, an auditor would consider factors such as:

- **Nature of the item.** An inventory of appliances purchased for resale, for example, their costs being easily determinable, results in lower inherent risk than an inventory of manufactured light bulbs, where the cost determination and valuation is more difficult.
- **Prior experience.** In satisfying the audit objective in previous years, an auditor may have uncovered numerous errors that required adjustment or, conversely, the item may have been error free.
- **Use of estimates.** Items that include estimated amounts can be difficult to audit, especially in a small entity where management’s estimates are less likely to be developed using formal models and procedures.

Other, more general entity level risks may have an impact on inherent risk for particular items. These include:

- **Financial position of the entity.** Financial statement items for an entity in a precarious financial position may be adversely affected: for example, assets may be overstated and liabilities understated.
- **Economic and industrial conditions.** For example, in a depressed industry, collection of receivables may be difficult, leading to an adverse effect on the valuation of accounts receivable.

The assessment of inherent risk is judgmental. To illustrate this process, the following is an example of a memo that might be used to document an inherent risk assessment:

“Inventory consists of light bulbs manufactured in the central plant. A process costing system is used and, at the end of the year, estimates are made for broken and defective bulbs. These factors (breakage and fragility) would indicate a relatively high inherent risk for valuation. In past years, there have been numerous adjustments to inventory valuation arising from the audit, confirming the risk assessment as being high. Other assertions for inventory are evaluated as moderate inherent risk, as they are not greatly affected by the above characteristics.”
Control risk
The audit risk standards require that, for all audits, an auditor must obtain an understanding of the internal controls relevant to the audit. This involves evaluating the design of a control and determining whether it has been implemented. In reviewing internal controls, the auditor needs to evaluate whether there is an expectation that controls will be effective at the assertion level. An example might be control over the numbering of sales invoices to help ensure that all sales are recorded, thus reducing the risk of material misstatement for the completeness assertion. Once this assessment is made, the auditor then needs to assign a level of control risk, usually expressed as high, medium or low. This approach provides the auditor with a better insight into the risk of material misstatement, as well as a better understanding of the entity. Controls are an important element of the entity and can reveal a great deal about its culture and business practices. In addition, in looking at the design and implementation of controls, an auditor may be better equipped to design appropriate tests of their effectiveness or substantive tests. This matter is discussed further in Chapter 6.

As management is responsible for the entity’s internal control, the auditor should make enquiries of management regarding its own assessment of the risk of fraud and the controls in place to prevent and detect it. In small entities, management’s assessment is likely to be less formal than in larger entities and the focus of the assessment may be on the risk of employee fraud.

One of the more common types of fraud existing in small entities is the misappropriation of revenue, either at the cash register, or at another point where cash is handled. The auditor would ordinarily presume that there are risks of fraud in revenue recognition and would consider which types of revenue, revenue transactions or assertions may give rise to such risks. This will require an evaluation of the design of the controls in place to prevent such misappropriations.

Reducing Risk through Substantive Procedures
When an auditor has determined the risk of material misstatement, audit risk is usually reduced to an acceptably low level by applying substantive procedures because a small entity usually has limited internal control. Conversely, if the risk of material misstatement is high, the auditor will need to extend substantive procedures to reduce audit risk to an acceptably low level. Previously, the auditor could assume that control risk would be high, and proceed with substantive testing. Under the current audit risk standards, however, as discussed in Chapter 3, paragraph 32, the auditor is required to make a determination as to whether the controls are likely to be operating effectively, by evaluating their design and determining whether they have been implemented. Having made a determination, the auditor then needs to decide whether to include the effect of controls in the audit strategy.
For audits of larger entities, the major accepted framework for analyzing internal controls is the report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. In 1992, COSO issued its report “Internal Control – Integrated Framework” to help businesses and other entities assess and enhance their internal control systems. In the Fall of 2005, the Committee released for comment an Exposure Draft particularly relevant to this study, “Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting.” This document provides a good deal of useful information for the audit of small entities.5

In discussing the effects of risk analysis, the CICA Handbook – Assurance states:

The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor’s further audit procedures and the risk assessment.6

Where the auditor has no basis for a conclusion on the effectiveness of controls, it will be necessary to carry out more extensive substantive procedures, which might include analytical procedures or tests of individual account balances or transactions.

When it is determined that there are material weaknesses in the controls, the auditor must report those weaknesses to management, and, in the case of entities with public accountability, such as not-for-profit organizations, to the Board of Directors. Whether a weakness is material is, of course, a matter of judgment. The CICA Handbook – Assurance suggests a format for such reporting, as follows:

This information could be communicated to management as follows:

The objective of my audit was to obtain reasonable assurance that the financial statements were free of material misstatement; my audit was not designed for the purpose of identifying matters to communicate. Accordingly, my audit would not usually identify all such matters that may be of interest to you and it is inappropriate to conclude that no such matters exist.

During the course of my audit of ............... for the year ended ............... I did not identify any of the following matters: misstatements, other than trivial errors; fraud; misstatements that may cause future financial statements to be materially misstated; illegal or possibly illegal acts, other than ones considered inconsequential; or significant weaknesses in internal control.

5 When finalized, this will be accessible from the COSO website — (www.coso.org).
This communication is prepared solely for your information and is not intended for any other purpose. I accept no responsibility to a third party who uses this communication.7

AN EXAMPLE OF RISK ANALYSIS VS. SAMPLE SIZES
Mr. Brown and his family own ABC Limited, a small fertilizer manufacturing company. His sales are made to farmers in the region who, although they may be slow to pay sometimes, nevertheless take great pride in always discharging their debts. There has been minimal turnover in the accounting staff. Mr. Brown tends to be rather aggressive in the application of accounting principles, in particular when it comes to saving taxes. ABC uses standard accounting software. Each year, there are few adjustments to the accounting records as a result of the audit. The company has received significant government grants for plant and equipment additions in the past few years and is required to submit financial statements to the government agency. ABC has also obtained bank loans to help finance the expansion, which are secured by the accounts receivable. Competition is becoming stiffer and pricing is becoming a major issue in efforts to retain customers and acquire new business.

The company’s total assets amount to $3,522,000 and its revenues equal $5,678,000. Accounts receivable total $1,200,000. Planning materiality is estimated at $60,000 and no errors are expected. Based on the auditor’s risk assessment, the decision has been made to use a totally substantive approach. Because there will be no tests of the operating effectiveness of controls, control risk is assessed as high. Referring to the matrix in Appendix E and assuming that analytical procedures are deemed not to be particularly effective produces a testing factor of 3 if inherent risk is high, a testing factor of 2.3 if inherent risk is moderate and 1.9 if inherent risk is low.

In this example, inherent risk could reasonably be assessed as moderate, given the reliability of customers and the fact that only few adjustments are made each year as a result of the audit. The fact that the accounts are pledged to the bank and Mr. Brown tends to be aggressive may prevent the assessment from being established at a low level.

Using the approach to determining sample sizes outlined in Appendix E, the sampling interval at a testing factor of 2.3 would be precision/testing factor = $60,000/2.3 = $26,000. If we assume that eight high-value accounts totalling $300,000 have already been selected for confirmation, the remaining sample size would be calculated as: population to be sampled/interval = ($1,200,000 – $300,000)/$26,000 = 35 accounts. Add to this the eight high-value accounts and the total number of accounts to be confirmed is 43.

If the testing factor had been 1.9, the sampling interval would become $60,000/1.9 = $31,000, the statistical sample would become \((1,200,000 - 300,000)/31,000 = 29\) accounts, which when added to the high-value accounts would make a total selection of 37 confirmations.

This reduction of six in the number of confirmations is achieved by assessing inherent risk at low rather than moderate. This shows the importance of careful evaluations of inherent risk, especially in substantive audits. A similar effect could be achieved by reducing the assessment of control risk from high to moderate, in light of, for example, Mr. Brown having established specific controls to monitor and approve customer accounts. This reduction would have to be supported by performing tests of those controls.

If inherent risk were low and the auditor decided to test controls to reduce control risk to low, the testing factor would be 1, and the substantive sample would be reduced to 23. Again, to support the lower assessment of control risk, the auditor would have to document and test controls (as per the sample formula for tests of the operating effectiveness of controls in Appendix E). The cost of carrying out this additional work would have to be weighed against the saving in substantive testing.

While this example is based on statistical sampling, it should be noted that judgmental sample sizes would normally exceed those determined through the use of statistical techniques. Some firms have determined that the difference can be significant.

Risk assessment is a fundamental and important part of the planning process. It is necessary for identifying areas of importance in the audit, as well as determining appropriate sample sizes. Proper use of risk analysis provides support for audit programs and improves the chances of developing audit strategies that are effective.
Chapter 5

MATERIALITY

This chapter sets out considerations for determining materiality in the audit of a small entity.

MATERIALITY AND THE SMALL ENTITY AUDIT

Introduction

The prime objective of an audit is to obtain reasonable assurance that there are no material misstatements in the financial statements. The CICA Handbook – Assurance, “Materiality,” paragraph 5142.04, defines materiality as follows:

- A misstatement or the aggregate of all misstatements in financial statements is considered to be material if, in the light of surrounding circumstances, it is probable that the decision of a person who is relying on the financial statements, and who has a reasonable knowledge of business and economic activities (the user), will be changed or influenced by such misstatement or the aggregate of all misstatements. …

Together with audit risk, materiality is a significant determinant in assessing the nature, timing and extent of audit procedures. In determining the audit procedures to be applied to a specific account balance or class of transactions, an auditor designs procedures to detect errors that are believed to be material to the financial statements as a whole, when aggregated with errors in other account balances or classes.

The concept of materiality pervades the financial reporting and auditing process. Materiality has both a quantitative and a qualitative dimension. Quantitatively, items are considered material when their size exceeds a particular benchmark, such as a given percentage of net income, as discussed below. Qualitative materiality recognizes that the nature of an item may be such as to influence the decisions of the users of the financial statements regardless of its size.

The determination of materiality is a matter of professional judgment. In determining the materiality of an item, the auditor considers not only the item’s nature and amount relative to the financial statements, but also the needs of financial statement users.
Materiality in Planning

Materiality has to be considered before a detailed audit program can be prepared. In the initial planning, however, an auditor cannot anticipate all of the factors that will ultimately influence the materiality judgment in the evaluation of audit results at the completion of the audit. Therefore, these factors must be considered as they arise, and materiality must be evaluated throughout the audit.

In some cases, materiality at the conclusion of the audit may differ significantly from that determined at the planning stage. If materiality is carefully planned and monitored, however, this should rarely happen. If the materiality limit is significantly reduced from that determined at the planning stage, the auditor would need to re-evaluate the sufficiency of the audit procedures that were performed based on that initial level.

Determining a materiality level at the planning stage is useful in the following areas:

• Planning the nature and extent of audit tests. For example, an auditor can define “key” items for the purpose of substantive testing to include all unusual items, plus all other items above a certain percentage of materiality.

• Identifying immaterial items for which adequate audit assurance could be obtained through minimum review procedures and which do not warrant detailed audit testing.

After the audit is completed, materiality is useful for evaluating the audit results and determining the appropriate audit opinion. This evaluation requires the consideration of the aggregate effect of misstatements caused by errors in relation to materiality.

Materiality has significant implications for audit efficiency. To be efficient, an auditor should not spend time examining balances where there is no chance of a material error. Sometimes, in an audit of a small entity, there is a temptation to audit everything because it does not seem as though it will take much time when individual items are considered. The unnecessary time can, however, add up to a significant amount overall. During the planning stage, the auditor should assess the relative importance of the balances in the financial statements and identify the key audit areas and significant balances.

Determining a Materiality Level

The Auditing and Related Services Guideline, AuG-41, “Applying the Concept of Materiality,” sets out guidance for calculating materiality, including suggested percentage levels. While this guidance is concrete, it still leaves room for judgment and for the recognition of the qualitative aspects of materiality, as well as an entity’s particular circumstances.

The calculation of materiality is needed at an early stage in audit planning so that effective substantive tests can be designed. Factors an auditor should consider when calculating materiality for the audit of a small entity include the following:
• Materiality for profit-oriented entities is most often expressed as a percentage of adjusted after-tax income. This calculation allows for non-recurring, unusual and discretionary or non-arm’s length items. For example, an auditor would adjust after-tax income by eliminating unusual and discretionary items, such as management salaries and bonuses in excess of market rates, in arriving at adjusted after-tax income. The guideline suggests that, “When net income is consistently nominal, as might be the case for an owner-managed enterprise with a tax-minimization objective, a measure such as net income before bonus might be appropriate.” The guideline suggests a level of 5% of income from continuing operations and 1/2 to 2% of total revenues or expenses for not-for-profit entities.

• If adjusted after-tax income were not an appropriate base for materiality in a particular situation, perhaps because the entity operates at or near the break-even point, the auditor would need to decide on an alternative base. Normally, the best alternative is sales or gross revenue. The range of 1/2 to 2% of total expenses or revenue suggested in the guideline might be reasonable not only for not-for-profit organizations, but also for profit-oriented entities where the calculation of normalized income is not applicable.

Sometimes the amount of income taxes is not known when the audit is being planned, and it will be necessary to use an estimate to calculate an amount for planning materiality. Later, when the taxes are known, this initial estimate will have to be revisited, along with the adequacy of the testing and any decisions made on the basis of the initial estimate.

In determining materiality, consideration should be given to the effects of changes in year-to-year calculations. For example, AuG-41 states, in paragraph 10, that:

> When changed circumstances, such as a substantial reduction in an entity’s business activity, and/or net income, suggest the use of a significantly lower materiality level than that used in the previous audit, the auditor needs to pay particular attention to the level of misstatement that may exist in balances representing opening equity. These will have been audited to the previous (higher) materiality level and this may contribute to a material misstatement in the current financial period.

Along these lines, it may also be necessary to plan for the effects of reversing unadjusted errors encountered in the previous year’s audit. These effects will be known at the planning stage and sometimes it happens that some, or all, of the current year’s margin for material error is used up before the audit begins. Various

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scenarios can follow from this situation. It could mean that the audit is directed to the remaining unused materiality. More often, it means that the opening unadjusted errors will be offset by a recurring adjustment in the current year, in which case the materiality for planning purposes would be unaffected. Sometimes, it might be necessary for some or all of the previous year’s unadjusted errors to be adjusted in the current year.

15 The estimate of materiality used in the audit should be documented in the working papers, along with the rationale used in arriving at the estimate. A sample materiality worksheet is included in the Professional Engagement Manual.

16 In addition to the quantitative factors discussed above, the auditor also needs to address the qualitative aspect of materiality. The reason for this is found in the definition of materiality, which refers to items that may influence or change decisions and does not refer to the size of the items. For example, if a company leases property from a director at an amount that substantially differs from market value, the nature of this transaction may lead to a decision that disclosure is necessary even when the size of the transaction falls below materiality. Similarly, if fraud were to be discovered during an audit, it would have to be investigated, regardless of whether the initially discovered amount is material.

**Consider Client Expectations**

17 Finally, in determining materiality, it is necessary to consider the expectations of the client. While an auditor may believe that $500 is not material for audit purposes, the client may think that it is very material indeed. Sometimes, these expectations must be managed, perhaps even by reaching an agreement with the client as to a level of materiality.

> It is important that management and the audit committee or equivalent understand the limitations concerning the degree of precision that can be expected from an audit. They also need to be aware that it is not economically feasible to design an audit that will provide absolute assurance that the financial statements are not materially misstated; an audit can only provide reasonable assurance in this regard.³

18 This paragraph goes on to say that the decision on communicating the materiality level to the client is a matter of judgment. Because it is important, however, for the client to understand the limitations of an audit, disclosure of materiality is often a good way to bring about this understanding.

Sometimes a client may have specific concerns that transcend materiality, for example, that all expense report claims in excess of $300 were properly supported. The auditor might tell the client that it is not efficient to perform the whole audit to a materiality of $300, but that extra procedures can be added, or a special engagement performed, to meet this need.

