Philippine Auditing Practice Statement 1005 (Revised)

THE SPECIAL CONSIDERATIONS
IN THE AUDIT OF SMALL ENTITIES
PHILIPPINE AUDITING PRACTICE STATEMENT 1005 (REVISED)

THE SPECIAL CONSIDERATIONS IN THE AUDIT
OF SMALL ENTITIES
(Effective for audits of financial statements for periods beginning
on or after December 15, 2004)

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Philippine Auditing Practice Statements (PAPSs) are issued by the Auditing Standards and Practices Board, an independent standard setting body, to provide interpretative guidance and practical assistance to professional accountants in implementing Philippine Standards on Auditing (PSAs) and to promote good practice. PAPSs do not establish new basic principles or essential procedures.

Professional accountants should be aware of and consider PAPSs applicable to the engagement. The extent to which the audit procedures described in this IAPS may be appropriate to a particular engagement requires the exercise of professional judgment. A professional accountant who does not consider and apply the guidance included in relevant PAPSs should be prepared to explain how the basic principles and essential procedures in the PSAs addressed by the PAPSs have been complied with.

In circumstances where specific guidance contained in a IAPS is not applicable in a public sector environment, or when additional guidance is appropriate in such environment, the PAPS so states in a Public Sector Perspective (PSP) at the end of the PAPSs. When no PSP is added, the PAPS is to be applied as written to engagements in the public sector.
In September 2002, the International Auditing and Assurance Standards Board (IAASB) agreed that its International Auditing Practice Statement (IAPS) 1005, The Special Considerations in the Audit of Small Entities, issued in March 1999, should be revised to take account of International Standards on Auditing (ISAs) issued between March 1999 and March 2003, and that for ISAs issued subsequent to March 2003, whenever necessary, considerations in the audit of small entities should be included in the body of those ISAs.

Guidance contained in the revised IAASB IAPS 1005 will be withdrawn when the revisions to related ISAs become effective.

The Auditing Standards and Practices Council (ASPC) has adopted the March 1999 version of IAPS 1005 as PAPS 1005 that became effective on June 30, 2004. The ASPC has been adopting the new IAASB pronouncements that generally revise, amend or supersede IAASB existing pronouncements, including the revised IAPS 1005.

Accordingly, readers are cautioned that, in addition to the guidance in this PAPS, reference should be made to the special considerations in the audit of small entities included in PSAs adopted from ISAs issued by the IAASB subsequent to March 2003.

INTRODUCTION

1. Philippine Standards on Auditing (PSAs) contain basic principles and essential procedures together with related guidance that apply to the audit of the financial statements of any entity, irrespective of its size, its legal form, ownership or management structure, or the nature of its activities. The ASPC recognizes that small entities give rise to a number of special audit considerations. This PAPS does not establish any new requirements for the audit of small entities; nor does it establish any exemptions from the requirements of PSAs. All audits of small entities are to be conducted in accordance with PSAs.

2. The objective of this PAPS is to describe the characteristics commonly found in small entities and indicate how they may affect the application of PSAs. This PAPS includes:

   (a) discussion of the characteristics of small entities; and

   (b) guidance on the application of PSAs adopted from ISAs issued by the IAASB until March 2003 to the audit of small entities.

3. The owner-manager of a small entity often needs assistance with the preparation of accounting records and financial statements. Section 8 of the Code of Ethics for...
Professional Accountants in the Philippines (the Philippine Code) deals with independence, and auditors considering rendering other services to small entity audit clients are to refer to the Code and their national independence requirements. The appendix to this PAPS contains a commentary on the application of PSAs when auditors also prepare the accounting records and financial statements of small entity audit clients.

3. In determining the nature and extent of the guidance provided in this PAPS, the ASPC has aimed to provide a level of guidance that will be of general applicability to all audits of small entities and that will assist the auditor in exercising professional judgment with respect to the application of PSAs. However, detailed guidance of a procedural nature has not been provided, as the issue of such guidance may undermine the proper exercise of professional judgment in auditing.

THE CHARACTERISTICS OF SMALL ENTITIES

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

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

7. For the purposes of this PAPS, a small entity is any entity in which:

(a) there is concentration of ownership and management in a small number of individuals (often a single individual); and

(b) one or more of the following are also found:

• few sources of income;
• unsophisticated record-keeping;
• limited internal controls together with the potential for management override of controls.

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1 The word “individual” denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a “small entity” for the purpose of this PAPS if the owner exhibits the relevant characteristics.
8. The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purposes of this PAPS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

**Concentration of Ownership and Management**

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

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

**Few Sources of Income**

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

**Unsophisticated Record-Keeping**

12. Small entities need to keep sufficient accounting records to comply with any relevant statutory or regulatory requirements and to meet the needs of the entity, including the preparation and audit of financial statements. Therefore, the accounting system needs to be designed in such a manner so as to provide reasonable assurance that:

   (a) all the transactions and other accounting information that should have been recorded have in fact been recorded;

   (b) assets and liabilities recorded in the accounting system exist and are recorded at the correct amounts; and
(c) fraud or error in processing accounting information will be detected.

13. Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated or poor, which results in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.

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

**Limited Internal Controls**

15. Size and economic considerations in small entities mean that sophisticated internal controls are often neither necessary nor desirable, the fact that there are few employees limits the extent to which segregation of duties is practicable. However, for key areas, even in the very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. Supervisory controls exercised on a day-to-day basis by the owner-manager may also have a significant beneficial effect as the owner-manager has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities.

16. The owner-manager occupies a dominant position in a small entity. The owner-manager’s direct control over all decisions, and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of small entities. The exercise of this control can also compensate for otherwise weak internal control procedures. For example, in cases where there is limited segregation of duties in the area of purchasing and cash disbursements, internal control is improved when the owner-manager personally signs all checks. When the owner-manager is not involved, there is a greater risk that employee fraud or error may occur and not be detected.

