

SA 510 (REVISED)

INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES
*(EFFECTIVE FOR AUDITS OF FINANCIAL STATEMENTS FOR PERIODS
BEGINNING ON OR AFTER APRIL 1, 2010)*

INTRODUCTION

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. 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. When the financial statements include comparative financial information, the requirements and guidance in [proposed] SA 710 (Revised)³⁵ also apply. SA 300 (Revised)³⁶ includes additional requirements and guidance regarding activities prior to starting an initial audit.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Definitions

4. For the purposes of the SAs, the following terms have the meanings attributed below:

- (a) Initial audit engagement – An engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.

³⁵ Currently, SA 710 (AAS 25), "Comparatives" is in force. The Standard is being revised in the light of the corresponding International Standard.

³⁶ SA 300 (Revised), "Planning an Audit of Financial Statements".

- (b) Opening balances – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
- (c) Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

REQUIREMENTS

Audit Procedures

Opening Balances

5. The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
 - (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss³⁷;
 - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
 - (c) Performing one or more of the following: (Ref: Para. A1–A4)
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.
7. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450³⁸.

³⁷ Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

³⁸ Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified During the Audit", paragraphs 8 and 12.

Consistency of Accounting Policies

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor's Report

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.³⁹

Audit Conclusions and Reporting

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with Proposed SA 705.⁴⁰ (Ref: Para. A5)

11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with Proposed SA 705.

Consistency of Accounting Policies

12. If the auditor concludes that:

- (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
- (b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

The auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with Proposed SA 705.

³⁹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

⁴⁰ At present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditor's Report" and the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements" (Hitherto known as AAS 28). The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June, 2009 issue of the Journal.

Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with Proposed SA 705 and Proposed SA 710 (Revised). (Ref: Para. A6)

APPLICATION AND OTHER EXPLANATORY MATERIAL

Audit Procedures (Ref: Para. 6)

Opening Balances (Ref: Para. 6(c))

A1. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

A2. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

A3. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.

- Performing audit procedures on gross profit and cut-off.

A4. For non-current assets and liabilities, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A5. Proposed SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

- (a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or
- (b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations*, and cash flows, where relevant, and unmodified regarding State of Affairs*.

The Appendix includes illustrative auditor's reports.

Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A6. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

MATERIAL MODIFICATIONS VIS A VIS ISA 510, "INITIAL AUDIT ENGAGEMENTS - OPENING BALANCES"

Deletions

1. Paragraph 6 (a) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated. Since in India Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial

* Profit & Loss Account.

* Balance Sheet.

statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.

2. Paragraph 6 (c) (i) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period's financial statements by reviewing the predecessor auditor's working papers, where the prior year financial statements were audited. Since in India Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the requirement of reviewing the predecessor auditor's working papers has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements. Corresponding change has also been made in the paragraph A4 of ISA 510 and Paragraphs A1 and A5 have been deleted.

3. Paragraph A2 of ISA 510 dealt with the outsourcing of an audit of a public sector entity by the statutorily appointed auditor to a private sector audit firm. Since in the Indian context such situation does not exist, the paragraph A2 of the application part has been deleted completely.

Appendix

(Ref: Para. A5)

Illustrations of Auditors' Reports with Modified Opinions*

Illustration 1:

Circumstances described in paragraph A5 (a) include the following:

- **The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.**
- **The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's results of operations and cash flows.⁴¹**
- **The State of Affairs at year end gives a true and fair view.**

* The Reporting Standards may give rise to conforming amendments to the illustrations of auditors' reports. Further, at present, there is no separate Standard on Auditing (SA) corresponding to International Standard on Auditing (ISA) 705, "Modifications to the Opinion in the Independent Auditors Report" and the concept of modified audit report has been discussed in SA 700, "The Auditor's Report on Financial Statements" (Hitherto known as AAS 28). The Auditing and Assurance Standards Board (AASB) has issued the Exposure Drafts of Revised SA 700, "Forming An Opinion and Reporting on Financial Statements"; SA 705, "Modifications to the Opinion in the Independent Auditor's Report"; and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", corresponding to the ISA 700, ISA 705 and ISA 706. These Exposure Drafts are published in the June 2009 issue of the Journal.

⁴¹ If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim an opinion on the results of operations and cash flows.

In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁴²

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards.⁴³ This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation⁴⁴ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁴⁵ An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

⁴² The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁴³ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

⁴⁴ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

⁴⁵ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 13, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

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We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1, and of its Results of Operations and its cash flows for the year then ended in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities].

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation⁴⁶)
Membership Number

Place of Signature

Date

Illustration 2:

Circumstances described in paragraph A5 (b) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the

⁴⁶ Partner or Proprietor, as the case may be.

entity's results of operations and cash flows.⁴⁷

- The State of Affairs at year end gives a true and fair view.

An opinion that is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs is considered appropriate in the circumstances.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements⁴⁸

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and presentation⁴⁹ of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation⁵⁰ of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.⁵¹ An audit also includes evaluating the

⁴⁷ If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's results of operations and cash flows, the auditor would disclaim the opinion on the results of operations and cash flows.

