

July 2008

**Basis for Conclusions:
ISA 510 (Redrafted), Initial
Audit Engagements—
Opening Balances**

*Prepared by the Staff of the International Auditing and
Assurance Standards Board*



**International Federation
of Accountants**

BASIS FOR CONCLUSIONS:

ISA 510 (REDRAFTED), INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 510 (Redrafted), “Initial Audit Engagements—Opening Balances,” which was unanimously approved by the IAASB in March 2008.¹

Background

1. In September 2006, the IAASB agreed the conventions to be used in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB’s Clarity conventions.²
2. The IAASB has undertaken to redraft all of its ISAs in accordance with the Clarity 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. ISA 510 is in the latter category.
3. The IAASB issued an exposure draft of proposed ISA 510 (Redrafted) (ED-ISA 510) in July 2007, with a comment date of October 31, 2007. The IAASB received thirty-seven comment letters from a variety of respondents, including IFAC member bodies, national standard setters, firms, regulators, government organizations, and others. Input was also received from IFAC’s Small and Medium Practices Committee. The IAASB made changes to ED-ISA 510 in response to these comments. In addition, the IAASB discussed significant issues in the development of ED-ISA 510, and the finalization of ISA 510 (Redrafted), with its Consultative Advisory Group (CAG). The CAG raised no significant concerns about the proposed treatment of these issues with the IAASB.
4. This Basis for Conclusions explains the more significant issues raised by respondents on ED-ISA 510, and how the IAASB has addressed them. In general, ED-ISA 510 received strong support from respondents in terms of how the extant ISA had been redrafted in accordance with the IAASB’s Clarity conventions.

¹ See minutes of the March 10-14, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142>.

² The IAASB’s Clarity conventions, and the authority and obligation attaching to them, are established in the amended Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface). The amended Preface can be accessed at http://www.ifac.org/download/IAASB_Preface.pdf. Elements of the authority and obligation attaching to the Clarity conventions have been exposed as part of ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

Scope of the ISA

5. Paragraph 1 of ED-ISA 510 stated that the proposed ISA deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. It explained that, in addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
6. Some respondents commented that the scope of the ISA was unduly constrained. They suggested that the scope should be broadened to include consideration of:
 - All aspects of an initial engagement, such as obtaining an understanding of the entity, on the basis that initial balances are only one consideration.
 - Opening balances in all audit engagements and not just in initial engagements.
 - Partner rotation, on the basis that certain procedures would still need to be performed when there is a change of auditor for the engagement within the firm.
7. The IAASB noted that the extant ISA is specifically focused on the auditor's consideration of *opening balances* in an initial audit engagement, and it would therefore be inappropriate under the scope of this Clarity redraft to extend the scope of the ISA to include all other matters that need to be considered in such engagements. In addition, ISA 315 (Redrafted)³ already deals with the performance of risk assessment procedures *necessary to provide a basis* for the auditor's identification and assessment of the risks of material misstatement, which establishes an appropriate frame of reference to guide an incoming auditor's judgments on obtaining the required understanding of the entity and its environment. The IAASB nevertheless determined that reference to ISA 300 (Redrafted)⁴ in the Scope paragraph would be relevant in relation to the additional requirements and guidance in that ISA regarding activities prior to starting an initial audit. See paragraph 1 of ISA 510 (Redrafted).
8. For similar reasons, the IAASB did not agree that the scope of the ISA should include opening balances in all audit engagements. The work effort defined in the extant ISA is focused on the audit evidence an incoming auditor needs to obtain regarding opening balances in order to form an opinion on the current period's financial statements. The procedures necessary in a continuing engagement would necessarily be different as the auditor would have obtained evidence regarding the opening balances in the prior period's audit. Accordingly, the IAASB believes that guidance for ongoing engagements is better addressed in other ISAs, such as proposed ISA 710 (Redrafted).⁵
9. The IAASB also did not agree that the ISA should deal with partner rotation. The definition of a predecessor auditor in paragraph 4(c) of ED-ISA 510 (and ISA 510 (Redrafted)) makes

³ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

⁴ ISA 300 (Redrafted), "Planning an Audit of Financial Statements."