17. While a lack of sophistication in internal controls does not, of itself, indicate a high risk of fraud or error, an owner-manager’s dominant position can be abused: management override of controls may have a significant adverse effect on the control environment in any entity, leading to an increased risk of management fraud or material misstatement in the financial statements. For example, the owner-manager may direct personnel to make disbursements that they would otherwise not make in the absence of supporting documentation.

18. The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude,
and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

COMMENTARY ON THE APPLICATION OF PHILIPPINE STANDARDS ON AUDITING

19. The commentary that follows provides guidance on the application of PSAs to the audit of a small entity. This guidance is a supplement to, and not a substitute for, the guidance contained in the relevant PSA and takes account of the special considerations relevant to the audit of small entities. For the specific requirements of PSAs, the auditor refers to the PSA concerned. Where a PSA is, in principle, applicable to the audit of the financial statements of small entities and there are no special considerations applicable to the audit of a small entity, no guidance is given in respect of that PSA.

PSA 210: Terms of Audit Engagements

20. In many cases, owner-managers of small entities are not fully aware of their own responsibilities or those of their auditors. In particular, owner-managers may not appreciate that the financial statements are their responsibility, particularly where the owner-manager has outsourced the preparation of the financial statements.

21. One of the purposes of an engagement letter is to communicate clearly the respective responsibilities of the owner-manager and the auditor. The Appendix to PSA 210 provides an example of an audit engagement letter.

22. Paragraph 7 of PSA 210 states that the auditor may wish to include in the engagement letter the auditor’s expectation of receiving written confirmation concerning representations made in connection with the audit. PSA 580, “Management Representations” requires the auditor to obtain evidence that management acknowledge its responsibility for the fair presentation of the financial statements in accordance with the relevant financial reporting framework, and has approved the financial statements. Other PSAs require certain specific representations. The auditor may consider including in the engagement letter an indication of the anticipated matters on which management representations will be obtained. This provides an opportunity for the auditor to discuss with the owner-manager at the outset of the engagement the reason for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained, which may help to avoid a problem arising as the audit is nearing completion. It will also help the auditor consider audit and reporting implications if the owner-manager cannot make or refuse to make the necessary representations.
23. In some cases the auditor may determine that it will not be possible to obtain sufficient evidence to form an opinion on the financial statements because of weaknesses that may arise from the characteristics of the small entity. In these circumstances, and where permitted by the relevant jurisdiction, the auditor may decide not to accept the engagement, or to withdraw from the engagement after acceptance. Alternatively, the auditor may decide to continue with the engagement but qualify or disclaim the audit opinion. The auditor has regard to paragraph 40 of PSA 700 “The Auditor’s Report on Financial Statements” which states that the auditor would not ordinarily accept an audit engagement in which the terms of the engagement are such that the auditor believes that the need to express a disclaimer of opinion exists.

PSA 220: Quality Control for Audit Work

24. The primary objective of quality control is to provide assurance that audits are conducted in accordance with generally accepted auditing standards. The auditor of a small entity keeps this objective in mind when determining the nature, timing, and extent of the policies and procedures appropriate to the circumstances.

25. Paragraph 5 of PSA 220 states: “The nature, timing and extent of an audit firm’s quality control policies and procedures depend on a number of factors such as the size and nature of the practice…” Many audits of small entities are undertaken by small audit firms. Such firms, in determining appropriate policies and procedures, consider the areas listed in paragraph 6 of PSA 220 which are:

(a) professional requirements;

(b) skills and competence;

(c) assignment;

(d) delegation;

(e) consultation;

(f) acceptance and retention of clients; and

(g) monitoring.

26. With the possible exception of “assignment” and “delegation” (which may not be relevant to sole practitioners with no assistants), each of these will ordinarily be reflected in the arrangements established by firms auditing small entities.

27. The requirements of PSA 220 relating to quality control on individual audits are mostly relevant to engagements where some of the work is delegated to one or
more assistants. Many small entity audits are carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations, questions of direction and supervision of assistants and review of their work do not arise as the audit engagement partner, having personally conducted all significant aspects of the work, is aware of all material issues.

28. The audit engagement partner (or sole practitioner) nevertheless needs to be satisfied that the audit has been conducted in accordance with PSAs. Developing or obtaining a suitably designed form of audit completion checklist may provide a useful tool for testing the completeness and adequacy of the process followed in an audit. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performed the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor’s professional body, on a confidential basis.

PSA 230: Documentation

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

30. The discipline imposed by the requirement to record the reasoning and conclusions on significant matters requiring the exercise of judgment can often, in practice, add to the clarity of the auditor’s understanding of the issues in question and enhance the quality of the conclusions. This is so for all audits, even in the case of a sole practitioner with no assistants.

31. Different techniques may be used to document the entity’s accounting and internal control systems, depending on their complexity. However in small entities the use of flowcharts or narrative descriptions of the system are often the most efficient techniques. These can be kept as permanent information and are reviewed and updated as necessary in subsequent years.

32. Paragraph 11 of PSA 230 provides examples of the contents of working papers. These examples are not intended to be used as a checklist of matters to be included in all cases. The auditor of a small entity uses judgment in determining the contents of working papers in any particular case.

33. Nevertheless, the auditor of a large or a small entity, records in the working papers:
(a) the audit planning;

(b) an audit program setting out the nature, timing, and extent of the audit procedures performed;

(c) the results of those procedures; and

(c) the conclusions drawn from the audit evidence obtained together with the reasoning and conclusions on all significant matters requiring the exercise of judgment.

