Agenda Item 3-A

PROPOSED INTERNATIONAL STANDARD ON AUDITING 510

(REDRAFTED)

INITIAL ENGAGEMENTS—OPENING BALANCES

(Effective for audits of financial statements for periods beginning on or after [date])*

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* See footnote 1

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) 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 contingencies and commitments requiring disclosure that existed at the beginning of the period. ISA 710, "Comparatives", deals with the auditor's responsibilities regarding comparatives and for reporting on them.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [date]. 1

Objective

3. 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;

   (b) Appropriate accounting policies have been consistently applied or changes thereto are properly accounted for.

Definitions

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

   (a) Initial audit engagement – An engagement in which either:

      (i) The financial statements are audited for the first time; or

      (ii) The financial statements for the prior period were audited by another auditor.

   (b) Opening balances – Those account balances which 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 of prior periods and accounting policies applied in the prior period. Opening balances also include contingencies and commitments requiring disclosure that existed at the beginning of the period.

   (c) Predecessor auditor – The auditor who was previously the auditor of an entity and who has been replaced by an incoming auditor.

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1 This date will not be earlier than December 15, 2008.

Requirements

Audit Procedures

Opening Balances

5. The auditor shall determine whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated.

6. The auditor shall also obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements and whether the opening balances reflect the application of appropriate accounting policies. (Ref: Para. A1)

7. When the prior period's financial statements were audited by a predecessor auditor, in obtaining sufficient appropriate audit evidence, the auditor shall, unless prohibited by law or regulation, review the predecessor auditor's working papers. (Ref: Para. A2 – A3)

8. When the auditor is unable to obtain sufficient appropriate audit evidence by reviewing the predecessor auditor's working papers or when the prior period's financial statements were not audited, the auditor shall perform such additional audit procedures as necessary to obtain sufficient appropriate evidence regarding the opening balances. (Ref: Para. A5-A6)

9. When the auditor obtains audit evidence that the opening balances contain misstatements which could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances. When the auditor concludes that such a misstatement exists, the auditor shall inform management and, subject to obtaining management's authorization, the predecessor auditor, if any.

Accounting Policies

10. The auditor shall obtain sufficient appropriate audit evidence whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed. (Ref: Para. A1)

Audit Considerations and Reporting

11. When the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall consider the effect thereof on the opinion in the auditor's report (Ref: Para. A7)

12. When the auditor concludes that the opening balances contain misstatements that materially affect the current period's financial statements, and the effect of the misstatement is not properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate. (Ref: Para. A7)

13. When the current period's accounting policies have not been consistently applied in relation to opening balances or the change in accounting policies has not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion as appropriate. (Ref: Para. A7)

14. When there was a modification to the opinion in the entity's prior period auditor's report, the auditor shall evaluate the effect thereof on the current period's financial statements. When a modification to the prior period's auditor's opinion regarding the prior period's financial statements remains relevant and material to the current period's financial statements, the auditor should modify the current auditor's report accordingly. (Ref: Para. A8)

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Application and Other Explanatory Material

Audit Procedures

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

- The accounting policies followed by the entity.
- The nature of the accounts and the risk of material misstatement in the current period's financial statements.
- The materiality 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 auditor's report was modified. (Ref: Para. 6 and 10)

A2. When the prior period's financial statements were audited by a predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor. (Ref: Para. 7)

A3. Relevant ethical and professional requirements guide the current auditor's communications with the predecessor auditor. (Ref: Para. 7)

A4. When the prior period's auditor's report was modified, the matter which resulted in the modification is relevant to the auditor's risk assessment in the current year's audit in accordance with ISA 315, 'Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment".

A5. For current assets and liabilities some audit evidence 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, it is more difficult for the auditor to be satisfied as to inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, such as:

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

- Performing audit procedures on gross profit and cutoff.

A combination of these audit procedures may provide sufficient appropriate audit evidence. (Ref: Para. 8)

A6. For non current assets and liabilities, such as fixed assets, 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 confirmation of opening balances with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures. (Ref: Para. 8)

Audit Conclusions and Reporting

A7. [Proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report" 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

(b) A disclaimer of opinion; or

(c) An opinion which is qualified or disclaimed regarding the results of operations and unqualified regarding financial position.

The appendix contains illustrations of auditors' reports illustrating auditors' reports with modifications to the opinion where the auditor was unable to obtain sufficient appropriate evidence. (Ref: Para. 11-13)

A8. In some situations a modification to the prior period's auditor's opinion may not be relevant and material to the current period's financial statements. For example, if there was a scope limitation in the prior period, due to the inability to obtain sufficient appropriate audit evidence regarding opening inventory, the auditor may not need to modify the current period's audit opinion. (Ref: Para. 14)

Appendix

Examples of Auditors' Reports with Modifications to the Opinion

Example Report 1: Auditor's report with a qualified opinion where the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balance of inventory. The possible effects of this inability are deemed to be material, but not pervasive to the financial statements. (Ref: Para A6(a))

INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

Report on the Financial Statements[2]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and 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 fair presentation of these financial statements in accordance with International Financial Reporting 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 International 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 fair presentation of the financial statements in order to design audit procedures that

[2] The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[3] 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.

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 did not observe the counting of the physical inventory stated at XXX as at December 31, 20X0, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

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 (*or "present fairly, in all material respects,"*) the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

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.*]

[*Auditor's signature*]

[*Date of the auditor's report*]

[Auditor's address]

[3] 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."

Example Report 2: Auditor's report with a disclaimer of opinion regarding the financial performance and cash flows and unqualified regarding financial position where the auditor is unable to obtain sufficient appropriate audit evidence regarding the inventory quantities used in determining the opening balance of inventory. The possible effects of this inability are deemed to be both material and pervasive to the financial statements. (Ref: Para A6(c))

INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

Report on the Financial Statements[4]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and 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 fair presentation of these financial statements in accordance with International Financial Reporting 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 International 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 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

4 The subheading "Report on the Financial Statements" is unnecessary in circumstances when the second subheading "Report on Other Legal and Regulatory Requirements" is not applicable.

on the effectiveness of the entity's internal control.[5] 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.

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

Basis for Disclaimer of Opinion on financial performance and cash flows

We did not observe the counting of the physical inventory stated at XXX as at December 31, 20X0, since that date was prior to our appointment as auditors. We were unable to satisfy ourselves as to the inventory quantities at that date by other audit procedures.

Disclaimer of Opinion on financial performance and cash flows

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial performance of ABC Company and its cash flows for the year ended December 31, 20X1. Accordingly, we do not express an opinion on the financial performance of ABC Company and its cash flows for the year ended December 31, 20X1.

Opinion on the financial position

In our opinion, the balance sheet gives a true and fair view of (*or "presents fairly, in all material respects,"*) the financial position of ABC Company as of December 31, 20X1, in accordance with International Financial Reporting Standards.

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.*]

[*Auditor's signature*]

[*Date of the auditor's report*]

[*Auditor's address*]

[5] 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."

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