**Documentation**

There is a considerable emphasis on documentation in the *CICA Handbook – Assurance* standards. The normal practice is that all misstatements of possible significance encountered during an audit are documented in the file. Some of them are adjusted by the client. Others are not. Most auditors accumulate the unadjusted misstatements discovered during the course of the audit in the schedule of unadjusted errors, or what some auditors refer to as the “over and under” schedule. The schedule can then be used to make decisions as to whether the cumulative effects of the unadjusted misstatements are material. Some auditors of small entities prefer to see that all identified errors are adjusted, which means they have no need for such a schedule.

All of the judgments made in determining and using materiality, as well as the basis for its calculation, need to be documented.
Chapter 6

INTERNAL CONTROL AND THE SMALL ENTITY ENVIRONMENT

This chapter discusses:
- generally accepted auditing standards on internal control;
- components of small entity internal control; and
- planning tests of the operating effectiveness of controls in a small entity.

STANDARDS RELATED TO INTERNAL CONTROL

CICA Handbook – Assurance Guidance

The CICA Handbook – Assurance requires an understanding of internal control in conducting all audits. This is reflected in examination standard (ii), which states:

The auditor should obtain an understanding of the entity and its environment, including internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.¹

CICA Handbook – Assurance, Sections 5141 to 5143, provide guidance on the work required to meet this standard. In particular, paragraph 5141.054 states that “obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented.” Further, this evaluation involves considering whether the control is capable of effectively preventing, or detecting and correcting, material misstatements. Under this standard, the auditor would consider the design of the control, and use this information in considering its implementation. If a control is improperly designed, it may represent a material weakness in the entity’s internal control and may need to be communicated by the auditor to management and the audit committee. Internal control is defined as:

… the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity’s objectives with regard to reliability of

¹ CICA Handbook – Assurance, “Generally Accepted Auditing Standards,” paragraph 5100.02(ii).
financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.²

3 The Handbook then goes on, in discussing the responsibilities of auditors, to define the phrase “controls relevant to the audit,” as follows:

Ordinarily, controls that are relevant to an audit pertain to the entity’s objective of preparing financial statements for external purposes that are presented fairly, in all material respects, in accordance with generally accepted accounting principles and the management of risk that may give rise to a material misstatement in those financial statements. It is a matter of the auditor’s professional judgment, subject to the requirements of this Section, whether a control, individually or in combination with others, is relevant to the auditor’s considerations in assessing the risks of material misstatement and designing and performing further procedures in response to assessed risks.³

Components of Internal Control

4 In the CICA Handbook – Assurance, internal control is considered in terms of five major components:
(a) the control environment;
(b) the entity’s risk assessment process;
(c) the information system, including the related business processes, relevant to financial reporting and communication;
(d) control activities; and
(e) monitoring of controls.

5 Since small entities tend to take a less formal approach to internal control than large organizations, it may be difficult to distinguish these components in a small entity. The requirement, however, still applies, so the auditor must do what is possible to identify and understand them.

THE CONTROL ENVIRONMENT

6 The control environment represents the collective effect of such factors as management philosophy and operating style, organizational structure, personnel policies and practices on establishing, enhancing or reducing the effectiveness of specific policies and procedures. The control environment reflects management’s overall attitude, awareness, commitment and actions concerning the importance of internal control and its emphasis in the entity.

7 The effectiveness of specific control procedures depends directly on the internal control environment. A strong control environment (for example, where

³ CICA Handbook – Assurance, paragraph 5141.048.
management exercises tight supervision over the day-to-day operations of the entity) can significantly add to specific control procedures. By itself, however, a strong control environment does not guarantee the effectiveness of the internal control systems. It therefore provides little or no audit assurance unless linked to controls affecting specific financial statement assertions. On the other hand, a weak control environment may have a negative impact on the audit. It may lead to the conclusion that specific control procedures cannot be relied on in the audit and, in extreme cases, may mean an audit cannot be done.

Factors affecting the control environment that have particular relevance to small entity audits and require particular attention, are:
- the entity’s organizational structure;
- the competence of personnel; and
- the control consciousness of management.

Organizational Structure
The entity’s organizational structure serves as a framework for the direction and control of its activities. An effective structure provides for the communication of policies and personnel responsibilities. Although a small entity usually has few employees, there is still some scope for the introduction of limited segregation of incompatible duties. For example, employees not ordinarily regarded as part of the accounting group (such as receptionists or sales people) can be assigned certain responsibilities to enable the segregation of responsibility for initiation and recording of transactions.

Personnel
The proper functioning of any accounting system depends, among other things, on the competence of those operating it. The qualifications, selection and training, as well as the personal characteristics of the personnel involved, are important features of a strong control environment. In many situations, management believes it cannot afford highly qualified personnel, and this sometimes results in the employment of personnel that lowers the auditor’s assessment of the effectiveness of the control environment.

Control Consciousness of Management
Because small entities tend to be dominated by management and have limited segregation of duties, management has to, by necessity, perform many of the control procedures. Management’s personal involvement in an entity’s day-to-day operations and, most important, its attitude and leadership, can create an atmosphere of "control consciousness."

Audit evidence for elements of the control environment may not be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example, management’s commitment to ethical values and competence is often implemented through the
behaviour and attitude they demonstrate in managing the entity’s business instead of in a written code of conduct. Consequently, management’s attitudes, awareness and actions are of particular importance in the design of a smaller entity’s control environment. In addition, the role of those charged with governance is often undertaken by the owner-manager where there are no other owners.4

If management retains a direct involvement at key points in the accounting routine and ensures that established policies and procedures are adhered to, personnel are likely to be more conscientious in performing their duties. Conversely, if management’s attitude conveys basic disregard for, or ignorance of, sound business practices and established policies and procedures, personnel are more likely to be careless in discharging their responsibilities. In extreme cases, the disregard of basic control procedures may render the accounting records so undependable that the auditability of the entity is questionable.

Concern for control takes different forms, depending on management style and the size of the entity. Indicators of strong control consciousness by management include those described in the following paragraphs.

Performing important control functions
Management might perform:
• signature-approval functions, for example, the approval of key documents such as cheques, payrolls, credit notes, bank reconciliations and journal entries;
• supervisory functions, for example, monitoring employees that handle cash;
• inspection functions, for example, scrutinizing incoming mail, to keep abreast of payments on account, major sales orders and customer or supplier complaints.

Being involved in the design and approval of accounting procedures
Management is a major user of the accounting system and may be involved in designing and approving accounting procedures.

Preventing unauthorized access and destruction
Even the smallest entity normally has implemented basic measures to prevent unauthorized access to, or destruction of, documents, records and assets. Usually, management is involved in controls such as locking up the premises and securing unused cheques.

Understanding and using financial statements and periodic reports
A sole manager often uses financial reports such as:

- cash status reports;
- sales and production summaries;
- performance indicators, such as gross profit ratio, inventory turnover and return on investment; and
- aged accounts receivable balances.

The extent to which a sole manager’s use of financial reports will play a role in instilling control consciousness depends on whether the accounting system generates reports that are both useful and understandable.

BEYOND THE CONTROL ENVIRONMENT
In addition to obtaining an understanding of the control environment, an auditor also must obtain, for all audits, an understanding of the other four components of internal control. As mentioned, these include the entity’s risk assessment process, the information system relevant to financial reporting, control activities and the monitoring of controls.

The Entity’s Risk Assessment Process
The entity’s risk assessment process is defined as the “process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.” An example of such a business risk could be a potential decline in the value of a rental property caused by increased crime in its neighbourhood, leading to a need to revalue the property for financial statement purposes. It is recognized that, in smaller entities, there may be no formal process along these lines, and the CICA Handbook – Assurance suggests that it may be sufficient to discuss with management how risks to the business are identified by management and how they are addressed and document the results of the discussion.

The Information System Relevant to Financial Reporting
The information system relevant to financial reporting includes the procedures and records established to initiate, record, process and report transactions. To design effective substantive procedures, an auditor should obtain knowledge of the existence and availability of documents and records and have an understanding of their relationship to the accounts in the financial statements. Specifically, the auditor would identify the major classes of transactions and determine:

- Procedures for initiating transactions. This would involve establishing what events cause a transaction to be initiated, who performs the necessary steps, what documentation is generated and what authorizations are required.

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5 CICA Handbook – Assurance, paragraph 5141.076.
• **Accounting processing steps from initiation to inclusion of financial items in the statements.** Determining these steps would involve tracing the transactions through the system from initiation to inclusion in the financial statements, noting the functions performed on the data at each major stage of processing.

• **The supporting documents, accounting records and specific accounts involved in processing.** This stage would likely be performed concurrent with the preceding process, noting the documentation generated at each significant stage of processing.

• **A basic understanding of the accounting package and any other software being used to process data.** Where a widely known and popular software package is used, it may be easier to determine how that package processes data than where the package is less familiar or is a custom package. In the latter situations, it may be necessary to review the technical documentation or contract someone to do it.

**Control Activities**

22 The control activities are the policies and procedures that help ensure that management directives are carried out. An auditor must obtain an understanding of these activities to the extent considered necessary to assess the risk of material misstatement at the assertion level. The auditor does not have to obtain an understanding of all control activities, nor even all those carried out in important areas, but rather controls in areas that have the highest risk of material misstatement. The purpose of obtaining this understanding is to help in designing tests of controls where there is an expectation that the controls are effective.

23 In many cases in small entities, division of duties is often problematic, because of the limited numbers of people available. In these situations, however, the control objectives may sometimes be met through management oversight, which the auditor can assess as to its effectiveness. This is often the case for not-for-profit organizations.

**Monitoring of Controls**

24 An understanding of the procedures carried out to monitor the operation of controls and the corrective action that might be required often involves, in a small entity, the actions of management. It is quite appropriate to consider management’s activities, provided the auditor is satisfied they are strong enough to rely on.

25 Methods of documenting this understanding vary according to the complexity of the system. For most small entities, the simplest and most efficient approach is to write a concise memo describing the system. In subsequent years, the memo would simply have to be updated to reflect significant changes.
PLANNING TESTS OF CONTROLS

General

In certain circumstances, it will be efficient and effective to conduct tests of the operating effectiveness of controls. The decision as to whether to conduct such tests is made at the assertion level. When the understanding of the internal control obtained during the planning phase indicates that certain controls will be effective at the assertion level, the auditor must test those controls as they relate to the particular assertion if the auditor intends to rely on them to reduce the risk of material misstatement to an acceptable level. In addition, when there is a conclusion that, for certain assertions, substantive tests alone will not be sufficient, there is a requirement to test controls.

The auditor has to identify and document only the policies and procedures that support the assertions related to the specific financial statement items for which tests of controls are planned. In other words, in an audit of a small entity, the complete system would rarely need to be documented.

To derive assurance from specific controls related to an individual assertion, an auditor would perform the following steps before determining the nature, timing and extent of substantive procedures:

- Identify and review the controls that need to be tested. This could be done by observing the controls being performed, considering the documentary evidence available and interviewing the people who carry them out.
- Make a preliminary evaluation of the controls reviewed to plan appropriate tests of the operating effectiveness of controls to verify the existence and continuity of those controls.
- Perform tests of the operating effectiveness of controls to gain a sufficient degree of assurance that the controls:
  - operate in the manner identified in the review;
  - functioned effectively throughout the period being audited.
- Study and evaluate the results of the tests of the operating effectiveness of controls to assess the amount of assurance obtained and to determine the nature, timing and extent of substantive procedures.

Testing Sole Manager Controls

Opinions differ as to whether an auditor should include the testing of important sole manager controls in the audit strategy. Some auditors believe inclusion is justified because of management’s intimate understanding of the entity. Other auditors believe that it is not justified because of the potential for management override.

In general, the study group believes that sole manager controls are not fundamentally different from control procedures performed by personnel in other organizational positions and, accordingly, it seems logical that they would be subject to the same evaluation as other control procedures. In evaluating such controls, the auditor would:
• consider whether each control to be tested is adequately designed to meet the control objective;
• ascertain whether the control procedure performed by management represents an incompatible function; and
• assess the risk of management override of the control procedure.

Effectiveness of Testing Strategy

31 The requisite understanding of the five components of internal control (as identified in paragraph 4 above) must be obtained, which then allows the auditor to determine whether the controls are likely to be effective in auditing a particular assertion. If that is the case, the auditor may decide to carry out tests of controls (the combined approach). Nevertheless, this does not create as much change as might be expected. Most audits of small entities will use primarily substantive procedures for the following reasons:
• The small number of employees increases the likelihood that internal control might break down during peak business or vacation periods. For this reason, controls might be identified, but then found to be ineffective when they are tested to determine whether they are in place for the entire period.
• The risk of management override limits the reliability of the internal control during the period under audit, again raising the issue that testing may prove the controls to be ineffective.
• It is often difficult to evaluate the effectiveness of management involvement in internal control. Usually, there is greater effectiveness if management reviews periodic financial reports and carefully investigates unexpected results. On the other hand, management lack of interest in periodic financial reports, or a history of recordkeeping errors, may indicate ineffective management involvement. Between these extremes, it is a question of judgment.
• Conducting tests of the operating effectiveness of controls exercised by management of a small entity is often difficult because they usually do not result in documentary evidence. Several visits may be required to observe that the controls are operating effectively throughout the period of intended reliance, although this may not be feasible or necessary in the audits of very small entities.

32 For these reasons, substantive tests will normally provide the auditor of a small entity with sufficient appropriate audit evidence on the majority of assertions more effectively than a combined approach. There may be circumstances, however, when an auditor finds it more effective to obtain assurance by tests of the operating effectiveness of certain specific internal controls. For example, when the population to be audited comprises a large volume of small balances, substantive test sizes tend to be high when they are the only source of audit evidence. In such cases, the amount of time needed to do the audit may be excessive compared to the combined approach, where time is required to identify and test the related controls, but smaller substantive sample sizes are possible.
By gaining an understanding of internal control, an auditor can play a useful role in helping management learn to appreciate the importance of internal control. This might be done by explaining to the client how the system can help to ensure that all revenues are captured and recorded, or how good procedures can protect the entity from fraud. The more time an auditor spends on internal control, the more help can be given to the client in that area.

Discovery of significant internal control weaknesses can also lead to a re-evaluation of the planned audit approach because it can call into question the initial assessment as to whether or not controls are likely to be effective.

Examples of circumstances that, either individually or in combination, may make the auditor suspect the existence of misstatements, include control-related matters such as:
• unusual documentary evidence, such as handwritten alterations to documentation or handwritten documentation that would usually be electronically printed;
• seriously incomplete or inadequate accounting records;
• significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance that were not appropriately investigated and corrected on a timely basis; and
• inadequate control over IT processing; for instance, too many processing errors or delays in processing results and reports.

COMMUNICATION OF CONTROL WEAKNESSES
When an auditor discovers weaknesses in internal control, the question arises as to when and how these weaknesses must be communicated to the client. CICA Handbook – Assurance “Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,” paragraph 5141.121, requires the auditor to inform the audit committee or equivalent of any material weaknesses in the design or implementation of internal control identified during the course of the audit as soon as is practicable. The CICA Handbook – Assurance provides some specific commentary on the application of this standard for the audit of small entities.

This commentary recognizes the difficulties that auditors of small entities face when communicating control issues to clients year after year. Often, they are the same issues and the client knows all about them. But, sometimes, the client decided in previous years that the recommendations could not be implemented economically and efficiently. There is good reason, however, to continue to report these matters. It places on record the fact that the auditor has identified weaknesses in internal control and made appropriate recommendations to the client, which ensures that the client is aware of them. Moreover, not making the recommendations could be interpreted to imply that the auditor has made the cost-benefit decision for the client regarding implementation of the recommendations.
For small public entities, there are requirements to report to the audit committee. If there is no audit committee, the board of directors will be considered to be the audit committee. If the small entity is a not-for-profit entity, it likely has an audit or finance committee to which the auditor can report. If not, reporting should be to the full board of directors.
Chapter 7

INFORMATION TECHNOLOGY IN A SMALL ENTITY

This chapter discusses the impact of information technology (IT) on the internal control structure of a small entity. It also addresses the opportunities and challenges of using technology in the audit of a small entity.

IT CONTROLS

Need for Review

As costs have continued to decline and the power of IT has increased, small entity use of information technology has become commonplace. With the explosive growth of the Internet in recent years, the technologies being used have become quite sophisticated and complex. Many small businesses, for example, routinely use point of sale systems and electronic payment systems and have on-line stores tied into their internal systems. This presents new challenges for auditors — they need to understand these systems and deal with the control and audit issues they present.

