Proposed Redrafted International Standard on Auditing

ISA 520, Analytical Procedures

Proposed Conforming Amendment

ISA 315 (Redrafted), Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 520, “Analytical Procedures” for publication in December 2007. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by March 31, 2008. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at http://www.ifac.org.

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EXPLANATORY MEMORANDUM

Introduction
This memorandum provides background to proposed International Standard on Auditing (ISA) 520 (Redrafted), “Analytical Procedures.” The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA and related conforming amendment to ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” for exposure in December 2007.

Background
As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new Clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. Proposed ISA 520 (Redrafted) is in the latter category.

The conventions used by the IAASB in redrafting extant ISA 520, and the authority and obligation attaching to those conventions, are established in proposed ISA 200 (Revised and Redrafted)1 approved by the IAASB as an exposure draft in April 2007, and in the amended “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services” (Preface), approved by the IAASB in September 2006.2

Effective Date
The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the ISAs should be released as soon as they are approved so as to facilitate their implementation.

Significant Matter
Scope of ISA 520
The extant ISA 520 deals with analytical procedures as:

- Risk assessment procedures;

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1 Proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

• Substantive procedures in response to assessed risks; and
• Procedures that assist in forming the auditor’s overall conclusion on the financial statements.

The substance of the standard, however, is primarily concerned with the latter two categories. Relatively little is said about analytical procedures as part of the auditor’s risk assessment. Further, ISA 315 (Redrafted) contains the requirement to use analytical procedures as risk assessment procedures and includes relevant guidance. The IAASB decided that it would be more appropriate for all guidance on analytical risk assessment procedures to be in one place in support of the requirement and, consequently, agreed that the relevant material in extant ISA 520 should be relocated to ISA 315 (Redrafted). Proposed ISA 520 (Redrafted) therefore only deals with analytical procedures used as substantive procedures in response to assessed risks and analytical procedures that assist in arriving at the auditor’s overall conclusion on the financial statements.

Guide for Respondents

The IAASB is seeking comments only on changes resulting from applying the clarity drafting conventions, including the matter discussed above, and their effect on the content of the extant ISA. Respondents are asked to respond in particular to the following questions:

1. Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?

2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors?³

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

³ The IAASB has identified the following criteria for determining the requirements of a Standard:
• The requirement is necessary to achieve the objective stated in the Standard;
• The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and
• The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.
• **Special Considerations in the Audit of Smaller Entities**—Respondents are asked to comment whether, in their opinion, considerations in the audit of smaller entities have been dealt with appropriately in the proposed redrafted ISA.

• **Special Considerations in the Audit of Public Sector Entities**—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed redrafted ISA.

• **Developing Nations**—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed redrafted ISA in a developing nation environment.

• **Translations**—Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed redrafted ISA.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it will be helpful for the IAASB to be made aware of this view.

Respondents are also invited to comment on any undue costs, set against the benefits of more consistent auditor performance, arising from the fact that the proposed redrafted ISA includes requirements that would previously have been guidance under the old drafting conventions, as in the extant ISA (see below). In commenting on this matter, respondents should bear in mind the criteria that the IAASB has applied in redrafting the proposed ISA (see footnote 2) and the fact that the IAASB is seeking to clarify that there was some guidance in extant ISAs that was more in the nature of requirements and would already have been followed by many auditors.

**Supplement to the Exposure Draft**

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

• Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;

• Maps the material of the extant ISA to the proposed redrafted ISA; and

• Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0103. They are for information purposes only and do not form part of the exposure draft.
To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by March 31, 2008.
# PROPOSED INTERNATIONAL STANDARD ON AUDITING 520

## (REDAFTED)

### ANALYTICAL PROCEDURES

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor’s use of analytical procedures as substantive procedures in response to assessed risks, and as procedures that assist in arriving at the auditor’s overall conclusion in an audit of financial statements. The use of analytical procedures as risk assessment procedures is dealt with in ISA 315 (Redrafted). 1

Nature of Analytical Procedures

2. Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:
   - Comparable information for prior periods.
   - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
   - Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

3. Analytical procedures also include consideration of relationships, for example:
   - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.
   - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

4. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions, branches or segments) and individual elements of financial information.

Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009].

Objectives

6. The objectives of the auditor are:

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1 ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.”
(a) When using analytical procedures as substantive procedures in response to assessed risks, to design and perform such analytical procedures so that they are effective in responding to assessed risks of material misstatement in the financial statements at the assertion level; and

(b) To design and perform analytical procedures that assist in arriving at the overall conclusion in an audit of financial statements.

Definition

7. For the purposes of the ISAs, the term “analytical procedures” means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Requirements

Analytical Procedures as Substantive Procedures in Response to Assessed Risks

8. In deciding to use, and when designing and performing, analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA 330 (Redrafted), the auditor shall: (Ref: Para. A1-A2)

(a) Determine the suitability of using substantive analytical procedures given the assertions, taking account of the assessed risks of material misstatement and tests of details, if any, directed towards the same assertion; (Ref: Para. A3-A8)

(b) Develop an expectation of recorded amounts or ratios;

(c) Evaluate the reliability of data, whether internal or external, from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A9-A11)

(d) Evaluate whether the expectation is sufficiently precise to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A12)

(e) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 10. (Ref: Para. A13-A14).