PSA 240 (revised): The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements

34. Appendix 1 to PSA 240 (revised) contains examples of fraud risk factors. An example relevant to small entities is “management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.” Although the presence of a dominant owner-manager is an important factor in the overall control environment, as the need for management authorization can compensate for otherwise weak control procedures and reduce the risk of employee fraud and error, it can be a potential weakness since there is the opportunity for management override of controls. The owner-manager’s attitude to control issues in general and to the personal exercise of supervisory controls can have a significant influence on the auditor’s approach. The auditor’s assessment of the effect of such matters is conditioned by knowledge of that particular entity and the integrity of its owner-manager. Examples of matters that auditors take into account in this assessment include the following:

• Whether the owner-manager has a specific identifiable motive (for example, dependence of the owner-manager on the success of the entity) to distort the financial statements, combined with the opportunity to do so.

• Whether the owner-manager makes no distinction between personal and business transactions.

• Whether the owner-manager’s life-style is materially inconsistent with the level of his or her remuneration (this includes other sources of income of which the auditor may be aware by completing the owner-manager’s tax return, for example).

• Frequent changes of professional advisers.
• Whether the start date for the audit has been repeatedly delayed or there are unexplained demands to complete the audit in an unreasonably short period of time.

• Unusual transactions around the year-end that have a material effect on profit.

• Unusual related party transactions.

• Payments of fees or commissions to agents and consultants that appear excessive.

• Loans accounts, on which no payments are made, or which do not earn interest, and for which the owner-manager is unable to provide any satisfactory explanation.

• Advances given to or taken from third parties for supply of goods and services against which no good or services have been provided for an unreasonably long period.

• Disputes with tax authorities.

• Unusual delay in providing explanations or representations sought by the auditor for unusual transactions.

35. Paragraph 20 of PSA 240 (revised) requires the auditor, when planning the audit, to discuss with other members of the audit team the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error. Many small entity audits are carried out entirely by the audit engagement partner (who may be a sole practitioner). In such situations this requirement is not relevant, but the audit engagement partner, who will be planning the conduct of the audit personally, considers whether, and where, errors may be more likely to occur or how fraud might be perpetrated when assessing the risks of material misstatement and designing further audit procedures to respond to those risks.

36. Paragraph 22 of PSA 240 (revised) requires the auditor, when planning the audit, to make inquiries of management inter alia to obtain:

a. An understanding of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud, and the accounting and internal control systems management has put in place to address such risk; and

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

37. Paragraph 51(a) of PSA 240 (revised) requires the auditor to obtain written representation from management that it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error. As noted in paragraph 12 to 18 of this PAPS, limited or more informal accounting and internal control systems may exist. As a result, the owner-manager may be of the opinion that it is not possible to provide the required representation. The primary responsibility for the prevention and detection of fraud and error rests with management, irrespective of the size of the entity. It therefore is important to obtain the owner-manager’s acknowledgement of this responsibility. Such acknowledgement could be expanded to cover compensating controls (refer paragraph 16 of this PAPS). If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses a qualified opinion or a disclaimer of opinion.

38. Paragraph 51(d) of PSA 240 (revised) requires the auditor to obtain written representations from management that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud. As noted in paragraph 36 of this PAPS, the owner-manager of a small entity may not have conducted such assessment and therefore may be of the opinion that it is not possible to provide the required representation. The auditor requests the owner-manager to reflect in a written representation that such assessment was not conducted, as well as any actions that the owner-manager has taken to prevent or detect fraud and error. If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses a qualified opinion or a disclaimer of opinion.

**PSA 250: Consideration of Laws and Regulations in an Audit of Financial Statements**

39. PSA 250 requires the auditor to obtain a general understanding of the legal and regulatory framework to which the entity is subject. Apart from those laws and regulations that relate directly to the preparation of the financial statements, there may also be laws and regulations that provide a legal framework for the conduct of the entity and that are central to the entity’s ability to conduct its business. As most small entities have uncomplicated activities, the legal and regulatory
environment to which they are subject is less complicated than the environment in which larger more diversified entities operate.

40. Once the auditor of a small entity has identified any relevant industry-specific laws and regulations, this information is recorded as permanent information as part of the knowledge of the entity and is reviewed and updated as necessary in subsequent years.

PSA 260: Communication of Audit Matters With Those Charged with Governance

41. Paragraph 5 of PSA 260 requires the auditor to determine the relevant individuals who are charged with governance and with whom audit matters of governance interest are communicated. The governance structure in a small entity may not be well defined, or those charged with governance of the small entity may be the same individuals as those charged with management of the entity. It may also include spouses or other relatives, who may not be involved in the supervision or control of the entity on a day-to-day basis. The auditor determines who are entrusted with the supervision, control and direction of the small entity.

PSA 300: Planning

42. Audits of small entities are conducted by very small audit teams, many involve the audit engagement partner (or sole practitioner) working with one audit assistant (or without audit assistants). With a smaller team, co-ordination and communication between team members is easier. Planning the audit of a small entity need not be a complex or time-consuming exercise, it varies according to the size of the entity and the complexity of the audit. For example, on some small audits, planning may be carried out at a meeting with the owner-manager of the entity or when the entity’s records become available to the auditor for audit. Planning the audit can, however, start at the completion of the previous period’s audit as the auditor will be well placed to plan for the next period. A brief file note prepared at this time, based on a review of the working papers and highlighting issues identified in the audit just completed can be particularly helpful. This file note, amended for changes arising during the subsequent period, could then be the initial basis for planning the next audit. Discussion with the owner-manager is a very important part of planning, especially in a first-year audit. Such discussions do not need a special meeting they can often take place as a part of other meetings, conversations or correspondence.

43. In principle, planning comprises developing a general strategy (reflected in an overall audit plan) and a detailed approach for implementing the strategy in terms of the nature, timing and extent of the audit work (reflected in an audit program). However, a practical approach to the audit of a small entity need not involve excessive documentation. In the case of a small entity where, because of the size or nature of the entity, the details of the overall plan can be adequately documented in the audit program, or vice versa, separate documentation of each
may not be necessary. When standard audit programs are used, these are appropriately modified and tailored to the particular client circumstances.