IT controls can be important in a small entity audit for three additional reasons:

• An understanding of the controls is necessary to satisfy GAAS requirements.
• If a combined audit approach is to be used, some of the controls to be tested may be IT controls.
• IT-generated reports used in the course of an audit will need to be tested as to their accuracy to avoid “unwarranted reliance” on computer processing.

GENERAL IT CONTROLS

Obtaining an Understanding

The starting point for understanding an entity’s IT control environment is to first become familiar with the general IT controls, that is, the controls that govern the IT system as a whole. There are three categories of general controls: access controls, program development controls and other general controls, such as data backup and disaster recovery. These controls should be distinguished from controls that are specific to particular applications. Applications controls include input, processing and output controls.
Access Controls
Access controls are of two types: physical and logical. Physical controls involve precautions, such as separate server rooms with locks on the doors. Logical access controls involve using software to set passwords and define user privileges. The software to be used in this process can be the operating system, applications software or separate security software. Sometimes, access control is established at the applications level, in which case it becomes an applications control. Access control is often used as a method to achieve division of duties as it allows personnel to access only those programs and data needed to do their job.

Program Development Controls
When an entity hires programmers to design their systems, controls should be in place to ensure that staff members use only the systems authorized by management. These controls ordinarily include strict procedures for testing and moving approved programs from a development stage to actual use (into production).

Many of the same types of procedures apply to the purchase and implementation of new software. Although purchased software does not involve controls over the programming function, it does require controls over the authorization and implementation phases.

Other General Controls
Any entity can become quite reliant on the use of IT. This occurs in varying degrees, depending on the sophistication of the applications being used and the extent to which they have been integrated into the everyday functions of the entity. For example, if a drug store uses a point-of-sale system to record sales at the cash register, which simultaneously updates the inventory records, a system failure could make it impossible to process sales. For such a system, an effective backup and recovery plan would be essential.

GENERAL CONTROLS IN SMALL ENTITY SYSTEMS
In a small entity audit, the amount of work required on the general IT controls naturally depends on the type of IT system in use. Normally, small entities use Personal Computers, either alone or on local area networks (LANs), and typically use purchased software packages.

Access controls are important for all of these scenarios, as are backup procedures. Access controls serve two purposes: to restrict access to a system and to restrict access to particular objects and processes within a system. Usually, this is decided on the basis of job functions. For example, a sales representative might be given access to customer databases, but not to cash or payroll. Access controls are, therefore, used to enforce a division of duties in an organization. In small entities, however, the limited number of employees makes it difficult to divide up duties. Nevertheless, some small entities do have enough employees to implement some division of duties and to use access controls for enforcing it.
Program development controls usually are not a significant factor in small entities, since few of them develop their own applications. There should, however, be controls over the acquisition of software, such as the definition of needs and the identification of various packages that might meet those needs. In addition, when new software is implemented, there must be control over the conversion to the new system, to make sure that data are carried forward accurately.

As a minimum, a small entity audit file should include a brief memo addressing each of these areas, identifying, for example, whether passwords are being used and how they are administered; whether and by whom programs are changed (if this happens at all); and whether backups are made and stored off site. If new systems were implemented during the year, the auditor should prepare a memo on the conversion procedures the entity used. The more complex the system, the more fully these areas need to be addressed. The CICA publication *Information Technology Control Guidelines* offers excellent guidance on the issues to be addressed. Although it is directed primarily at complex systems, its principles also apply to small entity systems, which, in any event, are becoming more complex all the time.

The risk of unauthorized access to corporate systems increases considerably when a system is connected to the Internet. When an entity does business electronically over the Internet, therefore, it must implement firewalls, together with appropriate security policies, to prevent Internet users from gaining access to the entity’s systems.

Some General Considerations

Unfavourable attributes of some accounting software may create problems for both management and auditors. For example, some packages do not allow the retroactive adjustment of transactions after the year end is closed. Others allow the inadvertent entry of journal entries into the previous year. In some cases, the accounts for the year just ended cannot be closed and the current year’s transactions cannot be posted until after the audit is completed.

Procedures need to be put in place to deal with such situations. Those procedures depend on the functionality of the software. If there is a separate posting function, they may involve instructing an entity to enter the current year’s transactions but not to invoke the posting function. In other situations, appropriate procedures may involve not closing the past year and starting the new year in a different file, with opening balances that subsequently can be adjusted when the adjusting entries are known.

THE COMBINED APPROACH USING IT CONTROLS

The increased use of IT in small entities raises an interesting question: Has it increased or decreased the feasibility of using a combined approach in the audit? This question arises because it is common for computer users in small entities to
perform two or more incompatible duties, such as initiating and authorizing documents and using the output.

On the other hand, some have challenged this presumption of lack of control in a small IT system. For example, S. J. Gaston has said:

There is a widespread belief that, when confronted with a small [IT] system, auditors have no choice but to conduct examinations on a fundamentally substantive basis. The presumption is that controls are not sufficiently strong to be a cost effective source of audit satisfaction. These basic presumptions may be false for many of today’s small [IT] systems.

He goes on to explain areas where IT controls can be effective in a small business:

- Local area networks can provide a significant degree of logical access controls if user identification and password capabilities for these systems are used properly.
- When packages are purchased from outside suppliers or off the shelf, it is usually not possible to make changes to the software programs and to the calculations of accounting significance that they perform, thus enhancing control over the integrity of processing.
- Often, an acceptable division of duties between IT operations and the recording of transactions can be achieved with only three or four employees.

It may, in fact, be feasible to adopt a combined approach for audits of small entities where IT is involved. Because a combined approach involves identifying specific controls that support assertions for specific financial statement balances or transactions, using this approach does not mean that the whole system must meet unduly high and rigid standards of control. If both of the following requirements are met, it may be possible to reduce the level of control risk:

- At the level of general controls, it requires only that the three categories described in paragraph 3 of this chapter — access controls, program development (or acquisition) controls and other general controls — be reasonably addressed.
- At the applications controls level, it simply requires the specific relevant controls to be reasonably effective.

**USING IT IN THE AUDIT**

Like their clients, auditors have increased their use of software in recent years to do everything from working paper preparation to extracting and analyzing data from client systems. With such software, an entity’s data can be imported into the auditor’s system and then used in the course of the audit. With the ability to obtain

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information in electronic format and the growing power of the audit software, the use of IT has become a routine part of small entity audits.

The use of IT for audits of small entities has also become more efficient because more auditing applications have become available. Many of these packages can be used without a huge investment in training and, once some experience is gained with an application, it can be used for various audit clients.

Some of the opportunities for using IT applications in an audit include trial balance and financial statement preparation, preparation of audit programs, planning and administration and computer assisted audit techniques (CAATs).

Trial Balance and Financial Statement Preparation
Audit software used for trial balance and financial statement preparation eliminates the need for manual preparation of lead sheets, trial balances and financial statement groupings. This allows an auditor to prepare adjusting journal entries for a client and also provides for computerized footing of the lead sheets and trial balance. This is especially helpful in small entity audits where the trial balance and lead sheets are often changed many times, making it difficult to keep them in agreement.

When using a trial balance application, an auditor enters the general ledger accounts and balances into the computer and, from that information, lead sheets and financial statement groupings are then generated. When adjusting and reclassification journal entries are recorded, the application posts them to the trial balance and lead sheets simultaneously.

Certain reports can also be used for analytical procedures. Such reports include financial statement ratios and detailed current balances compared to the previous year, with the change and percentage change shown. These applications can also be used to prepare detailed supporting schedules for inclusion with the financial statements (for example, administration expenses, sales, cost of sales and gross profit by division). This means that the financial statements can be finalized in the field, improving both audit efficiency and client service.

Once the trial balance files are set up, they can be updated in subsequent years with the new general ledger balances in the subsequent period. It may be possible to have an entity’s personnel enter the year-end balances for the subsequent audit period and then simply check the entries. It is also possible, with most applications, to import the required data directly into an application, or by way of a spreadsheet file, as long as there were the appropriate controls and integrity checks in arriving at those balances.

Audit Program Generators
Audit software can also assist in the development of audit programs. Because audit programs usually do not change much from year to year, as long as an entity’s operations and risk profile stay the same, they can be carried forward with only
minor changes. Once the audit programs are developed, they can be used for other audits, often with only minor changes.

**Administrative Applications**

Most auditors use audit software to maintain the administrative aspects of their audit engagements as well. This includes, for example, planning documentation and time summaries.

A significant advantage of having planning documentation maintained on a computer lies in the fact that much of the planning information does not change from year to year. Each year, the prior year’s form can be updated and included in the current year’s audit working paper file.

Maintaining time summaries on a computer is the most effective way to monitor and control the time on a job. During the planning phase of the audit, an auditor should prepare a time budget for the current year. This can be entered on a spreadsheet together with the previous year’s actual time. As the engagement progresses, the actual hours and the areas where they were spent can be recorded on the spreadsheet. This application will provide daily information about the progress of the engagement and the remaining time available for the audit.

**Computer Assisted Audit Techniques (CAATs)**

Frequently, the best way to perform CAATs on small entity audits is to have an entity’s data recorded on disk and then read into the auditor’s computer. This gives the auditor control over the data and does not interfere with the entity’s usage of its system. It also avoids using the entity’s live data, which carries the risk that the auditor may accidentally corrupt or destroy the data.

Many accounting packages provide for the export of data into spreadsheets, and this is usually the most efficient way to obtain data. Once the data are in an auditor’s spreadsheet, they can be analyzed and manipulated in many ways and can also be transferred into CAAT processing software on the auditor’s computer.

A common application for this type of software is in the audit of accounts receivable. The accounts receivable trial balance can be exported to a spreadsheet, which can then be imported into a sampling application. The application can compute the sample size for confirmations and select the sample. Usually, the sample can be fed into a word-processing program and the “print merge” function used to print the confirmation letters automatically. After the initial set up, much time can be saved.

**Obtaining the data**

The biggest problem that auditors encountered in using CAATs in the past was obtaining data in a format that could be used in their computers. Now, the CAAT software has evolved to the point that it can handle most situations with little manual intervention. Some planning, however, is still required. Issues that must be addressed in advance include compatibility of an entity’s and its auditor’s systems,
data structures in the entity’s system and availability of entity staff to download the data for the auditor’s use. Usually, the auditor will want only certain fields from an entity’s master file and would ask to have only those fields saved on the disk. The entire master file might unnecessarily take up a great deal of disk space. The objective is to obtain the information from the entity without either party having to do a great deal of additional work.

The CAATs software includes automatic data import capabilities programmed to read data files from a number of common applications and convert the data to a form usable by the software. This feature uses built-in scanning programs to assist an auditor in identifying the fields contained in the data.

Finally, there is the option of displaying the data in a program and attempting to manually define the required fields and data types. Because this approach is very time consuming and requires a good deal of specialized knowledge, so-called manual data-definition is usually not feasible for audits of small entities.

If an entity’s and its auditor’s computers are incompatible, utility programs are available to convert data from one format to the other. Normally, however, the spreadsheet approach will work. An auditor would ask the entity to save the data in a spreadsheet, which could then be opened in the auditor’s spreadsheet software or audit software package.

**Using the data**

Once the data are on an auditor’s computer, they can be transferred into various programs for analysis. Spreadsheets, for example, can be used to analyze data in a number of ways. One common application is for analytical procedures to be applied to expenses, where the spreadsheet is used to show this year’s balance, last year’s balance, the change between the two years and the percent change. This permits comparisons to expectations and highlights any large fluctuations that should be followed up and discussed with the client or that require additional audit work. While such a comparison does not provide substantive assurance, it can be useful for planning purposes.

When a CAAT is used for accounts receivable confirmations, the accounts receivable master file is loaded into the auditor’s computer and the required information imported into a sampling program. Usually, the accounts receivable balance for each customer or each invoice (depending on whether balances or individual invoices are being confirmed) and some sort of identification would be input into the sampling program. The identification is normally the customer name, customer number or invoice number. Once the sample has been selected, the necessary information would be obtained from the data file and imported into a word-processing package to produce the confirmation letters. The sample information could also be recorded in the spreadsheet program and used as the confirmation control.
Once the accounts receivable master file is in the auditor’s computer, the data can be analyzed in other ways. The auditor can test the aging of the master file to ensure that the entity’s program is doing this correctly. In this way, the aging of the entire master file can be checked rather than just a sample. This ability of CAATs to check an entire file rather than just a sample is a major advantage, because the auditor obtains a higher degree of audit assurance.

Another example of this principle would be in the audit of inventory, where it may be efficient to transfer an entity’s inventory master file to the auditor’s computer. The entire file can be footed and extended to ensure the year-end inventory is accurately accumulated. The same data file could then be used to select inventory items to be tested.

CAATs can provide a high level of audit assurance in an efficient manner, provided their use is carefully planned with the entity. In more complicated applications, they usually require an up-front investment when they are developed, but the investment is likely to pay off in subsequent audits.
Chapter 8

OBTAINING AUDIT EVIDENCE

This chapter discusses methods for effectively and efficiently gathering audit evidence. In particular, it discusses:

- determining primary sources of evidence;
- selecting sources of substantive audit evidence;
- direction and extent of testing;
- timing of substantive procedures;
- application of sampling techniques; and
- methods for obtaining evidence to satisfy the completeness assertion.

Obtaining audit evidence is the core of an audit, and GAAS requires that sufficient appropriate audit evidence be obtained to support the audit opinion. All planning is directed towards one end — to do an audit that meets the standards of the profession and the expectations of the client within a time frame that enables competitive pricing and an adequate monetary return for the auditor.

It is clear, therefore, that audit evidence must be gathered using efficient but effective techniques. The question that arises is: What are the best techniques to use? Previous chapters have addressed the need to plan, to direct the audit towards material areas of risk and to use IT effectively. One important consideration remains: What should the primary sources of audit evidence be?

DETERMINATION OF PRIMARY SOURCES OF AUDIT EVIDENCE

An auditor may choose to obtain sufficient appropriate audit evidence about a particular assertion in the financial statements either by performing substantive procedures only (the substantive approach) or by performing a combination of tests of controls and substantive procedures (the combined approach). This choice, made on an assertion-by-assertion basis for each significant account balance or class of transaction, forms part of the audit strategy and helps to guide the audit planning. Under both approaches, a review of the design and evaluation of the entity’s internal controls is required at the planning stage in order to carry out an assessment of the risk of material misstatement.
Tests of the Operating Effectiveness of Controls

4 After an auditor has reviewed the design and evaluation of internal controls, and developed an expectation as to whether controls are likely to be effective, there must be a decision made as to whether to use this information in developing the audit strategy. If there is an expectation particular controls are likely to be effective, the auditor has the option of then testing those controls to determine whether they are in fact effective throughout the year, and therefore can be relied upon to reduce substantive testing.

5 Testing of controls is required where a decision is made that substantive tests alone will not be sufficient to test a particular assertion. For example, if banking transactions are highly automated, and there are no traditional deposit slips and no written cheques for some or all of the payments, there would be no hard evidence for substantive testing. In such circumstances, the audit strategy would most likely include the identification of controls over payments and tests of the effectiveness of those controls.

6 In testing compliance with stated controls, it is necessary to do more than enquire. It is necessary to actually test documents, re-perform control procedures, or observe the performance of the controls. Further details on the sources of evidence for compliance testing are found in the CICA Handbook – Assurance, Section 5300, “Audit Evidence.”

Substantive Testing

7 Because a substantive basis is most likely to be the primary approach for audits of small entities, an auditor should consider the sources of substantive audit evidence, which are:

- procedures performed on account balances, including both balance sheet and income statement balances;
- analytical review procedures; and
- procedures performed on transactions.