⁵ Proposed ISA 710 (Redrafted), "Comparative Information—Comparative Figures and Comparative Financial Statements."

clear that the ISA applies only when the predecessor auditor is from another firm. In the IAASB's view, this is appropriate because the circumstances are fundamentally different between an incoming auditor, which constitutes a change in the entire engagement team, and partner rotation, which involves a change of the engagement partner only while the continuity of the engagement team remains. The work effort described in the extant ISA focuses on the audit evidence needed when commencing an audit for the first time, and it applies to the team as a whole.

Objective

10. The objective set out in paragraph 3 of ED-ISA 510 reflected two distinct responsibilities of the auditor with respect to opening balances in initial engagements:

The objective of the auditor is, in conducting an initial audit engagement, to obtain sufficient appropriate audit evidence about whether:

- (a) Misstatements that materially affect the current period's financial statements arising from the opening balances exist; and
 - (b) Appropriate accounting policies have been consistently applied or changes thereto are accounted for properly.
11. While there was strong support from respondents for this approach to the objective, there were several suggestions to improve its clarity further:
- The part dealing with whether the accounting policies have been consistently applied or changes thereto accounted for properly should refer to disclosure and presentation as these are equally important. In addition, they suggested including a specific reference to the applicable financial reporting framework.
 - That this part should also clarify that the accounting policies are *those that are reflected in the opening balances*, and that those accounting policies are consistently applied *in the current period's financial statements*.
 - The introduction to the objective should be clarified so that the focus is on obtaining sufficient appropriate audit evidence regarding the *opening balances* to make clear that it does not apply to all other considerations in an initial audit engagement.
12. The IAASB accepted those suggestions as they clarified the objective. See paragraph 3 of ISA 510 (Redrafted)).
13. A respondent suggested that there should not be two separate considerations in the objective on the basis that concluding on subparagraph (b) of the objective is an integral part of being able to conclude on subparagraph (a). The IAASB did not agree with this view as it believes that the auditor has two clearly distinguishable responsibilities relating to opening balances in an initial engagement, that is,
- (a) To identify and appropriately address any misstatements in the opening balances; and
 - (b) To be satisfied regarding the continuity of the accounting policies.

The IAASB believes that it is important for the objective to identify these separate responsibilities so that the auditor has appropriate regard to them when performing procedures to obtain sufficient appropriate audit evidence about opening balances.

Defining the Work Effort

14. Paragraph 5 of ED-ISA 510 proposed that the auditor should perform the following procedures to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements:
 - (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
 - (b) Determining that the opening balances reflect the application of appropriate accounting policies; and
 - (c) Performing one or more of the following, as is necessary in the circumstances:
 - (i) Review of the predecessor auditor's working papers;
 - (ii) Evaluation of whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Specific audit procedures to obtain evidence regarding the opening balances.
15. A few respondents suggested that the procedures required in subparagraphs (a) and (b) in fact define what the auditor is trying to achieve, and the procedures required under subparagraph (c) should be treated as guidance on procedures to achieve them. Another respondent shared a somewhat similar view, suggesting that the procedures in (c) should be positioned as subsets of (a) and (b). Another respondent suggested that the ISA clarify that, if the previous period's financial statements had not been audited, it is always necessary to perform the procedures in subparagraph (c)(iii).
16. The IAASB did not agree that the procedures in (a) and (b) would be sufficient, by themselves, to define the work effort necessary in the circumstances. In the IAASB's view, to be able to reach a conclusion as to whether the opening balances contain misstatements that materially affect the current period's financial statements, it is also necessary for the auditor to go one step further to obtain audit evidence regarding the opening balances themselves. The IAASB believes that performing at least one of the procedures in subparagraph (c) will achieve this.
17. Accordingly, the IAASB determined that the structure of the requirement should be retained. Nevertheless, for greater clarity, the IAASB amended subparagraph (c) to clarify that at least one of the three procedures should be performed. See paragraph 6 of ISA 510 (Redrafted). The IAASB also concluded that it was appropriate to be neutral in terms of approach, however, as the order of the procedures should not matter given that the most important consideration for the auditor is to obtain sufficient appropriate audit evidence.
18. A respondent also suggested that the ISA should make explicit, as part of the work effort required, the need for the incoming auditor to obtain and review, where the prior period's

financial statements had been audited, the most recent of those financial statements and the predecessor auditor's audit report.

