

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 510**

**(REDRAFTED)**

**INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES**

**[CLEAN DRAFT]**

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

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International Standard on Auditing (ISA) 510 (Redrafted), “Initial Engagements—Opening Balances” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the authority of ISAs.

## 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 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] ISA 710 (Redrafted)<sup>1</sup> also apply. **[ISSUES A and F]**.

### Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

### 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 have been consistently applied or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework. **[ISSUE B]**

### 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 for the prior period were not audited; or
    - (ii) The financial statements for the prior period were audited by a predecessor auditor.
  - (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.

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<sup>1</sup> [Proposed] ISA 710 (Redrafted), "Comparative Information – Corresponding Figures and Comparative Financial Statements."

## Requirements

### Audit Procedures

#### *Opening Balances*

5. 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, have been restated;
  - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
  - (c) Performing one or more, as is necessary in the circumstances, of the following: (Ref: Para. A1 – A5)
    - (i) Review the predecessor auditor's working papers to obtain information relevant to the current period's financial statements and evaluate whether further audit evidence may need to be obtained in order to obtain sufficient appropriate evidence regarding the current period's financial statements;
    - (ii) Evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
    - (iii) Perform specific audit procedures to obtain evidence regarding the opening balances. **ISSUE C**
6. If the auditor obtains audit evidence that the opening balances contain misstatements, the auditor shall perform additional audit procedures to determine the effect on the current period's financial statements. If the auditor concludes that a material misstatement exists in the current period's financial statements, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance in accordance with [proposed] ISA 450 (Revised and Redrafted)<sup>2</sup>.

#### *Consistency of Accounting Policies*

7. 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*

8. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion or there was an Emphasis of Matter paragraph or an Other Matter(s) paragraph, the auditor shall evaluate the effect of the matter giving rise to the modification or the Emphasis of Matter paragraph or the Other Matter(s) paragraph in

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<sup>2</sup> Proposed] ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified During the Audit."

assessing the risks of material misstatement in the current period's financial statements in accordance with ISA 315 (Redrafted).<sup>3</sup>

## **Audit Conclusions and Reporting**

### *Opening Balances*

9. 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] ISA 705 (Revised and Redrafted).<sup>4</sup> (Ref: Para. A6)
10. If the auditor concludes that the opening balances contain a misstatement that materially affect the current period's financial statements, and the effect of the misstatement is not properly accounted for or adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with [proposed] ISA 705 (Revised and Redrafted)<sup>5</sup>.

### *Consistency of Accounting Policies*

11. If the current period's accounting policies have not been consistently applied in relation to opening balances in accordance with the applicable financial reporting framework and a change in accounting policies has not been properly accounted for or not adequately presented or adequately 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] ISA 705 (Revised and Redrafted)<sup>5</sup>.

### *Modification to the Opinion in the Predecessor Auditor's Report*

12. 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 current auditor's opinion in accordance with [proposed] ISA 705 (Revised and Redrafted) and [proposed] ISA 710 (Redrafted). (Ref: Para. A7 – A9)

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## **Application and Other Explanatory Material**

### **Audit Procedures**

#### *Opening Balances* (Ref: Para. 5)

- A1. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depends on such matters as:
  - The accounting policies followed by the entity.

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

<sup>4</sup> [Proposed] ISA 705 (Revised and Redrafted) "Modifications to the Opinion in the Independent Auditor's Report."

- 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 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 predecessor auditor’s report 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 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.
- A3. Relevant ethical and professional requirements guide the current auditor’s communications with the predecessor auditor in accordance with [proposed] ISA 220 (Redrafted).<sup>5</sup>
- A4. 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 cutoff.
- A5. 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 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.

### **Audit Conclusions and Reporting**

#### *Opening Balances* (Ref: Para. 9)

- A6. [Proposed] ISA 705 (Revised and Redrafted) 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

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<sup>5</sup> [Proposed] ISA 220 (Redrafted) “Quality Control for Audits of Financial Information.”

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) An opinion which is qualified or disclaimed, as appropriate, regarding the results of operations and unqualified regarding financial position. (The Appendix contains an example of an auditor's report with an opinion which is qualified regarding the financial performance and cash flows and unqualified regarding financial position.)  
**[ISSUE E]**

*Modification to the Opinion in the Predecessor Auditor's Report* (Ref: Para. 12)

A7. 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.

Considerations Specific to Public Sector Entities (Ref: Para. 12) **[ISSUE H]**

A8. In the public sector, there may be legal or regulatory limitations on the information that the current auditor can obtain from the predecessor auditor. For example, if a public sector entity that has previously been audited by the jurisdiction's Supreme Audit Institution (SAI) is privatized, the amount of access to working papers or other information that the SAI can provide an incoming auditor that is in the private sector may be constrained by privacy or secrecy laws or regulation. In situations where such communications are constrained, audit evidence may need to be obtained through other means and, if sufficient appropriate audit evidence cannot be obtained, consideration given to the impact on the auditor's opinion.

A9. The Auditor General may outsource the audit of public sector entities to private sector audit firms. When the Auditor General appoints a different audit firm to the firm that audited the financial statements of the public sector entity in the prior period, this is not usually regarded as a change in auditors, as the Auditor General remains responsible for the audit.

## Appendix

(Ref: Para. A6)

### Example of Auditor's Report with a Qualified Opinion

**Circumstances 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 inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory, the possible effects of which, in the auditor's judgment, are material but not pervasive to the entity's financial performance and cash flows<sup>6</sup>. (In this example Cash Flows are affected.)
- The financial position at the year end is fairly presented
- An opinion which is qualified regarding the financial performance and cash flows and unqualified regarding financial position is considered appropriate in the circumstances

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<sup>6</sup> If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim the opinion on the financial performance and cash flows.

## INDEPENDENT AUDITOR'S REPORT

[*Appropriate Addressee*]

### **Report on the Financial Statements<sup>7</sup>**

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 on the effectiveness of the entity's internal control.<sup>8</sup> 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.

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<sup>7</sup> 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.

<sup>8</sup> 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."

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unqualified opinion on the financial position and our qualified audit opinion on the financial performance and cash flows.

*Basis for Qualified Opinion on the Financial Performance and Cash Flows*

We were not appointed as auditors of the company until December 31, 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 December 31, 20X0. Since opening inventories enter into the determination of the financial performance 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 income statement and the net cash flows from operating activities reported in the cash flow statement.

*Qualified Opinion on the Financial Performance and Cash Flows*

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Income Statement and Cash Flow Statement give a true and fair view of (*or “presents fairly, in all material respects,”*) the financial performance and cash flows of ABC Company for the year ended December 31, 20X1 in accordance with International Financial Reporting Standards.

*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*]

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