Procedures on account balances

8 In many circumstances, after obtaining an understanding of the entity and its environment, including its internal control, the most effective way for an auditor to obtain the majority of audit evidence for a small entity audit is to begin with performing substantive procedures on balances of balance sheet accounts. This not only provides audit assurance on the balances being audited, it also provides assurance on the related transactions making up the balances. For example, if accounts receivable are confirmed, some credit can be taken for this work in designing the procedures related to sales and receipts. Confirmations help to provide evidence about the existence of account balances and, therefore, provide some evidence about the occurrence of related sales transactions. When designing audit procedures for sales revenues, therefore, the auditor may do less work on occurrence, as the confirmations will already have provided some of the needed evidence.
It is worthwhile to apply the same approach to income statement balances, even though the opportunity to audit such balances occurs less often. Where it can be done, auditing income statement balances is likely to be less time consuming than examining transactions, because balances represent the net accumulation of a number of transactions. Accordingly, by satisfying audit objectives on one account balance, an auditor also obtains assurance on the numerous transactions that make up that single balance. For example, if sales take place to a single customer, the confirmation of those sales provides audit assurance as to total sales without performing time-consuming transactions tests. Similarly, if an entity has few employees, payroll balances can be verified by making simple calculations, rather than by testing individual transactions.

Analytical review procedures
Analytical review procedures are occasionally viewed as just a supplement to other substantive tests. High-assurance analytical procedures can, however, provide excellent audit assurance. In fact, they can often be the most efficient method of gathering audit evidence about account balances or classes of transactions in a small entity audit. They represent substantive evidence and can provide assurance on the overall reasonableness of the financial data. For example, a calculation of fee revenue for a condominium, based on the number of units compared to reported revenue, may be all that is needed to verify the revenue. Such a test can provide a high level of assurance. Generally, predictive tests of this type provide more assurance than ratio-based tests, such as gross profit comparisons. The latter, while sometimes useful as corroborative tests, provide very little audit assurance and their use would not normally justify reducing other tests.

Analytical procedures often address several assertions at once: for example, sales analysis can support not only the fact that all goods shipped are invoiced and recorded in the accounts, but also that they have been properly priced, extended and summarized.

Examples of analytical procedures that an auditor can perform efficiently and effectively, based on an understanding of an entity and its environment and taking into account past experience and expected results, include the following:
- comparison of actual amounts to predicted amounts based on budgets, projections, prior periods and auditor-developed expectations;
- analysis of relationships among account balances (such as expenses as a percentage of sales);
- comparison of entity data with industry data;
- comparison of actual significant ratios to predicted ratios (such as inventory turnover or gross margin);
- prediction of balances based on the use of non-financial data or other data (such as estimating sales based on number of units shipped and total payroll expenses based on number of employees).
The degree of assurance derived from carrying out these procedures depends, in addition to the nature of the tests, on the reliability of the data used and the procedures performed to investigate unexpected or abnormal results. The practicability of the procedures depends on an entity’s complexity, for example, sales comparisons are more difficult where there are multiple products.

More reliability can be ascribed to data produced from accounting records if the accounts have been subjected to auditing procedures. Recorded sales, for example, may be compared to a predicted sales figure calculated from audited records of goods shipped. Such a comparison would also be considered more reliable if the shipping records are kept by personnel not responsible for keeping the accounting records. A comparison of two amounts produced from the same accounting source is generally less reliable than a comparison of accounting records to non-financial sources (such as sales based on production records or payroll based on personnel records) unless the data have been subjected to audit procedures.

When applying analytical procedures, an auditor must investigate unexpected results. The auditor can often generate data for comparison purposes and generally improve the quality of analytical review procedures by predicting normal expected fluctuations and by calculating anticipated results for certain accounts. For example, based on the acquired understanding of an entity, the auditor may be aware that the company has begun selling a new product and can, therefore, expect an increase in sales over the previous year. In addition, because of work carried out in the purchase and inventory areas, the auditor may have established that sales of other products have decreased by a certain percentage. The comparison of sales by product to the previous year might confirm the expected fluctuations. Or, if prices are fairly constant and the production records are reliable, the auditor may be able to predict the sales amount to within a satisfactory degree of precision (normally related to materiality). By performing a predictive test on sales, the auditor may be able to satisfy several audit objectives with respect to sales and accounts receivable. A predictive test would be used only if the auditor is confident that the predicted amount is reasonably accurate, because the test objective is to discover whether there are material errors in the recorded amount, not in the predicted amount. If the recorded amount and predicted amount differ because of the existence of errors in the prediction, the test is ineffective.

Care should be taken to avoid extensive use of analytical review procedures that result in duplication of effort. They should not be performed simply as another test but, rather, they must provide evidence to contribute to the achievement of audit objectives. Performance of such procedures may not be cost-effective if only limited additional assurance is obtained, but the costs of the procedures are high.

In addition, CICA Handbook – Assurance, Section 5143, “The Auditor’s Procedures in Response to Assessed Risks,” paragraph .53, notes that “when the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures”
(that is, enquiry or analysis alone cannot be used). For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

**Tests on transaction streams**
Sometimes, an auditor may choose to examine detailed transactions as a primary source of audit evidence. Usually, this approach is the least cost-effective and would be used only when the auditor cannot obtain audit assurance from one or more other sources of evidence. It is important to note, however, that an audit must cover assertions related to classes of transactions. If sufficient assurance cannot be obtained through other tests, it will be necessary to carry out transactions testing.

**SELECTING THE SOURCES OF SUBSTANTIVE AUDIT EVIDENCE**
In summary, the primary sources of audit evidence in a small entity environment would normally be ranked in the following order:

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>REASONS AND COMMENTARY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tests of balances (for balance sheet and income statement accounts)</td>
<td>For small populations, procedures can be performed in minimal time; provides assurance with respect to related balance sheet or income statement item assertions (other than completeness); lends itself to concentrating audit effort towards the year-end position; facilitates obtaining the best evidence (such as external confirmations).</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Tend to be highly effective as long as data are conducive to predicting results; simplicity of relationships can make analytical review procedures very effective in a small entity environment; generally applies to income items.</td>
</tr>
<tr>
<td>Tests of transaction streams</td>
<td>Tend to be more time consuming unless there are few transactions; usually used only if controls are poor, there are few balances and extensive substantive testing of transactions is the only means of obtaining sufficient audit assurance.</td>
</tr>
</tbody>
</table>

The most cost-effective audit strategy will frequently require a combination of primary and secondary sources of audit evidence on each financial statement assertion. For example, in the audit of accounts receivable, confirmation is likely to be the primary audit evidence, but it may be corroborated by statistical analysis of balance sizes, aging, etc. The analytical review procedures used in a case like this would not be as effective as the predictive tests mentioned in paragraph 15 above.

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1 Primary audit evidence is the evidence that forms the principal basis for satisfaction of audit objectives. Secondary evidence is obtained to corroborate that evidence.
DIRECTION OF TESTING

In designing audit procedures, an auditor usually decides to check assets and expenses for overstatement and liabilities and revenues for understatements. Although all items need to be audited for both overstatement and understatement, it is usually more efficient to draw assurance from tests of related debits or credits. For example, when sales are audited for completeness, this provides assurance about the completeness of accounts receivable — that they are not understated. Accordingly, emphasis on direct testing of accounts receivable can be placed on testing for overstatement.

When examining accounts for overstatement, an auditor would select items from the general ledger accounts and trace entries back from the books of account and accounting records to the source documents. Conversely, in examining accounts for understatement, the auditor would select items from source documents and trace these through the accounting records and books of account to the general ledger accounts.

WHETHER TO SAMPLE

In a small entity, accounts receivable confirmation and inventory pricing are the most common applications for sampling, whether statistical or otherwise. Although sampling has been used in many situations for sales and purchases testing, this is likely to result in large sample sizes. Usually, the most efficient way to reduce or even eliminate sample sizes for classes of transactions is to place as much reliance as possible on key-item testing and analytical review techniques.

Key items have been defined as items:

... having one or more particular characteristics of interest to the auditor. These characteristics may relate to monetary value either from the point of view of absolute value in relation to a pre-determined base (often materiality) or from the point of view of their apparent abnormality.²

In identifying key items, there are several possible factors to consider:

- The relative size or dollar amount of an item. An item might be so large that it could individually result in a material misstatement.
- An unusual item in the account or class of transactions.
- Prior-period experience. Using the understanding of an entity and its environment acquired in prior audits, an auditor could be aware of types of items that are highly susceptible to misstatement.
- Results of analytical review procedures. This can be an efficient means of identifying potential misstatements or misclassifications.
- Existence of related party transactions and balances.

Tests conducted on key items have the advantage of focusing audit attention on items that have a potentially higher risk of error because of size or nature (for example, long overdue accounts receivable, slow-moving items of inventory or related party transactions).

Before conducting detailed tests of transactions, an auditor needs to evaluate the audit evidence obtained from applying substantive procedures to key items. The issue to be addressed is whether such tests, alone or combined with appropriate analytical review procedures, provide sufficient and appropriate audit evidence. Various factors may influence the assessment:

- Similarity of items tested to remaining population. The auditor can obtain some understanding of the types of other items if the ones tested are similar in nature and the same system is used to process the transactions.
- Indication of problems. Test results might indicate that a potential problem rests in the untested portion of the population. Extension of testing will usually be required.
- Size of items tested compared to total balance. As the number increases, the need to use sampling or other testing will decrease.

This evaluation should enable an auditor to decide on the extent of substantive tests of detail to carry out, or whether such tests are necessary at all. For example, if the auditor has examined a substantial number of individual amounts using analytical and other procedures, and found no evidence of problems, there may be no need to sample the remaining population. Whether to use sampling is a judgment call. This decision process is illustrated in Exhibit 8.1.

Exhibit 8.1

SUBSTANTIVE TESTS
The exhibit attempts to summarize the logical process an auditor would follow in deciding on the nature and extent of tests of transactions. As mentioned in the preceding paragraphs, key items for the applicable classes of transactions would be tested and analytical procedures carried out. In addition, the audit procedures performed on balance sheet balances would provide some evidence about transactions, at least for certain assertions. For example, if accounts receivable confirmations were sent, this would provide assurance as to occurrence of sales transactions. Other evidence would still be needed, however, to satisfy the auditor as to the completeness assertion with regard to revenues. Such additional evidence would usually consist of tests of the operating effectiveness of controls or tests of transactions. It is important to note that, despite the extensive amount of testing that may be required in performing tests of transactions, such testing is necessary if adequate evidence cannot be obtained from testing key items, balance sheet balances or from analytical review.

**SAMPLING**

**Approaches to Audit Sampling**

If a decision is made to use sampling, it is necessary to decide whether to use statistical or non-statistical methods. Sample size is not a factor in making this decision — non-statistical sampling cannot result in a smaller number of items tested than statistical sampling. No matter which sampling method is chosen, professional judgment is important because the auditor should plan, perform and evaluate the results of the sample tested and form a conclusion about the balance or class of transactions.

Whether statistical or non-statistical techniques are followed, the following audit decisions are required:

- Define the population. The use of the wrong population for a sampling application could mean that conclusions based on the sample are invalid.
- Define the sampling unit (the individual items that are subjected to the tests). The sampling unit (for example, customer account balances, cheques) should be identified before the sample is selected to produce an effective sampling application.
- Define what will be classified as an error.
- Exclude individually significant items so that they may be verified separately.
- Identify homogeneous subgroups within the defined population. The subgroups should be tested separately and the strata results subsequently combined to produce an overall conclusion.
- Assess risk of incorrect acceptance of sample findings. The larger the sample size relative to the population, the lower the risk. In non-statistical sampling, the risk cannot be measured as a percentage, but it nevertheless exists. The only way risk can be reduced without using an unreasonably large sample size is to exclude key items and to stratify the population.
- Assess maximum error that is tolerable. (Further explained in Appendix E.)
- Evaluate the results of the sample.
TIMING OF SUBSTANTIVE AUDIT PROCEDURES

An auditor should consider whether any substantive procedures can or should be performed before the year end. This consideration is based on efficiency, but the extent to which the procedures can be moved back depends on a variety of factors, such as the risk of material misstatement, the adequacy of controls, the quality of the accounting systems, the nature of the test and the availability of evidence at the earlier date. If, in the judgment of the auditor, these factors do not reduce the effectiveness of the procedures, it may be desirable, for purposes of efficiency, to perform substantive procedures before the year end.

Substantive procedures that may be started before year end and then completed at year end are usually those applied to transactions such as:
- tests of detail of the additions to and reductions of balance sheet accounts with a low volume of entries (for example, fixed assets, debt, investments and owner’s equity); and
- tests of details of transactions that affect the income statement.

There is a need to carry out roll-forward work when substantive procedures are performed on balances prior to the year end. This needs to be weighed against the advantages of changing the timing of the work, particularly in the case of balance sheet items such as cash, receivables, inventory and payables.

EVIDENCE OF COMPLETENESS

Combined Approach

Obtaining evidence as to completeness is one of the more challenging aspects of auditing a small entity, because of the limited controls that often exist. It has sometimes been suggested that auditors should more frequently express reservations with regard to completeness in their small entity audit reports. Experience shows, however, that a combined approach using tests of the operating effectiveness of controls for this assertion can be effective and practical. Even the smallest entity usually uses a double-entry accounting system that incorporates some basic controls. In addition, most entities have some method in place to capture revenue (such as cash registers), which may help to identify controls that can be tested.

As part of policies and procedures regarding completeness, documents that are the initial record of transactions should be sequentially numbered as soon as possible (preferably they should be pre-numbered) and the numbers should be accounted for after processing. Control totals and transaction logs also contribute to completeness if the totals or logs are reconciled at appropriate stages in processing.

The same arguments would apply to the audit of small not-for-profit organizations. Nevertheless, the expression of reservations for completeness is more common for this type of organization, because of the nature of donations revenue and the difficulty of applying adequate controls over this revenue. Experience also
shows, however, that it can sometimes be feasible to establish acceptable controls over donations revenues for small non-profit organizations if sufficient effort is invested in designing and implementing such controls. Each situation must be evaluated on its own merits.

**Confirmation**

Confirmation of the year’s transactions can occasionally be obtained from third parties, for example, purchases from major suppliers or grants received from major agencies. This procedure is particularly useful in small entities that have purchase or sale transactions with one or a few major suppliers or customers. Direct confirmation of transactions with the supplier or customer would provide the best evidence of completeness.

**Transaction Testing**

Direct evidence that a population of accounting data is complete can be obtained from testing transactions. For example, testing the completeness of sales by checking shipping notices to sales invoices can provide such evidence. This approach is often the least efficient means of obtaining evidence as to completeness.

**Other Procedures**

Other audit procedures addressing the assertion of completeness include:

- inspecting and observing an entity’s methods of assuring completeness;
- conducting independent tests of the sequence of pre-numbered documents and reconciliation of totals;
- matching transactions with files of open items, such as open sales orders; unmatched items could indicate uncompleted or unrecorded transactions;
- reconciling transactions with records of physical movement to test completeness. For example, an auditor can trace records of goods received to amounts recorded as purchase transactions and records of goods shipped to amounts recorded as sales transactions and trace both records to the inventory records. As discussed above, it is important that the direction of testing be from the evidence of the transaction (source document) to the accounting record and that some means (such as numerical sequence) be employed to verify the completeness of the shipping/receiving document; and
- comparison of not-for-profit grant revenue to grant documents.

**Review**

A review of subsequent events and specific transaction streams can often provide reasonable assurance about the accuracy of the accounting cut-off and the disclosure of unrecorded liabilities and/or receivables. Procedures that are less direct, but increase the auditor’s confidence that the accounting system adequately captures all transactions, are discussed below.
Analytical review procedures
As mentioned earlier, information about balances and transaction totals can be obtained from effective analytical review procedures. These involve an element of predicting expected balances and transaction totals. Analytical review procedures confined to overall comparisons of the reasonableness of prior year or budgeted amounts to current year figures do not provide much assurance on the completeness assertion.

In some cases, operating data independent of the accounting records can be used to test completeness. A comparison of units purchased to units sold provides assurance on the completeness of sales, at least to the extent that purchases have been recorded. In other cases, an account balance might be sufficiently tested by computation. For example, a comparison of investment income to average investments held tests whether income earned on investments is recorded; and average pay times number of employees may substantiate that salaries are recorded. In the non-profit realm, an example would be the verification of revenues in a hospital by reference to the number of beds times the rate per bed per night. If substantive assurance is to be derived from such procedures, it is important that one of the variables, such as investments held, be verified directly by a procedure such as physical inspection.