PSA 310: Knowledge of the Business

44. The Appendix to PSA 310 gives a list of matters that the auditor may consider in relation to knowledge of the business. This list is illustrative only, it is not exhaustive, nor are all the matters listed relevant to every audit. In particular, the auditor of a small entity will often find that many of the points in this list are simply not relevant. It would therefore be inappropriate to regard this Appendix as a form of checklist to be applied routinely in all audits. It may, however, be sufficient for the auditor to use a checklist that has been appropriately tailored to the particular small entity; such a checklist can be reviewed and updated in subsequent years.

45. The auditor of a small entity is often in a position to have a wide and up-to-date knowledge of the business by virtue of the fact that there may be regular close contact with the owner-manager. This relationship often provides information on matters such as the following:

- The activities of the small entity, its main products and services, and the industry in which it operates.
- The management style, aims, and attitudes of the owner-manager.
- Any plans for changes to the nature, management or ownership of the entity.
- Trends in profitability or liquidity and the adequacy of working capital.
- Legal or regulatory issues facing the entity, including its relationship with the taxation authorities.
- The accounting records.
- The control environment.

46. Documenting the auditor’s knowledge of the business is equally important in all audits, irrespective of the size of the entity. However, the extent of the documentation depends on the complexity of the entity and the number of persons who will be engaged on the audit. Small entities are ordinarily not complex and their audit rarely involves large teams of assistants. In many cases the audit may

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2 PSA 315 “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” adopted from ISA 315 issued by IAASB in October 2003 contains special considerations in the audit of small entities and is applicable for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 44 to 46 of this PAPS will be withdrawn when PSA 315 becomes effective.
be performed by the partner and, perhaps, a single assistant. Therefore, whilst the auditor of a small entity will prepare documentation to a level sufficient to:

(a) facilitate proper planning of the audit; and

(b) provide for any change of responsibility within the audit firm, such as changes of audit engagement partner or the departure, illness or incapacity of assistants.

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

**PSA 320: Audit Materiality**

47. “Materiality” is defined in the Accounting Standards Council’s “Framework for the Preparation and Presentation of Financial Statements” as follows: “Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful”.

**Planning Stage**

48. For audit planning purposes, it is generally necessary to assess materiality from a qualitative and quantitative perspective. One purpose of this preliminary judgment about materiality is to focus the auditor’s attention on the more significant financial statement items while determining the audit strategy. As there are no authoritative pronouncements on how materiality is assessed in quantitative terms, the auditor in each case applies professional judgment in the light of the circumstances. One approach to the assessment of quantitative materiality is to use a percentage of a key figure in the financial statements such as one of the following:

- Profit or loss before tax (adjusted, if appropriate, for the effect of any abnormal levels of items of expenditure such as the owner-manager’s remuneration).
- Revenue.
- Balance sheet total.

49. Often in the case of small entities, draft financial statements are not available to the auditor at the commencement of the audit. When this is the case, the auditor uses the best information available at the time. The current year’s trial balance
may be used, if available. Often an estimate of revenue for the current period can be more readily obtained than of profit (or loss) or of a balance sheet total. A common approach in the preliminary judgment of materiality is to calculate materiality on the previous year’s audited financial statements as amended for known circumstances in relation to the year subject to audit.

50. Assessing materiality as a percentage of pre-tax results may be inappropriate when the entity is at or near the break-even point as it may give an inappropriately low level of materiality, leading to unnecessarily extensive audit procedures. In such cases, the auditor may apply the percentage method to, for example, revenue or balance sheet totals. Alternatively, materiality may be assessed having regard to assessed levels of materiality in prior years and the normal level of results. In addition to considering materiality at the overall financial statement level, the auditor considers materiality in relation to individual account balances, classes of transactions, and disclosures.

Assessment of Materiality when Evaluating the Results of Audit Procedures

51. Whatever basis may be used to assess materiality for audit planning purposes, the auditor reassesses materiality when evaluating the results of audit procedures. This reassessment takes account of the final version of the draft financial statements, incorporating all agreed adjustments and information obtained during the course of the audit.

52. Although materiality at the reporting stage is considered in quantitative terms, there is no clear threshold value but rather a range of values within which the auditor exercises judgment. Amounts above the upper limit of the range may be presumed material and amounts below the lower limit may be presumed not material, although either presumption may be rebutted by applying qualitative considerations.

53. In addition, although planning may have been based on a quantitative assessment of materiality, the auditor’s opinion will take into account not only the amount but also the qualitative nature of unadjusted misstatements within the financial statements.

PSA 400: Risk Assessments and Internal Control

Inherent Risk

54. In the audit of a small entity, control risk is often assumed or assessed as high, at least for certain financial statement assertions. The assessment of inherent risk

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3 PSA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and PSA 330, “The Auditor’s Procedures in Response to Assessed Risks” adopted from ISA 315 and ISA 330, respectively, issued by the IAASB in October 2003 contain small entity audit considerations and are applicable for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 54 to 65 of this PAPS will be withdrawn when these new PSAs becomes effective.
for those assertions takes on a particular significance, as it has a direct impact on the extent of substantive procedures. There are difficulties in the assessment of the inherent risk of a small entity, for example there may be increased risk as a result of the concentration of ownership and control. However, the auditor’s assessment of inherent risk in a small entity depends on its particular characteristics. A careful assessment of inherent risk for material financial statement assertions, rather than an assumption that it is high, may enable the auditor to conduct a more efficient and effective audit.

**Control Risk**

55. An understanding of the control environment is essential to the understanding of control risk. The auditor considers the overall influence of the owner-manager and other key personnel. For example, the auditor considers whether the owner-manager displays a positive control consciousness and considers the extent to which the owner-manager and other key personnel are actively involved in day-to-day operations.

