201112 Answer

- ISA 510 Initial Audit Engagements – Opening Balances requires certain audit procedures to be carried out in an initial engagement **where the prior year financial statements were not audited**.
- **Firstly**, it is required that the auditor shall **read the most recent financial statements** for information relevant to opening balances, including disclosures. ①
- **Then** the auditor shall obtain sufficient appropriate evidence about **whether the opening balances contain misstatements that materially affect the current year's financial statements**. This evidence is obtained by firstly determining **whether the prior period's closing balances have been correctly brought forward**. The auditor shall also determine **whether the opening balances reflect the application of appropriate accounting policies**. ②

- **Depending on the nature of the opening balances**, specific audit procedures are performed to gain specific evidence on those opening balances. Additional procedures would be required if it appears that the opening balances contain misstatements that could materially affect the current period's financial statements.
- Finally, the auditor shall obtain sufficient appropriate evidence about **whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements**, and that **any changes in accounting policies have been accounted for and disclosed in accordance with IAS 8** Accounting Policies, Changes in Accounting Estimates and Errors.

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- In relation to the opening balance of inventory, the following procedures are recommended:
- Inspection of records of any inventory counts held at the prior period year end, 31 July 2010, to confirm the quantity of items held in inventory agrees to accounting records.
- Observation of an inventory count at the current period year end, 31 July 2011, and **reconciliation of closing inventory quantities back to opening inventory quantities**.
- **Analytical procedures on gross profit margins**, comparing the opening and closing gross profit margins year on year for the various types of items held in inventory.

- **Verifying the sales value in the current financial year** of items held in inventory at 31 July 2010, and **comparing the sales value with cost**. This should provide evidence that inventory is correctly valued at the lower of cost and net realisable value.
- Inspection of management accounts for evidence of any inventory items written off in the current financial period – this is important for inventory of calendars and diaries which are likely to be obsolete.
- Discussion with management regarding any slow moving items of inventory which were included in opening inventory.

2015 June Q1

Ted Co, a new audit client of your firm, **Craggy & Co**, with a financial year ended 31 May 2015. Ted Co, a newly listed company, is a computer games designer and developer

The previous auditors of Ted Co, a small firm called **Crilly & Co**, resigned in September 2014. The audit opinion on the financial statements for the year ended 31 May 2014 was unmodified.

Discuss the matters specific to the **planning** of an initial audit engagement which should be considered in developing the audit strategy. (6 marks)

2015 June Q1 - Answer

In an initial audit engagement there are several factors which should be considered in addition to the planning procedures which are carried out for every audit. ISA 300 *Planning an Audit of Financial Statements* provides guidance in this area.

ISA 300 suggests that unless prohibited by laws or regulation, arrangements should be made with the **predecessor auditor**, for example, **to review their working papers**. Therefore communication should be made with Crilly & Co to request access to their working papers for the financial year ended 31 May 2014. The review of the previous year's working papers would help Craggy & Co in planning the audit, for example, it may highlight matters pertinent to the **audit of opening balances** or an **assessment of the appropriateness of Ted Co's accounting policies.**

It will also be important to consider **whether any previous years' audit reports were modified**, and if so, the reason for the modification.

As part of the client **acceptance process**, **professional clearance** should have been sought from Crilly & Co. **Any matters which were brought to our firm's attention** when professional clearance was obtained should be considered for their potential impact on the audit strategy.

There should also be **consideration of the matters which were discussed with Ted Co's management** in connection with the appointment of Craggy & Co as auditors. For example, there may have been discussion of **significant accounting policies** which may impact on the planned audit strategy.

Particular care should be taken in planning the audit procedures necessary to obtain sufficient appropriate audit evidence regarding **opening balances**, and procedures should be planned in accordance with **ISA 510** ***Initial Audit Engagements – Opening Balances***. For example, procedures should be performed to determine whether the opening balances reflect the application of appropriate accounting policies and determining whether the prior period's closing balances have been correctly brought forward into the current period.

With an initial audit engagement it is particularly important to develop an **understanding of the business**, including the legal and regulatory framework applicable to the company. This understanding must be fully documented and will help the audit team to perform effective analytical review procedures and to develop an appropriate audit strategy. Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of auditors' experts.

Craggy & Co may have **quality control procedures** in place for use in the case of initial engagements, for example, the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures. Compliance with any such procedures should be fully documented.

Given that this is a **new audit client**, that it is **newly listed**, and because of other risk factors to be discussed in the next part of these briefing notes, when developing the audit strategy consideration should be given to **using an experienced audit team** in order to reduce detection risk.

Marks

Generally up to 1½ marks for each point discussed, including:

– Communicate with the previous auditor, review their working papers

– Consider whether any previous auditor reports were modified

– Consider any matters which were raised when professional clearance was obtained

– Consider matters discussed with management during our firm’s appointment

– Need to develop thorough business understanding

– Risk of misstatement in opening balances/previously applied accounting policies

– Firm’s quality control procedures for new audit clients

– Need to use experienced audit team to reduce detection risk

Maximum marks 6