Observation and enquiry
A degree of assurance about management’s concern for control, the competence and integrity of employees and the condition of the accounting system may be provided by observation and enquiry. By touring an entity and observing it in operation, an auditor can gain a general impression of operating efficiency and effectiveness. The auditor can see whether the level of activity observed is what would generally be expected for the activity shown in the accounting records. The auditor can also gain an impression of the diligence with which control-related procedures are carried out.

Observation may include considering whether:

• management demonstrates a concern for control by performing important approval and checking functions;
• accounting personnel understand their duties and appear mindful of controlling the quality of their work; and
• there is a formal accounting system with a chart of accounts and clear lines of responsibility for accounting personnel.

Obtaining audit evidence is the core of the audit. When the evidence is gathered, the auditor must assess the sufficiency and appropriateness of the evidence and make a decision as to the form of audit report to be issued. Most of the support for the report that is issued rests with the evidence that the auditor has obtained and documented in the audit file.
This chapter addresses one of the more contentious issues facing the auditor of a small entity: How much documentation is sufficient to meet current auditing standards? In particular, the chapter explains the purpose of documentation and provides guidance on the extent of documentation required in an audit.

One of the most common complaints auditors have about small entity audits is that they spend more time documenting the audit to meet current auditing standards than actually doing the audit work. Underlying this complaint is the thought that at least some of the documentation may be unnecessary. With continuing pressures on audit fees, no one can afford to spend time on unnecessary documentation.

Documentation has been defined as the process of recording, assembling and organizing the evidence supporting financial statement assertions. In addition to supporting the work undertaken, documentation assists in the review of the audit and provides useful input in planning the next year’s audit. Moreover, the Rules of Professional Conduct require audit documentation, which is essential in defending any legal actions that might be launched against an auditor. Since it may be the only evidence that remains after an audit is completed, there is no question about the importance of good documentation. The challenge auditors face is to document what is needed without going overboard.

**DOCUMENTATION CONSIDERATIONS**

**Objectives**

When considering what documentation is needed, it is useful to focus on the main purposes it serves. These could be summarized as:

- to provide support for the content of the auditor’s report, including representations on compliance with GAAS;

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1 Subsequent to the completion of this Study, revised Handbook – Assurance Section 5145, “Documentation,” effective for years commencing on or after November 1, 2006, was issued by the Auditing and Assurance Standards Board. Reference should be made to this revised Standard with regard to additional documentation and other related requirements.
• to assist the auditor in the conduct of the audit;
• to facilitate effective engagement management;
• to help to demonstrate satisfaction of the first examination standard, which calls for the auditor’s work to be adequately planned, properly executed and properly supervised; and
• to provide a record of auditor judgments.

Documentation covers the audit from beginning to completion. The standards require documentation in at least the following areas:
• acceptance and independence;
• planning;
• understanding an entity and its environment, including its internal control;
• record of risk assessment and other audit procedures carried out and evidence gathered;
• evidence of review and supervision; and
• record of discussions and conclusions.

Acceptance and Independence

Before accepting an audit, an auditor must assess both the risk of material misstatement and their independence of the client. The file needs to document these considerations and lead to a conclusion on the acceptance or continuance of an engagement.

An auditor would not necessarily perform the entire risk assessment required to complete the audit at this stage, but would perform a risk assessment sufficient to reach a conclusion on the acceptance or continuance of the audit.

The considerations that should be documented in assessing risk are set out in Chapter 4. For independence, the considerations are set out in Chapter 2 and examples are provided in Appendix B.

Planning

Using generic checklists may not be efficient in documenting small entity audits because they often contain extensive information that may not apply. Checklists can, however, be useful as memory-joggers during planning. It is usually most efficient to maintain such checklists in electronic form, because much of the planning information does not change from year to year. Each year, the prior year’s form can be rolled forward, updated and included in the current year’s audit working paper file. The Professional Engagement Manual includes planning forms.

The audit planning process, described in Chapter 3, addressed the current year’s audit environment, materiality and the audit strategy. As was pointed out in that chapter, some auditors prefer to document the overall strategy in an overview working paper and to develop the strategy for each major financial statement assertion in supporting schedules.
One of the requirements in the CICA Handbook – Assurance calls for the engagement team to discuss the susceptibility of the entity’s financial statements to material misstatement due to fraud or error. Notes should be kept of this discussion, including a record of significant decisions reached, and should then be retained in the audit file. Where there is no audit team, because a sole practitioner, for example, carries out the audit, the documentation can consist of a memo stating the circumstances and the auditor’s consideration of any issues that might exist for that entity. One of the matters considered would likely include a discussion of the role of management in the company and whether that management is likely to increase or decrease risk in the circumstances.

Understanding the Entity and its Environment, Including its Internal Control

Understanding the entity

In a small entity audit, understanding the entity is one of the auditor’s most useful tools. Documentation of this understanding provides the auditor with the springboard for planning and conducting an effective audit. Extensive information concerning understanding of the entity is provided for in the sample form included in the Professional Engagement Manual.

Internal control

The CICA Handbook – Assurance sets out some guidance on documentation requirements arising from the internal control recommendations. Documentation may vary from a brief descriptive memorandum to more extensive documentation in the form of, for example, narrative descriptions, flowcharts or questionnaires.

For audits of small entities that follow a substantive approach, the only internal control information that must be documented is the understanding of the control environment, the control policies and procedures that are followed and a short evaluation of whether the system controls are designed and implemented effectively. This essentially involves knowing what accounting package is being used, how input is organized and how output is used, what controls are in place in using the software and drawing a conclusion on the likelihood of the effectiveness of those controls. Documentation of these matters in a memo is likely to be the most practical approach in most cases. Examples are provided in Appendix C.

Record of Risk Assessment and Other Audit Procedures Carried out and Evidence Gathered

Documentation of the risk assessment process involves documenting the key elements of the understanding of the entity and each of the internal control components identified in obtaining that understanding. Documentation is also required of:

• the identification of assessed risks of material misstatement at the financial statement level and at the assertion level
• the risks identified and controls evaluated for significant risks, and
• the risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.

In addition, the sources of the information obtained must be documented. Then the auditor is in a position to formulate the response to the risks and document the results of those responses.

The responses will involve audit procedures, which need to be documented in audit programs. Documenting the evidence gathering process is not any different for a small audit than for a large audit. The working papers must provide a trail of what audit evidence was sought and found to support financial statement assertions. The trail should be sufficiently well documented that the audit procedures could be re-performed based on the details recorded in the file. This means that the documents examined should be recorded in the file in sufficient detail to permit a reasonable opportunity of finding them again, if necessary.

There is a requirement to document the linkage of the audit procedures with the assessed risks at the assertion level. This is best done in the form illustrated in the audit programs included in the Professional Engagement Manual.

Evidence of Review and Supervision

The review and supervision process for small entity audits is likely to include fewer levels of review than for large audits. Nevertheless, it must be documented, usually by listing the personnel that will work on the engagement in the planning documentation and by initialling and dating work papers for review and signing off the completion questionnaire.

Record of Discussions and Conclusions

Discussions with the client, colleagues and others and the auditor’s judgment process are often rather poorly documented in audit files. Yet, these are the areas that can cause the most difficulty to auditors needing to defend their audit opinions several years later. Sensitive situations encountered in audits of small entities often involve inventory valuation, accounts receivable collectibility and accounting for unusual transactions. Without appropriate documentation, discussions about these issues, as well as the judgments made in resolving them, could be difficult to recall years later.

The importance of including memos in the files of all significant discussions, as well as the rationale for audit decisions and conclusions, cannot be over-emphasized.

In many small entity audits, the auditor will often provide adjusting entries for the entity, prepare the financial statements and advise on the computation of accounting estimates. This would include, for example, setting up accruals and

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2 The Quality Assurance Manual provides specific guidance on Review and Supervision.
assistance with the calculation of the allowance for doubtful accounts and a provision for inventory obsolescence. In such circumstances, the auditor would need to document the advice given and the amount of any resulting adjustments.

If there are unrecorded adjustments, including those carried over from the previous year, they will need to be summarized along with their effect on key items, such as income before taxes, total assets and working capital. It is important that the auditor’s conclusions on the disposition of these unrecorded adjustments be documented, including the effect, if any, on the auditor’s report.
Appendix A

STANDARDS SPECIFICALLY DIRECTED TO SMALL BUSINESS AUDITS

These standards have been extracted from the CICA Handbook – Assurance and Provincial Institute sources as of October 31, 2005. As they may have been changed subsequently, reference should be made to the current version of the CICA Handbook – Assurance and the other formal relevant documents in determining current standards. It is also important to read the CICA Handbook – Assurance in order to place these excerpts in the context in which they appear in that document.

As a result of a review of these and related sections of the standards, the following conclusions can be drawn with regard to the audit of small entities.

1. An engagement partner who completes an entire audit as a sole practitioner will not be able to have a meeting to discuss susceptibility to fraud, but does need to consider it. (5135.031)

2. The auditor needs to weigh the ability of small entity management to exercise effective oversight against the ability to override controls in considering the susceptibility to fraud. (5135.036)

3. A smaller entity does not need to have a written code of conduct, but the auditor needs to consider its culture. (5135.052)

4. In a small entity, a lack of division of duties can be offset by day-to-day supervision by the owner-manager. (5135.059)

5. Smaller entities do not need formal strategic plans. (5141.034)

6. Smaller entities with active management involvement in the financial reporting process do not necessarily need to have extensive descriptions of accounting procedures or detailed written policies. (5141.045)

7. In a smaller entity, management does not necessarily need to have a formal risk assessment process, but does need to have some means of identifying and addressing business risks. (5141.079)

8. The integrity and ethical values of management are critical and need to be assessed by the auditors.

9. All of the above considerations must be documented in the working papers.

General Quality Control Standards (CICA Handbook – Assurance)

.007 The nature, extent, timing and documentation of the policies and procedures developed by firms to satisfy the requirements of these
Recommendations will vary and will depend on many factors, including the size and the nature of the practice of the firm and its operating characteristics. The policies and procedures need not be complex or time-consuming to be effective. These Recommendations describe responsibilities for several different roles and functions within the firm, including overall quality control and monitoring. For a small firm, it may be necessary for one person to perform more than one of these functions. In some circumstances, it may be appropriate to use the services of a suitably qualified external person. When a firm decides to use such a person, care would be taken to establish the legal responsibilities of the parties and to safeguard client confidentiality.

The size and circumstances of the firm will influence the structure of the firm’s performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

To facilitate the assignment of an assurance team with the competencies necessary to perform the assurance work expected of the assurance team, the firm would establish procedures to require the periodic assessment of the knowledge, skills and abilities of individuals within the firm. Where the competencies of individuals are widely known, particularly in a small firm, such procedures need not be formalized.

A person would not be considered objective for the purpose of performing an engagement quality control review if he or she is, or would be, directly or indirectly involved in reviewing his or her own work in any capacity. For example, the engagement quality control reviewer:
(a) would not otherwise participate in the performance of the assurance engagement;
(b) would not make important decisions specific to the assurance engagement; and
(c) would not be subject to other considerations that would threaten the reviewer’s objectivity.

A small firm or a sole practitioner may wish to use the services of a suitably qualified external person or another firm to carry out assurance engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations and thereby facilitate monitoring activities.

The firm would investigate such complaints and allegations in accordance with established policies and procedures. The investigation would be

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1 “Use of Specialists in Assurance Engagements: Selecting a specialist,” Section 5049, paragraphs 27 to 37, provides guidance concerning the competence of specialists.
supervised by a practitioner with sufficient and appropriate experience and
authority within the firm but who is not otherwise involved in the assurance
engagement, and would include involving legal counsel as necessary. Small
firms may use the services of a suitably qualified external person or another
firm to carry out the investigation. Complaints, allegations and the
responses to them would be documented.

.109 The manner in which such matters are documented is for the firm to
determine. For example, large firms may use electronic databases to
document matters such as independence confirmations, performance
evaluations and the results of monitoring inspections. Smaller firms may use
more informal methods such as manual notes, checklists and forms.

Section 5135 — The Auditor’s Responsibility to Consider Fraud
.031 Discussing the susceptibility of the entity’s financial statements to material
misstatement due to fraud is an important part of the audit. It enables the
auditor to consider an appropriate response to the susceptibility of the
entity’s financial statements to material misstatement due to fraud and to
determine which members of the engagement team will conduct certain
audit procedures. It also permits the auditor to determine how the results of
audit procedures will be shared among the engagement team and how to
deal with any allegations of fraud that may come to the auditor’s attention.
Many audits of small entities are carried out entirely by the engagement
partner (who may be a sole practitioner). In such situations, the
engagement partner, having personally conducted the planning of the audit,
considers the susceptibility of the entity’s financial statements to material
misstatement due to fraud.

.036 In a small owner-managed entity, the owner-manager may be able to
exercise more effective oversight than in a larger entity, thereby
compensating for the generally more limited opportunities for segregation
of duties. On the other hand, the owner-manager may be more able to
override controls because of the informal system of internal control. This is
taken into account by the auditor when identifying the risks of material
misstatement due to fraud.

.052 The size, complexity and ownership characteristics of the entity have a
significant influence on the consideration of relevant fraud risk factors. For
example, in the case of a large entity, the auditor ordinarily considers factors
that generally constrain improper conduct by management, such as the
effectiveness of the audit committee or equivalent, the internal audit
function and the existence and enforcement of a formal code of conduct.
Furthermore, fraud risk factors considered at a business segment operating
level may provide different insights than the consideration thereof at an
entity-wide level. In the case of a small entity, some or all of these
considerations may be inapplicable or less important. For example, a
smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise weak controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential weakness since there is an opportunity for management override of controls.

It is important for the auditor to obtain an understanding of the controls that management has designed and implemented to prevent and detect fraud, because in designing and implementing such controls management may make informed judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. The auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties; this may often be the case in small entities where the owner provides day-to-day supervision of operations. Information from obtaining this understanding may also be useful in identifying fraud risk factors that may affect the auditor’s assessment of the risks that the financial statements may contain material misstatements due to fraud.

Section 5141 — Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

Smaller entities often do not set their objectives and strategies, or manage the related business risks, through formal plans or processes. In many cases there may be no documentation of such matters. In such entities, the auditor’s understanding is ordinarily obtained through enquiries of management and observation of how the entity responds to such matters.

Smaller entities ordinarily do not have formal processes to measure and review the entity’s financial performance. Management nevertheless often relies on certain key indicators that knowledge and experience of the business suggest are reliable bases for evaluating financial performance and taking appropriate action.

The way in which internal control is designed and implemented varies with an entity’s size and complexity. Specifically, smaller entities may use less formal means and simpler processes and procedures to achieve their objectives. For example, smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures or detailed written policies. For some entities, in particular very small entities, the owner-manager may perform
functions that in a larger entity would be regarded as belonging to several of the components of internal control. Therefore, the components of internal control may not be clearly distinguished within smaller entities, but their underlying purposes are equally valid.

Most entities make use of IT systems for financial reporting and operational purposes. However, even when IT is extensively used, there will be manual elements to the systems. The balance between manual and automated elements varies. In certain cases, particularly smaller, less complex entities, the systems may be primarily manual. In other cases, the extent of automation may vary with some systems substantially automated with few related manual elements and others, even within the same entity, predominantly manual. As a result, an entity’s system of internal control is likely to contain manual and automated elements, the characteristics of which are relevant to the auditor’s risk assessment and further audit procedures based thereon.

Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. The potential for override of controls by the owner-manager depends to a great extent on the control environment and in particular, the owner-manager’s attitudes about the importance of internal control.

Audit evidence for elements of the control environment may not be available in documentary form, in particular for smaller entities where communication between management and other personnel may be informal, yet effective. For example, management’s commitment to ethical values and competence is often implemented through the behaviour and attitude they demonstrate in managing the entity’s business instead of in a written code of conduct. Consequently, management’s attitudes, awareness and actions are of particular importance in the design of a smaller entity’s control environment. In addition, the role of those charged with governance is often undertaken by the owner-manager where there are no other owners.