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

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

58. The auditor of a small entity may decide, based on the auditor’s understanding of the accounting system and control environment, to assume that control risk is high without planning or performing any detailed procedures (such as tests of controls) to support that assessment. Even where there appear to be effective controls it
may be more efficient for the auditor to confine audit procedures to those of a substantive nature.

59. The auditor makes management aware of material weaknesses in the design or operation of the accounting and internal control systems that have come to the auditor’s attention. Recommendations for improvement may also be made in this communication. Such recommendations are particularly valuable for the development of the small entity’s accounting and internal control systems.

Detection Risk

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

PSA 401: Auditing in a Computer Information Systems Environment

61. The increasing availability of computer-based accounting systems that are capable of meeting both functional and economic circumstances of even the smallest entity impacts on the audits of those entities. Small entities’ accounting systems often make use of personal computers. Philippine Auditing Practice Statement 1001, “CIS Environments—Stand-Alone Personal Computers” gives additional guidance regarding the special considerations of such an environment.

62. Small entities are likely to use less sophisticated hardware and software packages than large entities (often “packaged” rather than developed “in house”). Nevertheless, the auditor has sufficient knowledge of the computer information system to plan, direct, supervise, and review the work performed. The auditor may consider whether specialized skills are needed in an audit.

63. Because of the limited segregation of duties, the use of computer facilities by a small entity may have the effect of increasing control risk. For example, it is common for users to be able to perform two or more of the following functions in the accounting system.

- Initiating and authorizing source documents.
- Entering data into the system.
- Operating the computer.

See footnote 3.
• Changing programs and data files.
• Using or distributing output.
• Modifying the operating systems.

64. The use of computer information systems by small entities may assist the auditor in obtaining assurance as to the accuracy and appropriateness of accounting records by reducing control risk. Computerized information systems may be better organized, less dependent upon the skills of people using them, and less susceptible to manipulation than non-computerized systems. The ability of the auditor to obtain relevant reports and other information may also be enhanced. Good computerized systems facilitate accurate double entry and the reconciliation of subsidiary ledgers with control accounts. Report generation and the production of bank reconciliations may be more disciplined and effective, and the availability of reports and other information to the auditor is often improved. The assurance provided by such features, as long as they are properly evaluated and tested, may permit the auditor to limit the volume of substantive testing of transactions and balances.

65. The general principles outlined in Philippine Auditing Practice Statement 1009 “Computer-Assisted Audit Techniques” (CAATs) are also applicable in small entity computer environments and give additional guidance regarding the special considerations in such an environment. However, in many cases where smaller volumes of data are processed, manual methods may be more cost-effective.

PSA 500: Audit Evidence

66. PSA 500 recognizes that, although audit evidence may be obtained in a number of ways, including from an appropriate mix of tests of control and substantive procedures, in some circumstances evidence may be obtained entirely from substantive procedures. A typical example of such circumstances would be where segregation of duties is limited and evidence of supervisory control is lacking, as is the case in many small entities.

67. In the audit of small entities, there are particular problems in obtaining audit evidence to support the assertion of completeness. There are two principal reasons for this:

(a) the owner-manager occupies a dominant position and may be able to ensure that some transactions are not recorded; and

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5 PSA 500 (revised), “Audit Evidence,” adopted from ISA 500 which was revised and issued by the IAASB in October 2003, contains small entity audit considerations and is applicable for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 66 to 70 of this PAPS will be withdrawn when the revised PSA becomes effective.
(b) the entity may not have internal control procedures that provide documentary evidence that all transactions are recorded.

68. The auditor plans and conducts the audit with an attitude of professional skepticism. In the absence of evidence to the contrary, the auditor is entitled to accept representations as truthful and records as genuine.

69. The auditor of a small entity need not assume that there will be limited internal controls over the completeness of important populations such as revenue. Many small entities have some form of numerically based system to control the dispatch of goods or the provision of services. Where there is such a system to ensure completeness, the auditor may obtain audit evidence of its operation, by means of tests of control, to assist in determining whether control risk can be assessed at less than high in order to justify a reduction in the extent of substantive testing.

70. Where there are no internal controls relevant to the assertion, the auditor may be able to obtain sufficient evidence from substantive procedures alone. Such procedures may include the following.

- Comparing recorded amounts with amounts calculated on the basis of separately recorded data, for example, goods issues recorded in physical stock records may be expected to give rise to sales income, and job sheets or time records may be expected to give rise to charges to clients.
- Reconciling total quantities of goods bought and sold.
- Analytical procedures.
- External confirmation.
- A Review of transactions after the balance sheet date.

PSA 520: Analytical Procedures

Analytical Procedures in Planning the Audit

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

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

73. An unsophisticated predictive model can sometimes be effective. For example, where a small entity has employed a known number of staff at fixed rates of pay throughout the period, it will ordinarily be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items. The extent of analytical procedures in the audit of a small entity may be limited because of the non-availability of information on which the analytical procedures are based.

74. Predictive analytical procedures can often be an effective means of testing for completeness, provided the results can be predicted with a reasonable degree of precision and confidence. Variations from expected results may indicate possible omissions that have not been detected by other substantive tests.

75. However, different types of analytical procedure provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can be a very persuasive source of evidence and may eliminate the need for further verification by means of tests of details. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may be a less persuasive source of evidence, but may provide useful corroboration if used in combination with other audit procedures.

Analytical Procedures as Part of the Overall Review

76. The analytical procedures ordinarily performed at this stage of the audit are very similar to those that would be used at the planning stage of the audit. These include the following.

- Comparing the financial statements for the current year to those of previous years.
• Comparing the financial statements to any budgets, forecasts, or management expectations.
• Reviewing trends in any important financial statement ratios.
• Considering whether the financial statements adequately reflect any changes in the entity of which the auditor is aware.
• Inquiring into unexplained or unexpected features of the financial statements.

**PSA 530: Audit Sampling and Other Selective Testing Procedures**

77. There are a variety of methods of selecting items for testing, the auditor’s choice of an appropriate method will be guided by considerations of effectiveness and efficiency. The means available to the auditor are:

(a) selecting all items (100% examination);

(b) selecting specific items; or

(c) audit sampling.