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2 ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks.”

Analytical Procedures that Assist in Arriving at the Auditor’s Overall Conclusion in an Audit of Financial Statements

9. The auditor shall design and perform analytical procedures that assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditor’s understanding of the entity. (Ref: Para. A15-A17)

Investigating Results of Analytical Procedures

10. If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

   (a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and

   (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A18-A19)

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Application and Other Explanatory Material

Analytical Procedures as Substantive Procedures in Response to Assessed Risks (Ref: Para. 8)

A1. The decision about which audit procedures to use is based on the auditor’s judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

A2. The auditor may inquire of management as to the availability and reliability of information needed to apply analytical procedures as substantive procedures, and the results of any such procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Suitability of Using Analytical Procedures Given the Assertions (Ref: Para. 8(a))

A3. Analytical procedures as substantive procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions captured in the information produced by the entity’s information system relevant to financial reporting. However, the suitability of a particular analytical procedure will depend upon the auditor’s assessment of how effective it will be in detecting a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A4. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has employed a known number of staff at fixed
rates of pay throughout the period, it may 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.

A5. Different types of analytical procedures 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 provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the components are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

A6. The determination of the suitability of analytical procedures as substantive procedures is influenced by the nature of the assertion and the auditor’s assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than analytical procedures for assertions related to receivables; or if inventory balances are material, the auditor may decide not to rely only on analytical procedures when performing audit procedures on the existence assertion.

A7. Analytical procedures as substantive procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers’ accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Considerations Specific to Public Sector Entities

A8. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.
The Reliability of the Data (Ref: Para. 8(c))

A9. The reliability of data is influenced by its source and by its nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing analytical procedures as substantive procedures:

(a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;

(c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

A10. The auditor may consider testing the operating effectiveness of controls, if any, over the entity’s preparation of information used by the auditor in applying analytical procedures as substantive procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor could test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. [Proposed] ISA 500 (Redrafted) establishes requirements and provides guidance in determining the audit procedures to apply to the information to be used for analytical procedures as substantive procedures.5

Considerations Specific to Smaller Entities

A11. The extent of use of analytical procedures as substantive procedures in response to assessed risks in the audit of a smaller entity may be limited because of the unreliability, or lack, of information on which the analytical procedures are based.

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5 [Proposed] ISA 500 (Redrafted), paragraph [12].
Evaluation whether the Expectation is Sufficiently Precise (Ref: Para. 8(d))

A12. In evaluating whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, the auditor may consider matters such as the following:

- The accuracy with which the expected results of analytical procedures as substantive procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design analytical procedures as substantive procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A9 and A10 above.

Amount of Difference of Recorded Amounts from Expected Values that is Acceptable (Ref: Para. 8(e))

A13. The auditor’s determination of the amount of difference from expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, when aggregated with other misstatements, may cause the financial statements to be materially misstated. ISA 330 (Redrafted) requires the auditor to obtain more persuasive audit evidence the higher the auditor’s assessment of risk.6 Accordingly, a smaller amount of difference that would be considered acceptable without investigation is needed to achieve the desired level of assurance as the assessed risk increases.

A14. The matters discussed in paragraph 9(a)-(d) are relevant irrespective of whether the auditor performs analytical procedures as substantive procedures on the entity’s period end financial statements, or at an interim date and plans to perform analytical procedures as substantive procedures with respect to the intervening period as part of the period end. ISA 330 (Redrafted)7 establishes requirements and provides guidance on substantive procedures performed at an interim date.

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6 ISA 330 (Redrafted), paragraph 7(b).
7 ISA 330 (Redrafted), paragraphs 23-24.
Analytical Procedures that Assist in Arriving at the Auditor’s Overall Conclusion in an Audit of Financial Statements (Ref: Para. 9)

A15. The conclusions drawn from the results of analytical procedures during the overall review stage of the audit are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements, and assist in arriving at the auditor’s overall conclusion on whether the financial statements as a whole are free from material misstatements.

A16. The results of such analytical procedures may identify a previously unrecognized risk of material misstatement. In such circumstances, ISA 315 (Redrafted) requires the auditor to revise the auditor’s assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.\(^8\)

A17. The analytical procedures performed as part of the auditor’s overall review of the financial statements are often similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 10)

A18. Audit evidence relevant to management’s responses may be obtained by considering how those responses compare with the auditor’s understanding of the entity and its environment, or with other audit evidence obtained during the course of the audit.

A19. The need to apply other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation is not considered adequate.

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\(^8\) ISA 315 (Redrafted), paragraph 30.
PROPOSED CONFORMING AMENDMENT

ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”

Analytical Procedures

A7. Analytical procedures performed during risk assessment of the entity may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures. Analytical procedures applied as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A78. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A89. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. ISA 520, “Analytical Procedures,” establishes requirements and provides guidance on the use of analytical procedures.

Considerations Specific to Smaller Entities

A10. The availability of information to perform analytical procedures as risk assessment procedures in the audit of a smaller entity may be limited by the timeliness of processing of transactions and preparation of reliable financial information by the entity. Further, smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. Accordingly, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity’s financial statements is available.