The nature of an entity’s control environment is such that it has a pervasive effect on assessing the risks of material misstatement. For example, owner-manager controls may mitigate a lack of segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. The auditor’s evaluation of the design of the entity’s control environment includes considering whether the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and are not undermined by control environment weaknesses. For example, human resource policies and practices directed toward hiring competent financial, accounting and IT
personnel may not mitigate a strong bias by top management to overstate earnings. Changes in the control environment may affect the relevance of information obtained in prior audits. For example, management's decision to commit additional resources for training and awareness of financial reporting activities may reduce the risk of errors in processing financial information. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed.

In a smaller entity, management may not have a formal risk assessment process as described in paragraph 5141.076. For such entities, the auditor discusses with management how risks to the business are identified by management and how they are addressed.

SECTION 5141, APPENDIX B
Control Environment
Application to small entities
Small entities may implement the control environment elements differently than larger entities. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Similarly, those charged with governance in small entities may not include an independent or outside member.

Entity’s Risk Assessment Procedures
Application to small entities
The basic concepts of the entity’s risk assessment process are relevant to every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognized implicitly rather than explicitly in small entities. Management may be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

Information System, Including the Related Business Processes, Relevant to Financial Reporting and Communication
Application to small entities
Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communication may be less formal and easier to
achieve in a small entity than in a larger entity due to the small entity’s size and fewer levels as well as management’s greater visibility and availability.

**Control Activities**

*Application to small entities*

The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management’s retention of authority for approving credit sales, significant purchases and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in small entities. Even companies that have only a few employees, however, may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

**Monitoring of Controls**

*Application to small entities*

Ongoing monitoring activities of small entities are more likely to be informal and are typically performed as a part of the overall management of the entity’s operations. Management’s close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

**Section 5143 — The Auditor’s Procedures in Response to Assessed Risks**

.09 In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor’s further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in paragraph 5143.08, the auditor considers whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

**Section 5150 — Planning**

.12 In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the audit engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination and communication between team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity and the complexity of the audit.
The form and extent of documentation depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement.

Institute of Chartered Accountants of Ontario Council
Interpretations to Rules 204.1 to 204.6, Interpretation #52
.52 The size and structure of the firm and the nature of the assurance client and the engagement will affect the type and degree of the threats to independence and, consequently, the types of safeguards appropriate to eliminate such threats or reduce them to an acceptable level. For example, it is understood that not all the safeguards noted in paragraphs 47 – 51 will be available to the sole practitioner or small firm or within smaller clients such as owner-managed entities. Smaller clients often rely on members to provide a broad range of accounting and business services. Independence will not be impaired provided such services are not specifically prohibited by Rule 204.4 and provided safeguards are applied to reduce any threat to an acceptable level. In many circumstances, explaining the result of the service and obtaining client approval and acceptance for the result of the service will be an appropriate safeguard for such smaller entities. Similarly, such clients often have a long-standing relationship with an individual who is a sole practitioner or partner from a firm. Independence will not be impaired provided safeguards are applied to reduce any familiarity threat to an acceptable level. In most circumstances, periodic external practice inspection and, where appropriate, consultation will reduce any threat to independence to an acceptable level.

Quality Assurance Manual
A smaller firm will have less staff and resources available to segregate important tasks such as consultation on a specialized issue or reviewing a high-risk engagement file. In these circumstances, it may be appropriate to contract with a suitably qualified person outside of the firm. When a firm uses such a person, care should be taken to establish the legal responsibilities and to safeguard client confidentiality. A1.1-2

For smaller firms, the practice of partner or senior staff rotation may simply not be practical. There may not be enough assurance partners with the necessary knowledge and experience to serve as the lead engagement partner. In these circumstances, the firm should involve an additional professional accountant, (not otherwise associated with the assurance team) to review the work done or otherwise advise as necessary. This person will likely be someone from outside the firm. A3.4-2

On smaller engagements considered to be low risk, the practitioner or engagement partner may perform both the detailed and the general review. This is called a combined review. On larger and higher risk engagements, the engagement
partner may complete the detailed review, but another partner or a FQR [File Quality reviewer] should then perform the general review. A4.3-5

**External FQ reviewers**

Smaller firms may not have a person who is qualified to perform an objective FQ [File Quality] review. This may be due to a variety of factors ranging from a lack of suitably qualified personnel, familiarity with the client, involvement in engagement decision-making or the existence of independence issues.

When an external FQ reviewer is required, the firm should search for a suitable firm or individuals who can perform the reviews required at the required times. In some cases it may be possible for a firm to perform the File Quality Review for another firm.

In addition to the qualifications outlined above, the four Cs can be used to assess potential candidates as follows:

- **Competence**
  
  Rate the competence level for each of the qualification criteria outlined above and any other criteria that may be particularly relevant to the firm and its clients.

- **Character**
  
  Is the person known for high integrity and high ethical standards?

- **Commitment**
  
  Will the person be available to complete the reviews when needed and will he/she be accessible during the year for consultation and possibly reviewing parts of the file while engagement is in process?

- **Chemistry**
  
  Is the person compatible with the firm’s culture and will they get along with firm personnel?

Other factors to consider include:

- The distance and time required to travel between offices. This could be particularly important if access to your location could be blocked during major snowstorms;
- The estimate of fees. It is recommended that this time be charged on a per diem basis;
- Assurances that the information obtained will not be used in any way to entice clients to move their business to the reviewer’s firm. These assurances could extend to banning any direct contact between the reviewer and the client unless authorized in advance;
- Possible concerns by clients that use of the external FQ reviewer might not be acceptable or create a possible conflict of interest; and
- Obtaining representations about confidentiality and use of client data generally.

A5.5-3 and 5-4
EXAMPLE 1

Threats
The entity’s internal accounting records are prepared on a cash basis by a bookkeeper independent of our firm. We draft the adjusting journal entries necessary to bring the statements in accordance with GAAP and propose them to the client for approval. These entries normally include:

- Accrued interest on term deposits.
- Government subsidy receivable at year end.
- GST rebate recoverable, if eligible.
- Capitalizing asset purchases.
- Recording annual amortization.
- Accruing year-end payables for payroll, suppliers, vacation pay.
- Adjusting deferred grants and related grant revenue to actual.

Safeguards

- None of the journal entries is a product of complicated accounting decisions and/or estimates.
- Certain of the adjustments that we will provide will potentially be subjected to audit by Canada Revenue Agency (CRA).
- We have discussed all entries with the client, who understands their rationale and purpose.
- Source documents are tested in the course of the audit.
- The client has approved all entries in writing (see letter of representation).

Conclusion
The safeguards used are sufficient to reduce to an acceptable level any threats to independence arising from our preparation of the adjusting journal entries.

EXAMPLE 2

Threats
I have audited this client since 1975. In addition, the owner and I have belonged to the City Business Club for approximately the same length of time. At present, we
both serve on the club’s board of directors for the customary three-year term. The owner has just started his term and I have one year left to go.

These circumstances could be perceived as raising a familiarity threat to my independence.

Safeguards
- I have discussed the matter with the client and explained the rules and the potential of a threat to my independence.
- We both agree that, notwithstanding our long relationship, we will both approach our business relationship in a professional manner as client and auditor.
- My partner has agreed to perform a pre-release review of the audit files and financial statements.

Conclusion
The safeguards used reduce to an acceptable level any threats to my independence.

EXAMPLE 3
Threats
I accompanied my client to a meeting with her bankers to discuss the need for funding a new store outlet and a larger line of credit. My firm had prepared cash flow projections for her to take, and I accompanied her at her request to provide any additional facts and financial advice that might be required. This service could raise an advocacy threat to my independence as auditor.

Safeguards
- I explained to the client that I would be unable to take a strong advocacy position for her, as I am the auditor of her company and, therefore, cannot compromise my independence.
- I indicated that I could attend the meeting and offer any further facts or advice as might be required. She understood and accepted that approach.
- At the meeting, I provided factual information about the company’s cash flows and explained why it can afford to carry the requested line of credit, based on existing facts and assumptions as stated in the documents.
- Afterwards, I prepared a summary of the main comments made at the meeting.

Conclusion
The safeguards used are sufficient to reduce to an acceptable level any threats to independence arising from advocacy with regard to the meeting with the bankers.
EXAMPLE 4

Threats
In April of this year, I prepared a Notice of Objection with regard to the client’s last income tax assessment. I accompanied the client to the CRA district office to provide any additional tax advice that might be required.

Safeguards
- I explained to the client that my purpose in attending was to offer independent tax advice with regard to any issues that might arise, explain the client’s position and relate it to any applicable tax laws and interpretations.
- The client agreed with this approach.
- Subsequent to the meeting, I prepared notes of the discussions held.

Conclusion
The safeguards used are sufficient to reduce to an acceptable level any threats to independence arising from advocacy with regard to the preparation of the Notice of Objection and the meeting with the CRA.
CONTROL DOCUMENTATION

Although a form could be used for documentation of the control environment, usually the most efficient approach for a small entity audit is a memo. The following areas would be considered for inclusion in such a memo. (Not all points are necessary in all cases and others may be required.)

Control Environment

The control environment includes the attitudes, awareness and actions of management and those charged with governance concerning the entity’s internal control and its importance in the entity. The control environment also includes the governance and management functions and sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.

The following items would be considered for inclusion in documentation about the control environment:

(a) A description of the organizational structure, including number of employees and an indication of the scope for segregation of incompatible duties.

(b) The attributes of those charged with governance, which should include independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the appropriateness of their actions, the information they receive, the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(c) Management’s attitudes and actions towards financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed).

(d) Management’s attitudes toward information processing and accounting functions and personnel.

Several of the paragraphs in this Appendix are worded either the same as or very closely to relevant paragraphs in the CICA Handbook – Assurance.
(e) How internal control procedures are communicated to employees. Communication takes such forms as policy manuals, accounting and financial reporting manuals and memoranda. Communication also can be made electronically, orally and through the actions of management.

(f) An indication of methods of assigning authority and responsibility within an entity, including consideration of:
- policy on matters such as acceptable business practices;
- methods of dealing with matters such as organizational goals and objectives, operating functions and regulatory requirements;
- policies and practices for hiring, training, evaluating, promoting and compensating employees, and for giving them the resources necessary to carry out their assigned responsibilities;
- employee job descriptions specifying duties, reporting relationships and constraints; and
- IT systems documentation indicating procedures for authorizing transactions and approving systems changes.

(g) Management control methods to exercise authority and supervise activities, including consideration of:
- planning and reporting systems that set forth management’s plans and the result of actual performance;
- methods that report actual performance and exceptions from planned performance.

(h) Competence of personnel, including qualifications and training, as well as the personal characteristics of the personnel involved.

(i) Management’s control consciousness as evidenced by personal involvement in the day-to-day operations of the entity and, most important, attitude and leadership.

(j) Involvement of management in performing such functions as:
- signature-approval functions: for example, the approval of key documents such as cheques, payrolls, credit notes, bank reconciliations and journal entries;
- supervisory functions: for example, monitoring employees that handle cash;
- inspection functions: for example, scrutinizing incoming mail to keep abreast of payments on account, major sales orders and customer or supplier complaints.

(k) Involvement of management in designing and approving accounting procedures.

(l) A description of how access to the accounting records and data are controlled (for example, through the use of locked files, password controls, etc.). Usually, management is involved in these controls, such as locking up the premises and securing unused cheques.

(m) Management understanding and use of financial statements and periodic reports such as:
- cash status reports;
- sales and production summaries;
performance indicators, such as gross profit ratio, inventory turnover, etc.; and aged accounts receivable balances.

(n) Effects of external influences on an entity, including factors such as monitoring and compliance requirements imposed by legislative and regulatory bodies.

(o) A description of how important accounting records and data are backed up and whether the backups are stored off site.

The CICA Handbook – Assurance standards state that small entities may implement control environment elements differently than larger entities. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Similarly, those charged with governance in small entities may not include an independent or outside member.

Entity’s Risk Assessment Process
An entity’s risk assessment process is its process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity’s risk assessment process includes how management identifies risks relevant to the preparation of financial statements, estimates their significance, assesses the likelihood of their occurrence and decides upon actions to manage them.

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity’s ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements.

Risks can arise or change due to circumstances, such as the following:

(a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

(b) New personnel. New personnel may have a different focus on or understanding of internal control.

(c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.

(d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

(e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

(f) New business models, products or activities. Entering into unfamiliar business areas or transactions may introduce new risks associated with internal control.

(g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
(h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.

(i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

7 The CICA Handbook – Assurance standards state that the basic concepts of the risk assessment process are relevant to every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. All entities should have established financial reporting objectives, but small entities may recognize such objectives implicitly rather than explicitly because they are less likely to state them in a formal manner. Management may be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

Information System, Including Related Business Processes Relevant to the Financial Reporting System and Communication

8 The information system relevant to financial reporting objectives, which includes the financial reporting system, consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that an entity uses in measuring and reviewing its financial performance and in other functions. The quality of system-generated information affects management’s ability to make appropriate decisions in managing and controlling the entity’s activities and to prepare reliable financial reports.

9 Information systems perform a variety of controls to check accuracy, completeness and authorization of transactions. The two broad groupings of information systems control activities are application controls and general IT controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions that have occurred are authorized and are completely and accurately recorded and processed. (See Appendix D.)
The following items would be considered for inclusion for documentation in this area:

(a) A brief description of the accounting system and accounting responsibilities, covering topics such as procedures for carrying out cash and bank procedures, approving sales and sales prices, ordering goods and services, calculating, authorizing and recording payroll, authorizing and entering general journal entries and preparing monthly financial statements.

(b) As a minimum, this documentation would identify the major classes of transactions and determine:
   • procedures for initiating transactions;
   • accounting processing steps from initiation to inclusion of financial items in the statements;
   • the supporting documents, accounting records and specific accounts involved in processing; and
   • a brief description of the computer equipment and the accounting package being used.

Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records or written policies. Communication may be less formal and easier to achieve in a small entity than in a larger entity due to the small entity’s size as well as management’s greater visibility and availability.

Control Activities
Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity’s objectives. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels.

Documentation of control activities might include the following items:
   • reviews and analyses of actual performance versus budgets, forecasts and prior period performance;
   • relating different sets of data — operating or financial — to one another, together with analyses of the relationships and investigative and corrective actions;
   • comparing internal data with external sources of information; and
   • reviewing functional or activity performance, such as a bank’s consumer loan manager’s review of reports by branch, region and loan type for loan approvals and collections.

Physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation and, therefore, the audit.
Segregation of duties. Assigning different people the responsibilities of authorizing transactions, recording transactions and maintaining custody of assets is intended to reduce the opportunities for any person to both perpetrate and conceal errors or fraud in the normal course of the person’s duties.

The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate varies. Moreover, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management’s retention of authority for approving credit sales, significant purchases and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties may appear to be difficult in small entities. Even companies that have only a few employees, however, may be able to assign responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

Monitoring of Controls
Management’s monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management’s review of whether bank reconciliations are being prepared on a timely basis, internal auditors’ evaluation of sales personnel’s compliance with the entity’s policies on terms of sales contracts, and a legal department’s oversight of compliance with the entity’s ethical or business practice policies.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Ongoing monitoring activities of small entities are more likely to be informal and are typically performed as a part of the overall management of the entity’s operations. Management’s close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data, leading to corrective action to the control.
EXAMPLES OF CONTROL DOCUMENTATION MEMOS

1. Example for a small family-owned and managed business
This example illustrates the documentation that might be appropriate for a small business, in this case, a convenience store run by a husband and wife with the assistance of a part-time bookkeeper:

JEFFERSON SUNDRIES
The company is a convenience store that has been in business for approximately 30 years. It is run by Tom Jefferson and his wife, Donna. The part-time bookkeeper, Carla Dodds, maintains all the books and prepares monthly financial statements. Tom is a reliable and honest individual who does not take business risks and has consistently been helpful and cooperative in all dealings with the auditors. The business has always shown good profits and is not aggressive in its tax filings.

Carla readily consults us with any questions about accounting and tax matters and both Tom and Donna consult us on a variety of tax and business issues.

Tom and Donna own all the shares of the business.

Carla has a certificate in accounting from Success Business College and has worked for Jefferson for 20 years. She has a thorough knowledge of the accounts of the company and we rarely have to make adjusting entries arising from errors. We usually provide adjustments regarding fixed asset disposals and various year-end accruals. Carla seeks our help in preparing the year-end financial statements.