19. The IAASB agreed that this should be an integral part of the auditor's work effort on opening balances in all such circumstances, as the previous financial statements may contain information on matters (such as disclosures) of continuing relevance to the current period financial statements that may need to be reflected in those financial statements. The IAASB, however, noted that the requirement should be to *read* the financial statements (as opposed to reviewing them to avoid confusion with terminology associated with review procedures), and that it should not be limited to audited financial statements only as the predecessor practitioner might only have performed a review of the financial statements. Accordingly, the IAASB determined that the auditor should be required to read the most recent financial statements, if any, and the predecessor's report thereon, if any, for information relevant to opening balances, including disclosures. See paragraph 5 of ISA 510 (Redrafted).
20. A number of comments were received on the wording of the requirement regarding the auditor's response if the auditor obtains audit evidence that the opening balances contain misstatements. One respondent recommended that the auditor evaluate the effect of misstatements and, furthermore, if management refuses to authorize the auditor to inform the predecessor auditor of such misstatement, that the auditor should be required to evaluate the impact on the current audit.
21. The IAASB amended paragraph 6 to reflect that the auditor's procedures should be focused on misstatements *that could materially affect the current period's financial statements* and that the auditor should then only perform such additional procedures *as are appropriate in the circumstances* to determine their effect on the current period's financial statements. The wording of the relevant paragraph was amended accordingly. The IAASB did not include communicating the misstatement with the predecessor auditor as this was seen to be a matter of professional courtesy rather than necessary to obtain audit evidence regarding the opening balances. See paragraph 7 of ISA 510 (Redrafted).

Predecessor Auditor's Independence and Competence

22. Paragraph A2 of ED-ISA 510 explained that whether a review of a predecessor auditor's working papers provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor. Several respondents suggested that the consideration of the predecessor auditor's independence and competence is similar to those regarding a component auditor in a group audit context. They therefore questioned whether the ISA should provide enhanced guidance on these considerations along the lines set out in ISA 600 (Revised and Redrafted).⁶
23. In the IAASB's view, the situations are not necessarily comparable because the incoming auditor is able to obtain audit evidence regarding the opening balances from procedures performed on the current year's financial statements. The incoming auditor does not,

⁶ ISA 600 (Revised and Redrafted), "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)."

therefore, rely on the predecessor auditor's work to the same extent as the auditor would of a component auditor. In addition, the IAASB believes that significantly expanding the guidance or introducing a new requirement to implement this suggestion would represent a substantive change to the ISA and therefore be outside the scope of the redraft. Accordingly, the IAASB determined that no changes should be made in this regard.

Split Opinion

24. Extant ISA 510 restricts the circumstances when the auditor can express an unmodified opinion on the closing financial position of the entity and a qualified opinion or disclaimer of opinion on the results of operations and cash flows ("split opinion") to jurisdictions permitting it. The IAASB proposed to remove the restriction in ED-ISA 510 on the basis that it is unnecessary and inconsistent with other ISAs.
25. Most respondents expressed support for this proposal. A minority of respondents, however, disagreed. One suggested that the ISA should clarify that split opinions are acceptable unless explicitly prohibited by the applicable financial reporting framework or by law or regulation. Another suggested that "split opinions" should be addressed in proposed ISA 705 (Revised and Redrafted).⁷
26. A few respondents suggested enhancements to recognize the following:
 - Cash flows may not always need to be qualified even though there is insufficient audit evidence regarding financial performance.
 - There may be a scope limitation regarding the opening financial position even if sufficient appropriate audit evidence can be obtained regarding the closing financial position, which would affect the comparative financial information. (See further discussion of this matter in the discussion below of the alignment of ISA 510 (Redrafted) and proposed ISA 710 (Redrafted)).
27. The IAASB noted that the ED-ISA 510 is consistent with the principles established in proposed ISA 705 (Revised and Redrafted), which explicitly acknowledges the possibility of the expression of an unmodified opinion on the closing financial position but a disclaimer of opinion on the results of operations and cash flows if the auditor has been unable to obtain sufficient appropriate audit evidence concerning the entity's opening balances. Given the significant level of support from respondents, the IAASB determined that its original proposal should remain.
28. The IAASB did not agree with the suggestion that split opinions should be dealt with only in proposed ISA 705 (Revised and Redrafted) because this type of opinion relates more to circumstances when there are specific evidence issues regarding *opening balances*. As ISA 510 (Redrafted) addresses reporting, there would be a gap in its requirements and guidance, if this particular reporting issue was not also addressed in this ISA.
29. The IAASB did agree that the application material should clarify that the split opinion can be used *unless prohibited by law or regulation*. The IAASB also acknowledged that it is