⁴⁸ The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

⁴⁹ Depending on the circumstances, this sentence may read: "Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards".

⁵⁰ Depending on the circumstances, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control".

⁵¹ In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances". In the case of footnote 19, this sentence may read: "In making those risk assessments, the auditor considers internal control relevant to

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appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the State of Affairs and our qualified audit opinion on the results of operations and cash flows.

Basis for Qualified Opinion on the results of operations and Cash Flows

We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion on the results of operations and Cash Flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Statement of Profit and Loss and Cash Flow Statement give a true and fair view of the results of operations and cash flows of ABC Company for the year ended March 31, 20X1 in accordance with applicable Accounting Standards.

Opinion on the State of Affairs

In our opinion, the balance sheet gives a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1 in accordance with applicable Accounting Standards.

Other Matters

The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)

(Designation⁵²)
Membership Number

Place of Signature

Date

the entity's preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances".

⁵² Partner or Proprietor, as the case may be.

SA 520(REVISED)
ANALYTICAL PROCEDURES
(EFFECTIVE FOR ALL AUDITS RELATING TO ACCOUNTING PERIODS
BEGINNING ON OR AFTER APRIL 1, 2010)

INTRODUCTION

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315¹. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures².

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

3. The objectives of the auditor are:
- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
 - (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Definition

4. For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor's choice of procedures,

¹ SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 6 (b) and A6a-A8a.

² SA 330, "The Auditor's Responses to Assessed Risks", paragraphs 6 and 20.

methods and level of application is a matter of professional judgement. (Ref: Para. A1-A3)

REQUIREMENTS

Substantive Analytical Procedures

5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330³, the auditor shall: (Ref: Para. A4-A5)

- (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)
- (b) Evaluate the reliability of data 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. A12-A14)
- (c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17-A19)

Investigating Results of Analytical Procedures

7. If analytical procedures performed in accordance with this SA 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. A20-A21)

Application and Other Explanatory Material

Nature of Analytical Procedures (Ref: Para. 4)

A1. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

³ SA 330, paragraph 20.

- 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.

A2. 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.

A3. 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, components and individual elements of information.

Substantive Analytical Procedures (Ref: Para. 5)

A4. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, 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.

A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical 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 Particular Analytical Procedures for Given Assertions (Ref: Para. 5(a))

A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. 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, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees 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 recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

A8. 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 elements 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.

A9. The determination of the suitability of particular substantive analytical 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 on substantive analytical procedures for assertions related to receivables.

A10. Particular substantive analytical procedures may also be considered suitable 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

A11. 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 capitalised, 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. 5(b))

A12. The reliability of data is influenced by its source and 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 substantive analytical procedures:

- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity⁴;

⁴ SA 500 (Revised), "Audit Evidence", paragraph A31.

- (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 specialised 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.

A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical 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 may 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. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures⁵.

A14. The matters discussed in paragraphs A12(a)-A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity's period end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date⁶.

Evaluation of Whether the Expectation Is Sufficiently Precise (Ref: Para. 5(c))

A15. Matters relevant to the auditor's evaluation of 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, include:

- The accuracy with which the expected results of substantive analytical 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, substantive analytical procedures may be more effective when applied to financial information on

⁵ SA 500 (Revised), paragraph 10.

⁶ SA 330, paragraphs 23-24.

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 substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12 - A13 above.

Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable
(Ref: Para. 5(d))

A16. The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality⁷ and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk⁸. Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence⁹.

Analytical Procedures that Assist When Forming an Overall Conclusion (Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor's opinion.

A18. The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly¹⁰.

A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 7)

A20. Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

A21. The need to perform other audit procedures may arise when, for example, management

⁷ SA 320 (Revised), "Materiality in Planning and Performing an Audit", paragraph A13.

⁸ SA 330, paragraph 7(b).

⁹ SA 330, paragraph A19.

¹⁰ SA 315, paragraph 30.

is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Modifications *vis-a-vis* ISA 520, "Analytical Procedures"

The Revised SA 520, "Analytical Procedures" does not contain any modifications *vis-à-vis* ISA 520.

Appendix

ANALYTICAL PROCEDURES

Trends

Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Reasonableness

Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

Ratios

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Sources of information

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- VAT returns
- Board minutes
- Discussion or correspondence with the client at the year-end

Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 520 (Revised), “Analytical Procedures”

The amendments to SA 315 have been shown in Track Changed mode.

SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”

Analytical Procedures

A6a. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks*. Analytical procedures performed 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.

A7. 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.

A8. 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.

Considerations Specific to Smaller Entities

A8a. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, 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.

[When the consequential limited revisions are included in SA 315, paragraph A6a will become paragraph A7 and the SA will be renumbered accordingly.]

* SA 520 (Revised), “Analytical Procedures”, paragraphs A1-A3 describe the nature of analytical procedures.