Records are computerized on an IBM microcomputer using ACCPAC. Modules include General Ledger (GL), Accounts Payable (AP), Payroll and Inventory. All modules are integrated. The computer is kept in Carla’s office and is protected by passwords.

Tom carefully reviews all monthly reports from the computer, including aged inventory listings and monthly income and expense summaries compared to prior periods.

Tom and/or Donna count, balance and deposit the cash daily. In the mornings, they give Carla cash register tapes for the preceding day and she enters them in the computer. She submits bills to Tom or Donna, who authorize them for payment. The cheques are then prepared and need to be signed by Tom or Donna, who are the only signing officers. Payroll cheques are included in the regular monthly bills and are processed in the same way.

Tom and/or Donna place all orders for supplies and look after all other business personally. They are fully aware of any risks that might arise, which are not unusual for a business of their type.
Evaluation of design and implementation of internal controls

The control environment: The control environment is favourable. The owners demonstrate concern for accuracy and completeness of financial reporting, participate in procedures to provide for accurate and complete financial reporting and demonstrate ethical values. This conclusion is based on my experience obtained from past audits, in addition to discussions with Tom and Carla at the outset of this year’s audit regarding control procedures they indicate they have carried out over the year. The primary responsibility for prevention and detection of fraud rests with Tom and Carla, the shareholders to whom I am reporting.

Business Risk Assessment Process: Tom and Donna both respond to business risk (cash flow fluctuations, product mix changes, sales and income tax issues) by consulting with professionals. They have a history of acting on advice received.

Financial reporting information system: The computer and accounting software are off-the-shelf and assistance can be easily obtained in the event the equipment breaks down or the bookkeeper is absent for an extended period. Backups of financial data appear adequate.

Control activities: Authorization, information processing and physical controls activities, including monthly report reviews and payment authorizations, appear adequate to detect material misstatements of inventory and cost of sales. Daily balancing of cash appears adequate to detect material misstatements of sales. Management carries out all physical controls themselves. Segregation of duties is inadequate because of the limited number of personnel involved.

Conclusion

While the control environment is favourable, and there are reasonable control activities and monitoring by management of risk assessment and the information system, we do not feel that there are controls strong enough to warrant testing and that leave a trail that is conducive to testing. Accordingly, we anticipate relying primarily on substantive testing.

2. Example for a mid-sized small business with several employees

This example illustrates the documentation that might be appropriate for a small business, in this case, a car dealer run by an owner-manager with a small staff consisting of:

- business manager;
- receptionist;
- bookkeeper;
- ten salesmen, including the sales manager; and
- five parts and service personnel, including the manager.
ANDERSON CHEV-OLDS LIMITED
The company is the largest car dealer in town and is run by Jim Anderson with his business manager, Alice Cooper. Jim dominates the management of the 25-year-old business and owns 80% of the shares, with the employees owning the other 20%. Alice runs much of the day-to-day business, and Jim relies on her heavily.

Most of the employees have worked with the company since its inception and are reasonably competent. The business is generally well run and records are accurate for recording routine transactions, although the audit usually reveals a number of adjustments to be made.

Jim resists paying any professional fees and does not consult our office unless forced to do so. He takes an aggressive stance with regard to income taxes, and Alice prepares all tax returns and files.

Nevertheless, Jim believes in paying his employees well, and has strong company benefits for them, as well as a good bonus plan based on profits. He has an excellent understanding of his business and a reputation for the best customer service in the province. He pays close personal attention to all the departments.

The board of directors includes Jim, Alice and a representative of the employees.

Records are kept on the customized accounting package designed for car dealers and provided by General Motors. The system is considered stable. The accounting system contains a GL, Sales/Accounts Receivable (AR), AP, Inventory, Payroll, and an Electronic Data Interchange (EDI) parts ordering system.

Sales, Receivables, Receipts
Sales of cars are initiated by the salesmen, who prepare a Sales Contract Sheet, which the customer signs. All sales must be approved by Jim, Alice or Jackson, the sales manager. Upon approval, a cheque is received or financing is arranged with a local bank. The car is then sent to service to be prepared for delivery. The sales contract is forwarded to Sarah, the bookkeeper, who records all sales and maintains the AR Ledger. An AR account is set up, which is then cleared when the bank financing is received. When cash has been received, or financing approved, the car is released to the customer.

When the car is delivered, a delivery report is prepared and sent to Jonathan, the Parts and Service manager, with a copy to Sarah, who records the reduction of inventory and files it with the sales contract. Physical inventory of cars is balanced to the records monthly and parts are balanced quarterly.

Parts and Service revenue is initiated in the department by issuing pre-numbered service orders. One copy is given to the customer, a copy is retained in the department and the third copy is sent to Sarah for recording.

Daily cash is received and balanced by Nancy, the receptionist, who prepares the daily deposit and takes it to the bank and forwards the receipts and deposit slips.
to Sarah for recording. A summary cash receipts report is prepared and submitted to Jim each morning by 9:00 a.m. Sarah reconciles the monthly bank statements.

Jim and Alice review the receivables listing weekly with Sarah and all overdue accounts are approved or sent for collection.

Evaluation of design and implementation of internal controls
It would be necessary to add a section here on the evaluation of the controls. It is not practicable, since this is a partial example, to provide an example of such an evaluation here. Readers, however, should refer to the Practice Engagement Manual for further guidance.

Conclusion
The following controls are to be included in the audit programs because there is a likelihood that they will be effective in supporting particular assertions:
(1) management approval of sales;
(2) monthly balancing of physical inventory;
(3) monthly bank reconciliations; and
(4) approval of overdue accounts receivable.

The remainder of the memo is not reproduced here. It would continue along similar lines under such headings as:
- purchases, payables and payments;
- inventory;
- payroll;
- preparation of journal entries; and
- preparation of monthly financial statements.
Appendix D

IT CONTROLS — GENERAL

DOCUMENTATION OF IT CONTROLS
The documentation of IT controls for an audit generally covers the areas of access controls, controls over program change and other general controls (which would include disaster recovery and backup procedures).

The following material sets out background information pertaining to the types of systems most often encountered in small entity audits. In such audits, it is necessary to obtain a sufficient understanding of the software being used to know which controls are built into the system and how they should be configured to be effective.

CONTROL ISSUES OF STAND-ALONE COMPUTERS

Access Controls
Computers are usually situated in areas of offices that are quite accessible by many people. This, together with their ever-decreasing size, means the physical security of the hardware and software is usually weak. Logical security, or security built into the software, such as password capability, is usually weaker, or non-existent. Yet, computers often contain just as much important information about a company as mainframes of larger companies, such as records of customers, payrolls, costs on bidding contracts and detailed financial information. Clearly, security of computers is important.

Physical security of computers is particularly important where they contain sensitive information. They should, where possible, be located in areas of the office that are not heavily traveled. In addition, use should be made, where possible, of the hard-coded passwords included in them, such as power-on, screen and keyboard passwords. These features are often outside the software installed on the computer, including the operating system and, therefore, provide a higher level of security.

Password control within applications software is also available, and should be used. For example, most common accounting packages provide basic password security, as do spreadsheet packages.
Strengthening a password system often requires purchasing software that provides direct security over all files in the system, including the operating system files. Several products are available, the best and most suitable of which contain encryption capability for files and passwords that cannot be read with standard edit tools. How far an entity goes depends on the risk involved, bearing in mind that perceptions of risk often differ from the reality. Many home security alarm systems are sold to people whose houses have just been broken into.

**Program Change Controls**

In most small businesses, program change controls are a non-issue because their software is purchased off the shelf and cannot be changed by the user. Although this is generally true, it overlooks the fact that small entities using computers almost always do “programming” by using spreadsheets for data accumulation and reporting. The point is that the development and maintenance of spreadsheets should be under the same types of control as other systems development activities.

Spreadsheets can be set up to automatically incorporate many calculations. This means that some care is required to ensure that the calculations and resulting reports are accurate. The techniques often associated with software development are useful in controlling this activity.

Such techniques include testing by the developer, user acceptance testing and the building in of integrity checks. Logic errors arise when formulae in spreadsheets are incorrect. This can happen even with simple formulae, such as totals and cross-totals. For example, a total of a column may be intended to include cells A1 to A20, but in reality is set up to add only cells A1 to A19. Cell A20 will always be left out of the total and a user might not notice.\(^1\)

Spreadsheet logic can be tested by altering an entry by an amount such as 100 or 1000 and then checking the effect on the variables that should be affected, such as totals. This is called “perturbing” the value. This technique can be used anywhere the relationships among the values in a spreadsheet are known. It is best to use perturbing on a copy of the spreadsheet being checked because it requires that some of the data be altered, and there is always the danger of losing track of the changes.

Logic can also be tested by inserting check-totals. This involves placing “total” formulae in cells off to the side for columns and rows that are supposed to cross-add to the same total. Any differences in the resulting check-totals would indicate the existence of logic problems.

Data entry errors are more easily prevented than detected. The best way to prevent them is to design spreadsheets that make it very clear to users exactly where

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\(^1\) The potential problems of using spreadsheets are more fully discussed in Appendix 1 of *Managing and Using Microcomputers* (Toronto: CICA, 1991).
the data should go. This means carefully labelling rows and columns and placing them conveniently close together so that a user does not have to move all over the spreadsheet and constantly change the screens.

Spreadsheet programs also offer the feature of “protecting” cells to prevent changes being made to them. This feature should be used on important spreadsheets to protect any cells in which data entry is not required. This will minimize the chance of data being entered in the wrong cells.

It is also wise to document the purpose and nature of spreadsheets. This will help avoid the frustration of trying to find a particular spreadsheet by scanning long lists of cryptic file names.

Software change controls include controls over the purchase and implementation of new software. Many small entities have suffered the cost and inefficiency of purchasing the wrong software and implementing it poorly. Small entities need to take all of the normal precautions in this area, including carefully defined needs analysis, testing, planned conversions and parallel runs.

Other General Controls
While most entities appear to back up their data regularly, disaster recovery planning is often not considered a priority, because a computer can be easily replaced. This view misses the point that one of the main purposes of disaster recovery planning is to plan the process of recovery of data after a disaster. Usually, a small entity does not carry out tests to determine whether it can recover its data in the event of loss, but it should.

CONTROL ISSUES OF LOCAL AREA NETWORKS (LANs)
Access Controls
Because LANs consist of various computers linked together with a central computer or server, there are additional security considerations. Because the server contains the shared programs and data, physical security becomes more important as well as more feasible. The server should be located in a locked room, such as a filing room, closet or unused office.

For logical security, or password control, LANs typically make use of the LAN software. Such software has password features that not only restrict access, but also enable the system manager to control the files to which users can gain access. While the security capabilities of this software are limited in comparison to the traditional security software usually associated with mainframes, it can provide an adequate degree of security for most small entities.

Program Change Controls
In large measure, program change controls in LANs are similar to those for computers. The issues are simply compounded because several computers are being used.
Other General Controls

20 In practice, backup procedures are usually more complete and effective for LANs. Generally, the LAN administrator attaches tape backup devices to the server. It is rare, however, for disaster recovery plans to be in place for LANs, especially in small organizations, although it is wise for this issue to be addressed.

CONTROL ISSUES OF CUSTOM MULTI-USER SYSTEMS

21 The major issue with custom systems is that the software can be changed. Sometimes, an entity itself has the “source” code for the programs it is using. More commonly, an entity employs a consultant to write and maintain the applications. Whether or not there is a consultant, the basic issue is the same: proper control over the program changes.

22 Steps must be taken to ensure that all changes are authorized, tested and approved before they are implemented. The implementation process must also be controlled, but most small business managers are not trained in software change control procedures.
Appendix E

SAMPLE SIZE DETERMINATION

Auditors use many different methodologies for determining sample sizes. The one used in this study is presented in a simplified format to illustrate the ranges of sample sizes that would be reasonable in different situations. Different methodologies would yield different results.  

Basic Methodology
The starting point for this methodology is the Substantive Work Level Matrix, which was derived from the CICA Publication *Extent of Audit Testing*:

<table>
<thead>
<tr>
<th>Auditor’s Assessment of Inherent Risk</th>
<th>AUDITOR’S ASSESSMENT OF CONTROL RISK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HIGH</td>
</tr>
<tr>
<td>High</td>
<td>H</td>
</tr>
<tr>
<td>Moderate</td>
<td>H</td>
</tr>
<tr>
<td>Low</td>
<td>M</td>
</tr>
</tbody>
</table>

This matrix provides a means to relate the assessment of inherent and control risk to the amount of substantive work required. For example, if inherent risk were assessed at moderate and the control risk at high, the substantive work level would be high. If the control risk assessment were to drop to moderate, the work level would also drop to moderate. This analysis would be applied to each assertion for each significant account balance and class of transaction in the financial statements.

To calculate sample sizes, it is necessary to ascribe numbers to the various work levels, which is a matter of judgment. For purposes of illustration, the values of 3, 2 and 1 might be assigned to work levels of high, medium and low respectively. This would result in the following table. Practitioners may wish to apply different factors to the various levels of work.

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In this table, the numbers can represent testing factors approximating the risk factors derived from the CICA Research Study *Extent of Audit Testing*. The following table of confidence levels and risk factors is presented on page 111 of that study:

<table>
<thead>
<tr>
<th>Confidence Level</th>
<th>50%</th>
<th>55%</th>
<th>60%</th>
<th>65%</th>
<th>70%</th>
<th>75%</th>
<th>80%</th>
<th>85%</th>
<th>90%</th>
<th>95%</th>
<th>97.5%</th>
<th>99%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor</td>
<td>.7</td>
<td>.8</td>
<td>.9</td>
<td>1.1</td>
<td>1.2</td>
<td>1.4</td>
<td>1.6</td>
<td>1.9</td>
<td>2.3</td>
<td>3.0</td>
<td>3.7</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Using this table, a testing factor of 3.0 represents a confidence level of 95%, 2.0 represents 86% and 1.0 represents 63%.

The material in *Extent of Audit Testing* can be expanded into a larger matrix that relates the assessments of inherent and control risk to the selection of testing factors. Many audit firms expand their matrix to also include risk reduction achieved by performing analytical procedures.

Using this analysis produces a matrix such as the following:

<table>
<thead>
<tr>
<th>Testing Factors</th>
<th>3.0</th>
<th>2.3</th>
<th>1.9</th>
<th>1.6</th>
<th>1.4</th>
<th>1.2</th>
<th>1.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent Risk</td>
<td>H</td>
<td>H</td>
<td>M</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>L</td>
</tr>
<tr>
<td>Control Risk</td>
<td>H</td>
<td>H</td>
<td>M</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>H</td>
</tr>
<tr>
<td>Analytical Procedures (Risk)</td>
<td>H</td>
<td>M</td>
<td>H</td>
<td>L</td>
<td>M</td>
<td>M</td>
<td>H</td>
</tr>
</tbody>
</table>

This matrix provides a means to relate the assessment of inherent and control risk and analytical procedures to the extent of detailed substantive testing of balances required. For example, if inherent risk were assessed as moderate, control risk as high and analytical procedures as high, a testing factor of 2.3 would be used. If, however, control risk were moderate, the testing factor would drop to 1.9. This analysis would be applied to each assertion for each significant assertion for each significant account balance and class of transactions. As a practical matter, various groupings of assertions would likely be assessed together.
Sample Sizes for Substantive Tests of Balance Sheet Accounts

To determine sample sizes for substantive tests, a sampling interval must first be calculated, according to the following formula:

\[ \text{Interval} = \frac{\text{Precision}}{\text{Testing factor}} \]

Precision would be equal to materiality discounted by an appropriate factor to allow for expected errors. In this example, it is assumed that precision is equal to materiality.

The sample size would then be calculated as follows:

\[ \text{Sample size} = \frac{\text{Population to be tested}}{\text{Interval}} \]

The population to be tested would be equal to the total population minus the large value and key items selected for verification. An illustration of the application of this methodology is included in Chapter 4, paragraphs 44 – 52.

Sample Sizes for Classes of Transactions

As indicated in Chapter 4, the above analysis applied to classes of transactions results in sample sizes that most auditors judgmentally consider to be unreasonably large. Accordingly, many auditing firms reduce the extent of substantive testing of transactions through the use of lower testing factors than would be used for testing balance sheet accounts.