78. The small populations ordinarily encountered in small entities may make it feasible to test:

(a) 100% of the population; or

(b) 100% of some part of the population, for example, all items above a given amount, applying analytical procedures to the balance of the population, if it is material.

79. When the above methods of obtaining audit evidence are not adopted, the auditor considers the use of procedures involving audit sampling. When the auditor decides to use audit sampling, the same underlying principles apply in both large and small entities. The auditor selects sample items in such a way that the sample can be expected to be representative of the population.

**PSA 545: Auditing Fair Value Measurements and Disclosures**

80. In accordance with paragraph 4 of PSA 545, management is responsible for making the fair value measurements and disclosures included in the financial statements. Management is also responsible for establishing an accounting and financial reporting process for determining the fair value measurements and disclosures, selecting appropriate valuation methods, identifying and adequately supporting any significant assumptions used, preparing the valuation and ensuring
that the presentation and disclosure of the fair value measurements are in accordance with the entity’s identified financial reporting framework.

81. According to paragraph 11 of PSA 545, in some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process.

82. The owner-manager of a small entity may not have the expertise and experience necessary to fulfill the responsibilities referred to in paragraph 80 for fair value measurements other than those based on published price quotations. The auditor recognizes that the use of an expert, such as an independent valuer, may represent a significant cost to the small entity. However, if considered necessary in the circumstances, the auditor recommends to the owner-manager the use of an expert.

83. Any assistance provided by the auditor may create threats to the independence of the auditor. The auditor is to refer to paragraphs 8.171 to 8.176 of the Code of Ethics for Professional Accountants in the Philippines for guidance on valuation services that may pose a threat and the potential safeguards that can be considered.

84. Paragraph 63 of PSA 545 requires the auditor to obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures. Because of the reasons set out in paragraph 82, the owner-manager may be of the opinion that it is not possible to provide the required representation. The responsibility for making the fair value measurements and disclosures included in the financial statements rests with the owner-manager. If the owner-manager refuses to provide the required representation, this constitutes a scope limitation and the auditor expresses a qualified opinion or a disclaimer of opinion.

PSA 550: Related Parties

85. Significant transactions are often entered into between the small entity and the owner-manager, or between the small entity and entities related to the owner-manager. Small entities seldom have sophisticated policies and codes of conduct on related party transactions. Indeed, related party transactions are a regular feature of many entities that are owned and managed by an individual or by a family. Further, the owner-manager may not fully understand the definition of a
related party, especially where relevant accounting standards deem certain relationships to be related and others not. The provision of management representations in respect of the completeness of disclosure may entail some explanation by the auditor of the technical definition of a related party.

86. The auditor of a small entity ordinarily performs substantive procedures on the identification of related parties and related party transactions. However, if the auditor assesses the risk of undisclosed related party transactions as low, such substantive procedures need not be extensive. The auditor often acts as the auditor of other entities related to the small entity, which may assist in identifying related parties.

87. The auditor’s in-depth knowledge of the small entity may be of assistance in the identification of related parties, which in many instances, will be with entities controlled by the owner-manager. This knowledge can also help the auditor assess whether related party transactions might have taken place without recognition in the entity’s accounting records.

**PSA 560: Subsequent Events**

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

88. It is not common for small entities to be required to report shortly after their period-end. It is often the case that more time elapses between the period end and the approval or signature of the financial statements by the owner-manager in the case of small entities, than in the case of large entities. The period to be covered by the auditor’s subsequent events procedures is therefore often longer in the audit of a small entity, allowing more opportunity for the occurrence of subsequent events that can affect the financial statements. PSA 560 requires the auditor to perform procedures to cover the entire period from the period-end up to the date of the audit report.

89. The subsequent events procedures that the auditor of a small entity performs will depend on the information that is available and, in particular, the extent to which the accounting records have been written up since the period-end. When the accounting records are not up-to-date and minutes of meetings of the directors have not been prepared, relevant procedures can take the form of inquiry of the owner-manager, recording the owner-manager’s responses and inspection of bank statements. Paragraph 5 of PSA 560 gives examples of some of the matters that it may be appropriate for the auditor to consider in the course of these inquiries.

90. The auditor may, depending on the circumstances, consider that the letter of representation should cover subsequent events. The letter of representation is ordinarily dated on the same day as the audit report, thus covering the entire period since the period end.
91. Guidance on the auditor’s procedures relating to subsequent events (if any) in the period between the approval of the financial statements and the date of the auditor’s report is given in the guidance provided in this PAPS on PSA 700 “The Auditor’s Report on Financial Statements.”

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

92. Where, as in many small entities, the meeting at which the financial statements are approved or signed is immediately followed by the annual general meeting, the interval between the two does not require any separate consideration by the auditor as it is so short.

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

PSA 570: Going Concern

94. The size of an entity affects its ability to withstand adverse conditions. Small entities can respond quickly to exploit opportunities, but their lack of reserves limits their ability to sustain operations.

95. PSA 570 requires that auditors consider the risk that the going concern assumption may not be appropriate. Risk factors of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, the risk of the loss of a major customer or key employee, and the risk of the loss of the right to operate under a license, franchise or other legal agreement.

96. PSA 570 gives guidance on additional audit procedures that may be relevant when events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern. Such procedures may include a review of documentation such as cash flows and profit forecasts. Such procedure may include a review of documentation such as cash flows and profit forecasts. In the audit of a small entity, the auditor does not ordinarily expect to find detailed forecasts relevant to the consideration of going concern. Nevertheless, the auditor discusses with the owner-manager the going concern status of the entity and, in particular, the financing of the entity in the medium and long-term. The auditor considers these discussions in the light of corroborative documentation and the auditor’s knowledge of the business. The auditor seeks written management representation from the owner-manager of the matters discussed.