⁷ Proposed ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report."

possible to obtain sufficient appropriate audit evidence regarding cash flows even if this cannot be obtained with regard to financial performance. The IAASB therefore determined that the ISA should indicate that the auditor may issue an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, *where relevant*, and unmodified regarding financial position. See paragraph A8(c) of ISA 510 (Redrafted). In addition, illustrative reports for circumstances when a split opinion is permitted, and when law and regulation in the jurisdiction prohibit a split opinion are both included in the Appendix of ISA 510 (Redrafted).

Alignment of ISA 510 (Redrafted) with Proposed ISA 710 (Redrafted)

30. Several respondents suggested the need for greater alignment between this ISA and proposed ISA 710 (Redrafted), particularly in relation to the reporting requirements. One respondent noted, for example, that proposed ISA 710 (Redrafted) includes additional requirements for the current auditor regarding comparative figures, and suggested that all the requirements and guidance addressing considerations for incoming auditors in proposed ISA 710 (Redrafted) be transferred to ISA 510 (Redrafted).
31. The IAASB does not believe that it is necessary to transfer all of the requirements and guidance in proposed ISA 710 (Redrafted) that apply to incoming auditors to ISA 510 (Redrafted). The latter is focused on audit and reporting considerations regarding the opening balances whereas the former comprehensively addresses all audit and reporting considerations related to comparative financial information. The IAASB believes that as long as there are appropriate cross references from ISA 510 (Redrafted) to proposed ISA 710 (Redrafted) to alert the auditor that there are additional considerations when the financial statements include comparative financial information, the current structure of the two ISAs is appropriate.
32. The IAASB nevertheless reviewed both ISA 510 (Redrafted) and proposed ISA 710 (Redrafted) to ensure that there is appropriate alignment between the two, and determined that the following clarifications should be made:
 - The scope paragraph of ISA 510 (Redrafted) should state that when the financial statements include comparative financial information, the requirements and guidance in proposed ISA 710 (Redrafted) also apply. This would then reciprocate the cross reference to ISA 510 (Redrafted) in proposed ISA 710 (Redrafted). See paragraph 1 of ISA 510 (Redrafted).
 - A cross reference to proposed ISA 710 (Redrafted) should be included in the requirement dealing with the circumstances when a modification to the predecessor auditor's opinion remains relevant and material to the current period's financial statements. See paragraph 13 of ISA 510 (Redrafted).

Considerations Specific to Public Sector Entities

33. Some respondents noted that, in the public sector, there may be legal or regulatory limitations on information that the current auditor can obtain from the predecessor auditor. Another respondent noted that it would be useful to clarify that if a public sector statutorily appointed auditor outsources an audit of a public sector entity to a private sector audit firm and there is a change in the audit firm to whom it is outsourced, this may not be a change in auditor as intended in ISA 510 (Redrafted) as the public sector statutorily appointed auditor remains.
34. The IAASB agreed that additional guidance to clarify the applicability of the ISA in those circumstances would be useful. See paragraphs A1-A2 of ISA 510 (Redrafted).

Additional Requirements or Guidance

35. Various suggestions were received from respondents for additional requirements or guidance in the ISA, for example to establish a requirement that the auditor considers the effect on the auditor's risk assessment when the prior period financial statements were not audited.
36. The IAASB considered that these suggestions would introduce requirements or guidance that would go beyond a redraft of the extant ISA. Accordingly, the IAASB determined that they should not be accepted.