This is a judgmental issue that depends on the degree of reliance being placed on the substantive tests of details in the particular circumstances. As indicated in Chapter 8, there are circumstances where the quality and extent of evidence obtained from other sources, such as verification of balances, key item testing and analytical review, is sufficient to reduce and even eliminate substantive tests of details. In any case, sufficient evidence must be obtained to support the audit report. The use of non-statistical sampling cannot be used to derive sample sizes that are smaller than those derived from using statistical sampling.

Sample Sizes for Tests of the Operating Effectiveness of Controls

Sample sizes for tests of the operating effectiveness of controls are derived according to the following formula:

\[ \text{Sample size} = \frac{\text{Testing factor}}{\text{Maximum tolerable deviation rate (MTDR)}} \]

MTDR may be defined as the maximum rate of departures from key control procedures that is tolerable before reassessing control risk at a level greater than low. In undertaking tests of the operating effectiveness of controls, a MTDR of 5% is commonly used.
In setting the testing factor, a factor of 3.0 (or 95%) is frequently used. This would yield a sample size of \(3.0/0.05 = 60\). When a sample size of 60 is used, practitioners will often accept one error before determining that control risk is greater than low.

In situations where no errors can be tolerated, it can be mathematically demonstrated that the equivalent confidence level is 80% (a testing factor of 1.6). Therefore, where no errors are tolerated, the resulting sample size is 32. (This confidence level of 80% is the level for a particular test and should not be confused with the confidence level of 95% for the whole audit.)

When samples are planned tolerating one error (sample size of 60) and no errors (sample size of 32), errors found will result in the following established control risks:

<table>
<thead>
<tr>
<th>SAMPLE SIZE USED</th>
<th>32</th>
<th>60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deviations Found</td>
<td>0 1</td>
<td>0 1 2</td>
</tr>
<tr>
<td>Resulting Risk Level</td>
<td>L M</td>
<td>L L M</td>
</tr>
</tbody>
</table>

Where errors exceed 1 (in the case of a sample of 32) and 2 (in the case of a sample of 60), the resulting risk level will be “High.”

Substantive tests would then have to be designed taking into account the revised risk level. If it becomes necessary to conclude that control risk is high, the sample would have to be rejected and the test carried out on a substantive basis. This is a common risk with attempting a combined approach — there is the chance that the test of controls will demonstrate that the system is not working, which means that no savings can be realized in substantive testing. This may, however, lead to a useful client service in terms of helping the entity to improve the system.

A related issue is the relationship of the tests of controls with substantive tests. This relationship may be illustrated based on the following assumptions:

- Population = $2,000,000
- Key Items = nil
- Materiality = $60,000

The substantive tests would be calculated as follows using a testing factor of 3 and 1.4 respectively.

- Sample size with testing factor of 3 = \(2,000,000 \div (60,000 \div 3) = 100\)
- Sample size with testing factor of 1.4 = \(2,000,000 \div (60,000 \div 1.4) = 47\)

The following three scenarios are illustrated:

A. Substantive approach (control risk at maximum)
B. Combined approach where test of control was satisfactory
C. Combined approach where test of control demonstrated that controls were not satisfactory
The following table illustrated the sample sizes under each of these scenarios:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tests of Controls</td>
<td>nil</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td>Substantive Tests</td>
<td>100</td>
<td>47</td>
<td>100</td>
</tr>
<tr>
<td>Total Tests</td>
<td>100</td>
<td>79</td>
<td>132</td>
</tr>
</tbody>
</table>

This table shows that taking a combined approach resulted in having to test 79 items rather than 100. If the test of controls did not prove satisfactory, however, 132 items would have to be tested.
Appendix F

ANALYTICAL REVIEW PROCEDURES

Chapter 8 discussed the use of analytical review techniques in auditing a small entity. Accounting ratios are often used as the primary tools in performing such a review. This appendix provides examples of potential applications of analytical review techniques. In addition, to facilitate calculation and interpretation of accounting ratios, appropriate material has been reproduced from the CICA Research Study, Analytical Review.¹

As discussed in Chapter 8, the use of analytical review techniques can be extremely important in conducting an audit of a small entity. The use of analytical review procedures can provide the auditor with a better perspective and understanding of current trends in the entity. It can also allow for prediction of annual totals in an account. This approach may, in addition, draw attention to possible errors in the financial statements and indicate the need to modify the extent of substantive tests.

Obtaining appropriate and useful data for a small entity audit can be challenging, although useful information can often be obtained from management. This can be helpful in at least two ways. Most small entity management will have some company-specific information used to run the entity. The auditor should be able to obtain copies of this data. In addition, the information can be related to known events that arise from the discussion with management.

Analytical review may include:

• a comparison of current financial information with that of previous periods, with that budgeted for the current period and, where appropriate, with statistics available for the entity and the industry; and/or
• a study of the interrelationship of elements of financial information that would be expected to conform to a predictable pattern.

¹ D.G. Smith, Analytical Review (Toronto: CICA, 1983), Appendix D.
EXAMPLES OF APPLICATIONS

4 The following are examples of applications of analytical review procedures in a small entity environment.

Comparison of the Detail of a Total Balance with Similar Detail for the Preceding Year

5 If there have been no significant changes in the entity’s operations in the current year, much of the detail making up the totals should also be unchanged. By comparing the detail of the current period with similar detail of the preceding period, it is often possible to isolate information that needs further examination. Comparison of the monthly totals for sales, repairs and other accounts for the current and preceding years are common applications. It must be re-emphasized that, if an auditor intends to extract a high degree of assurance from analytical review techniques, a tighter precision limit must be used. In this level of review, the auditor should perform a more detailed analysis and investigation of any month that shows a significantly different total.

Calculation of the Approximate Balance in an Expense or Revenue Account using Relationships to other Accounts

6 In this type of calculation, an auditor estimates an account balance by relating it to some other balance sheet or income statement data. The auditor then investigates any significant differences between the estimated and the actual balance. For example, an auditor might obtain data on the quantity produced/shipped by an agricultural operation and use them to estimate sales. Another example is estimating interest expense on long-term debt by multiplying monthly balances by the interest rates. Similarly, it may be possible to estimate total sales, depreciation expense, interest income, commission expense and similar account balances.

Computation of Ratios and Percentage Relationships for Comparison with Previous Years

7 The computation of ratios and percentage relationships for comparison with previous years is an important way to obtain an indication of whether an account is materially misstated. For example, a significant change in the gross margin percentage could be due to an error either in sales or in cost of goods sold. An error in the cost of goods sold could be caused by errors in the quantities or pricing of physical inventory, inadequate cutoff of accounts payable, or other factors. Sales could be misstated, for example, due to improper cutoff or the failure to invoice a customer. A large deviation would indicate a need for the auditor to make a detailed investigation to determine the cause. The investigation would include looking at the components of the items because the deviation might be attributable to a change in product mix or selling price rather than an error.
TYPICAL ACCOUNTING RATIOS

Introduction

The following ratios are typical of those an auditor of a small entity might use for an analytical review. Calculation of these ratios does not provide any audit assurance, but is merely a tool for assisting the auditor in performing an analysis. The calculations may also be useful in determining compliance with debt covenants. The specific selection of tools to use will depend on what is important to the particular entity.

<table>
<thead>
<tr>
<th>MEASURES OF TYPICAL ACCOUNTING RATIOS</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROFITABILITY</td>
</tr>
<tr>
<td>Gross profit as a percentage of sales</td>
</tr>
<tr>
<td>Sales to net current assets</td>
</tr>
<tr>
<td>Cost ratios</td>
</tr>
<tr>
<td>ACTIVITY</td>
</tr>
<tr>
<td>Cost of sales to inventory (turnover)</td>
</tr>
<tr>
<td>Days’ sales in inventory</td>
</tr>
<tr>
<td>Collection period</td>
</tr>
</tbody>
</table>

Profitability

1. Gross profit as a percentage of sales

The ratio of gross profit as a percentage of sales provides an important guide to the accuracy of the accounts. Any changes in that ratio over a period of time might indicate that there has been a genuine shift in trading conditions. They might also indicate the existence of material errors, distortions or frauds.

When the change in the gross profit percentage is caused by market factors, the auditor may expect to find one or more of the following features:

- level of unit sales;
- an improvement or, alternatively, a decline in cost efficiency;
- an increase or, alternatively, a decrease in selling prices;
- a change in the mix of sales.

Where the features in the previous paragraph are not present, the shift in the gross profit percentage may be caused by factors that will give the auditor cause for concern, such as the misstatement of inventory, sales or cost of sales.

Naturally, a further analysis of sales and related costs, where possible, and particularly by product, makes it simpler to isolate the reasons for, and the areas of, any variations. If a physical quantity of sales (for example, weight or units) is used in place of a monetary value, it helps in assessing the effect of changes in price and volume.

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2 This section is based on the 1983 CICA Research Study, Analytical Review, pp. 66-71.
2. **Sales to net current assets**
The ratio of sales to net current assets at the beginning of the period (and the ratio of sales to the constituents of current assets) indicates how effectively management is using the company’s working capital. Viewed from the standpoint of performance, a high ratio is desirable. Viewed from the standpoint of credit rating, however, too high a rate of turnover can indicate a shortage of working capital and may give early warning of a strained credit position.

3. **Cost ratios**
Many ratios are used to portray cost relationships and make comparisons. Common ones are:

- Direct labour, material and overhead costs:
  - cost as a percentage of sales;
  - cost as a percentage of total cost of manufacturing;
  - cost per finished unit.

- Selling, general and administrative costs:
  - commission expense as a percentage of sales;
  - bad debt expense as a percentage of sales or accounts receivable;
  - selling expenses as a percentage of sales.

**Activity**

4. **Cost of sales to inventory (turnover)**
The ratio of the cost of sales to inventories indicates the rate at which inventories are being converted into sales. It also indicates whether the level of inventories held is justified in relation to sales. An unduly slow rate of inventory turnover means that working capital is being tied up and that liquidity is being reduced. There is a risk of losses due to obsolescence and deterioration and also a risk that unnecessary costs are being incurred for storage space. An unduly slow rate of inventory turnover may also indicate that the buying, inventory control and production planning functions are inadequate. An adverse trend in this ratio can raise doubts about the value placed on inventory in the balance sheet and, in particular, can raise the question of whether adequate provision had been made for inventories that may not be disposed of in the course of normal trading.

There may be good justification for a high level of inventories being held at a particular time. For example, a company may have taken advantage of bulk purchasing or may have stocked up in preparation for a major contract. Considerations of matters such as these must be balanced against the need for liquid working capital to continue the entity during the time that it takes for inventories to be converted into sales.

It might be thought that a high level of inventory turnover is an ideal to strive for. Certainly, it may indicate that inventories and production are well managed, that available working capital is fully utilized and that there is high liquidity. In some cases, however, a high level of turnover may give cause for concern. It may
mean, for example, that inventories have been reduced to such dangerously low levels that it is not possible to meet delivery dates or to increase turnover. By contrast, if inventories are undervalued, the turnover will be high.

To obtain true inventory turnovers, an auditor should use the cost of sales rather than the selling value. In certain circumstances, the selling value may be the only source available, for example, when making inter-firm comparisons from published accounts. Alternatively, it may be that the cost of sales is not readily available, or that the auditor knows that it is affected by variations in the allocation of costs between the periods being compared. The auditor may be able to draw valid conclusions from inventory turnover based on selling value, but marked variations in profit margins could distort the true physical turnover position.

5. Days’ sales in inventory
This statistic measures the number of days’ sales that current finished-goods inventories could support at sales levels immediately preceding the calculation.

6. Collection period
This represents the number of days’ sales that are outstanding in accounts receivable at any time. Ideally, the collection period is the same as the period embraced by the standard credit terms a company offers.

From an audit point of view, any marked adverse difference between the actual collection period and the period in the standard credit terms, and any declining trend in the actual collection period, would raise doubts about the effectiveness of the system of credit control and the adequacy of the allowance for doubtful accounts. If it were found, in a particular case, that the collection period had been extended because credit terms had been relaxed as a matter of policy, even greater caution about credit control and the creation of provisions should be exercised, since this situation would indicate that there had been a general decline in trading conditions.

Liquidity
7. Current assets to current liabilities (current ratio)
The ratio of current assets to current liabilities, where both are taken at the close of the period (which is known as the working capital ratio), was one of the first ratios used in analyzing balance sheets. It is still of prime importance — particularly to creditors. An oft-quoted standard for this ratio is not less than 2:1, but it is unwise to place reliance on predetermined standards. It is preferable, instead, when looking at a particular company, to devote attention to trends. A declining trend in this ratio indicates, prima facie, that the company’s working capital is decreasing and it may have difficulty in meeting its current obligations (perhaps because it has expanded its trading too rapidly, or else because it has invested too heavily in fixed assets without having adequate resources).
An increasing trend may indicate that there is excessive liquidity because assets are being utilized badly. An auditor should not, however, draw firm conclusions about this without first referring to trends in supporting and associated ratios.

8. Liquid assets to current liabilities
In the context of the ratio of liquid assets to current liabilities, liquid assets are current assets less inventory. This ratio is known as the liquidity ratio, and it supplements the working capital ratio. It is a more severe test of financial safety because it deals only with assets that are quickly available for paying short-term creditors.

Equity
9. Shareholder’s funds to total assets
One way to test the fundamental financial stability of a company is to consider how the operating assets have been financed. There are only two basic sources of funds: the proprietors (shareholders, partners or sole proprietors) and outside lenders (who may range from long-term debenture holders through to unsecured trade creditors). Maintaining a proper balance between those two sources is of prime importance, and so the ratio of shareholder’s funds to total assets is of great significance. A company that works with a high proportion of borrowed money has the potential of producing a high rate of return on the proprietor’s funds. It also, however, incurs the burden of high interest charges and a high risk of insolvency should the entity falter. A situation such as this is even more dangerous if much of the outside funds are represented by current liabilities. Therefore, current liabilities to shareholder’s funds is a further ratio the auditor has to consider.

10. Total debt to net worth
This ratio compares the indebtedness with the capital base. A high ratio generally indicates vulnerability should sales volumes decrease, as debt servicing costs increase in proportion to ratio increases.

11. Fixed assets to net worth
These are criteria by which to judge the proportion of fixed assets to be financed out of equity capital in various industries. The higher the fixed asset investment, the higher the fixed costs (and, consequently, the company’s break-even point) and the greater the company’s vulnerability if sales drop off.

ANALYTICAL REVIEW FOR NOT-FOR-PROFIT ORGANIZATIONS
Some of the above ratios can be used for the audits of Not-for-Profit Organizations (NPOs). In addition, practitioners have developed several special ratios that have gained acceptance.
1. **Number of months operating expenses represented by internally restricted and unrestricted net assets**

An often-used measure of the adequacy of net assets is the number of months operating expenses represented by internally restricted and unrestricted net assets. An organization with annual operating expenses of $1,200,000 and net assets of $300,000 has net assets equal to three months of expenses.

A number of major foundations and government ministries providing funding to not-for-profit organizations have set internal policy guidelines specifying what are acceptable net asset ranges. A ratio outside of the range could trigger a review of solvency of the organization (unrestricted net assets too low) or a review of funding levels (unrestricted net assets too high).

2. **Fundraising costs as a percentage of related revenue raised**

Canada Revenue Agency regulations stipulate that a charity must spend at least 80% of receipted donations in charitable activities. The community has interpreted this as a 20% ceiling on fund-raising expenses.

3. **Administrative costs as a percentage of program expenditures**

Sector guidelines established by funders put this percentage in the range of 10% or lower. Accounting is “flexible” in the area of allocation of overhead to program costs. It is, nonetheless, a ratio looked at by many statement users.

4. **Staff costs as a percentage of fee revenue**

In many service delivery NPOs, staff costs comprise the majority of expenses. Revenue is often earned on a per-unit of service delivered basis (for example, a day of childcare provided or a shelter bed occupied). The ratio of salary costs to revenue earned is often a useful indicator of completeness of revenue recorded or costs incurred. Analysis is very similar to analyzing the cost of sales in a profit-oriented entity.