97. Where the small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the
continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating his loan to the entity in favor of banks or other financial institutions. In such circumstances the auditor inspects appropriate, documentary evidence of the subordination of the owner-manager’s loan. Where an entity is dependent on additional support from the owner-manager, the auditor considers the owner-manager’s ability to meet the obligation under the support arrangement. In addition, the auditor may ask for a written representation confirming the owner-manager’s intention or understanding.

**PSA 580: Management Representations**

98. Paragraph 6 of PSA 580 states that, when representations relate to matters that are material to the financial statements, the auditor:

- (a) seeks corroborative audit evidence from sources inside or outside the entity;
- (b) evaluates whether the representations made by management appear reasonable and are consistent with other audit evidence obtained, including other representations; and
- (c) considers whether the individuals making the representations can be expected to be well-informed on the particular matters.

99. Paragraph 7 of PSA 580 states that representations from management cannot be a substitute for other audit evidence that the auditor expects to be available. If such audit evidence cannot be obtained, this may constitute a limitation on the scope of the audit and the auditor considers the implications for the audit report. However, in certain instances, a representation by management may be the only audit evidence that the auditor can reasonably expect to be available.

100. In view of the particular characteristics of small entities, the auditor may judge it appropriate to obtain written representations from the owner-manager as to the completeness and accuracy of the accounting records and of the financial statements (for example, that all income has been recorded). Such representations, on their own, do not provide sufficient audit evidence. The auditor assesses the representations in conjunction with the results of other relevant audit procedures, the auditor’s knowledge of the business and of its owner-manager, and considers whether, in the particular circumstances, it would be reasonable to expect other audit evidence to be available. The possibility of misunderstandings between the auditor and the owner-manager is reduced when oral representations are confirmed by the owner-manager in writing.

101. Due to the nature of small entities, owner-managers may be of the opinion that it is not possible to provide certain specific representations. This may particularly be the case for the specific representations in PSA 240 (revised), PSA 545 and
PSA 570 (refer to paragraphs 37, 38, 84, 96 and 97 of this PAPS). The auditor is encouraged to discuss with the owner-manager the reasons for obtaining such representations and the potential impact on the auditor’s report should such representations not be obtained. As noted in paragraph 22 of this PAPS, it may be useful to discuss these representations with management when agreeing the terms of engagement.

**PSA 700: The Auditor’s Report on Financial Statements**

102. The objective of any audit is for the auditor to obtain sufficient appropriate audit evidence to be able to express an opinion on the financial statements. In many cases the auditor will be able to express an unqualified opinion on the financial statements of small entities. However there may be circumstances that necessitate a modification of the auditor’s report.

**Scope Limitations**

103. When the auditor is unable to design or carry out procedures to obtain sufficient appropriate audit evidence as to the completeness of accounting records, this may constitute a limitation in the scope of the auditor’s work. The limitation would lead to a qualification of the opinion or, in circumstances where the possible effects of the limitation are so significant that the auditor is unable to express an opinion on the financial statements, a disclaimer of opinion.

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

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

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

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the completeness and accuracy of the accounting records in respect of sales, the financial statements present fairly, in all material respects, the financial position of the company as of...and the results of its operations and its cash flows for the year then ended in accordance with....
Example of paragraphs for an auditor’s report with disclaimer of opinion when completeness of accounting records is not substantiated—scope limitation that is so significant that the auditor is unable to express an opinion.

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

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

Date and Signature of the Auditor’s Report

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

(a) to obtain assurance that, on that later date, the owner-manager would have acknowledged responsibility for the financial statements or the items appearing therein; and

(b) to ensure that their procedures for reviewing subsequent events cover the period up to that date.

PSA 720: Other Information in Documents Containing Audited Financial Statements

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

107. This PAPS is effective for audits of financial statements for periods ending on or after December 15, 2004. Earlier application is encouraged.

Acknowledgment

108. This PAPS, “Special Considerations in the Audit of Small Entities (Revised 2004),” is based on International Auditing Practice Statement (IAPS) 1005 (Revised October 2003) of the same title issued by the International Auditing and Assurance Standards Board.

109. This PAPS 1005 (Revised) differs from IAPS 1005 (Revised October 2003) with respect to the deletion of the related Appendix 1, “Commentary on the Application of ISAs When the Auditor Also Prepares the Accounting Records and Financial Statements of the Small Entity”. Appendix 1 is not applicable in the Philippines and therefore is not used. In the Philippines, the provision of bookkeeping services by a CPA to an audit client is prohibited under The Bookkeeping Regulations of the Bureau of Internal Revenue.
COMMENTARY ON THE APPLICATION OF ISAS WHEN THE AUDITOR ALSO PREPARES THE ACCOUNTING RECORDS AND FINANCIAL STATEMENTS OF THE SMALL ENTITY

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

ISA 210: Terms of Audit Engagements

1. Where the auditor has assisted with the preparation of the financial statements, owner-managers of small entities may not be fully aware of their own legal responsibilities or those of the auditor. Owner-managers may not appreciate that the financial statements are their responsibility, or that the audit of the financial statements is legally quite distinct from any accounting services that the auditor provides. One of the purposes of an engagement letter is to avoid any such misunderstandings.

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6 In the Philippines, Revenue Regulations V-1 (The Bookkeeping Regulations), as amended, provides that a Certified Public Accountant (CPA) or a firm of CPAs or any member of such firm who is employed to keep the books of accounts or to supervise the keeping of such accounts of a taxpayer cannot audit or examine the said books of accounts of the latter. While this particular provision of Revenue Regulation has been issued in 1947 and has not been amended, it is backed up by a Court of Tax Appeals Ruling which considers the rendering of bookkeeping services to an audit client as a violation of the independence rules.

The Code of Corporate Governance (Code) issued by the Securities and Exchange Commission allows the rendering of non-audit services by the external auditor of the same company provided they are not in conflict with the functions of the external auditor. No clear guidelines have been issued to date by the Securities and Exchange Commission as to what constitutes “conflict with the functions of the external auditor.” The Code defines the term “non-audit work” as “other services offered by the external auditor to a corporation that are not directly related and relevant to its statutory audit function. Examples include accounting, payroll, bookkeeping, reconciliation, computer project management, data processing or information technology outsourcing services, internal auditing, and services that may compromise the independence and objectivity of the external audit.” Likewise, the IFAC Code of Ethics permits the provision of accounting and other services to audit clients provided that independence is safeguarded.

On the basis of the provisions of The Bookkeeping Regulations, bookkeeping services should not be rendered to an audit client. Services other than bookkeeping can be rendered to an audit client, subject to the requirements of existing regulations.
2. Paragraph 3 of ISA 210 states that the auditor may agree with the terms of engagement for other services by means of separate letters of engagement. However, there is no requirement for separate letters and, in the case of a small entity, there may be practical reasons why a single combined letter may be more appropriate.

**ISA 230: Documentation**

3. When the auditor prepares the accounting records or financial statements for a small entity, such services are not audit work and the requirements of ISA 230 do not ordinarily apply to, for example, documentation of the work done in preparing the financial statements.

4. A consideration when establishing a retention policy for the working papers of a small entity is that owner-managers often request copies of the working papers containing accounting information to assist them in the administration of their entity. Paragraph 14 of ISA 230 states that working papers are the property of the auditor. Although portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditor, they are not a substitute for the entity’s accounting records. It may be helpful for the engagement letter to set out these requirements regarding the accounting records.

**ISA 240 (revised): The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements**

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

**ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements**

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

**ISA 300: Planning**

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

ISA 400: Risk Assessments and Internal Control

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

ISA 500: Audit Evidence

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

ISA 520: Analytical procedures

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

ISA 540: Audit of Accounting Estimates

11. Although the owner manager is responsible for determining the amount of the estimate to be included in the financial statements, the auditor of a small entity is often asked to assist with or advice on the preparation of any accounting estimates. By assisting with the process of preparing the accounting estimate, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 540. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness
and appropriateness of the underlying assumptions used in arriving at the estimates.

**ISA 545: Auditing Fair Value Measurements and Disclosures**

12. Although the owner-manager is responsible for fair value measurements and disclosures, the auditor of a small entity may be asked to assist with the process of preparing the fair value measurements or disclosures. Management remains responsible for the reasonableness of the assumptions on which the fair value measurements and disclosures are based and, as a result, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgement of responsibility.

13. By assisting with the process of preparing the fair value measurements or disclosures, the auditor at the same time gains evidence relevant to meeting the requirements of ISA 545. However, assisting with this process does not relieve the auditor from obtaining sufficient and appropriate audit evidence regarding the reasonableness and appropriateness of the underlying assumptions used in arriving at the measurements or disclosures.

**ISA 550: Related parties**

14. When assessing the risk of undisclosed related party transactions, the auditor considers matters arising when preparing the accounting records or financial statements of the small entity, assisting with the preparation of personal and corporate tax matters, or reviewing the owner-manager’s current accounts.

15. This, taken together with information obtained through discussion with the owner-manager, assists in the assessment of the risk in this area and may provide a reasonable basis for the risk to be assessed as low.

16. This assistance and the close relationship between the auditor and the owner-manager can assist in the identification of related parties, which, in most instances, will be with entities controlled by the owner-manager.

**ISA 570: Going Concern**

17. In some small entities, the auditor may be asked to assist the owner-manager with the assessment of going concern and sometimes with the preparation of any necessary cash flows or profit budgets or forecasts. In all cases, the owner-manager remains responsible for the assessment of going concern for any information prepared (even if the auditor assisted in its compilation), and for the reasonableness of the assumptions on which it is based. In such circumstances, the auditor takes appropriate steps to obtain the owner-manager’s agreement and acknowledgement of responsibility.
18. In the audit of a small entity, it is particularly important for the auditor to obtain management representations in which the owner-manager acknowledges responsibility for the fair presentation of the financial statements. This is particularly necessary where the auditor has prepared the financial statements, because of the danger of the auditor's role and responsibility in relation to the financial statements being misunderstood. In order to ensure that the representations are meaningful, the auditor considers explaining these matters to management before the representations are obtained.
### WHERE TO FIND SMALL ENTITY AUDIT CONSIDERATIONS

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

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PSA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” adopted from ISA 315 issued by the IAASB in October 2003 contains special considerations in the audit of small entities and is applicable for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 44 to 46 of PAPS 1005 will be
withdrawn when the new PSA becomes effective.

320 Audit Materiality

Paragraphs 54 to 60 of this PAPS will be withdrawn when the new PSAs become effective.

400 Risk Assessments and Internal Control

PSA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and PSA 330, “The Auditor’s Procedures in Response to Assessed Risks” adopted from ISA 315 and ISA 330, respectively, issued by the IAASB in October 2003 contain small entity audit considerations and are applicable for audits of financial statements for periods beginning on or after December 15, 2004.

401 Auditing in a Computer Information Systems Environment

Paragraphs 61 to 65 of this PAPS will be withdrawn when the new PSAs become effective.

500 Audit Evidence
PSA 500, “Audit Evidence,” adopted from ISA 500, which was revised and issued by the IAASB in October 2003 contains small entity audit considerations and is applicable for audits of financial statements for periods beginning on or after December 15, 2004. Paragraphs 66 to 70 of this PAPS will be withdrawn when the revised PSA 500 becomes effective.

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This Philippine Auditing Practice Statement 1005 (Revised) was unanimously approved on September 27, 2004 by the members of the Auditing Standards and Practices Council:

Benjamin R. Punongbayan, Chairman  Antonio P. Acyatan, Vice Chairman

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