



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item 5

Committee: IAASB

Meeting Location: New York

Meeting Date: February 13-16, 2007

Audit Evidence

A. Objective of Agenda Item

- A1. To approve as an Exposure Draft the proposed ISA 500 (Redrafted), “Audit Evidence” based on the clarity drafting conventions adopted by the IAASB.

B. ISA 500 Redrafting Task Force Members

- B1. The members of the Task Force are:

John Fogarty (Chair) IAASB member

John Kellas IAASB chairman

Gérard Trémolière IAASB member

C. Background

- C1. Drafts of a clarified ISA 500 were discussed at the September and October 2005 IAASB meetings. At the October meeting, it was agreed that ISA 500 would not be included with ISAs 240, 300, 315 and 330 in the first group of clarity EDs.
- C2. The main reasons for the IAASB’s decision at that time are discussed at C3-C12 below.

Explanatory Statements Treated as Requirements

- C3. The IAASB was concerned that the October 2005 draft converted some explanatory statements in the extant ISA 500 (e.g.: “Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability ...”) into requirements (“The auditor shall consider the appropriateness of audit evidence in relation to its relevance and its reliability ...”).
- C4. Such statements have not been converted to requirements in the attached draft.

Evaluation

- C5. At the October 2005 meeting, the IAASB was unsure whether all or part of ISA 500 should be subsumed into a new ISA dealing with the evaluation of evidence. The Board has since decided not to create such an ISA.
- C6. The only text in extant ISA 500 that refers to evaluation is the last sentence of extant paragraph 14:

“The auditor uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.”

This sentence has been deleted from the redrafted ISA 500 because it is, or will be, covered by redrafted ISA 200 (which will note the overriding role of judgment and include a general requirement to use professional skepticism), and ISA 330.27 (which requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained).

Separation of Sufficiency and Appropriateness

- C7. The IAASB was concerned that the October 2005 draft separated requirements related to the auditor’s consideration of appropriateness of evidence from those related to its sufficiency, and whether this could imply a two-step process, which might in turn imply separate documentation requirements.
- C8. The draft presented at this meeting does not separate requirements related to appropriateness from those related to sufficiency.

“Inappropriate” Audit Evidence

- C9. At the October 2005 meeting, the IAASB asked the Clarity Task Force to reconsider whether the definition of "audit evidence" should allow for audit evidence that is not “appropriate”, i.e., whether information that is not appropriate should be referred to as “audit evidence” at all.
- C10. The definition of audit evidence is: “All of the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements, and other information.” By itself, it would be a matter of interpretation whether “the information used by the auditor” was appropriate or not; the current definition therefore does not rule out the possibility.
- C11. However, the definition of ‘appropriateness’ is: “The measure of the quality of audit evidence...,” which appears to assume that some audit evidence exists that is of poor quality and therefore not appropriate. This view is consistent with the often used expression “sufficient appropriate audit evidence” – if all evidence were appropriate, then the word “appropriate” in that expression would have no meaning.
- C12. The current definitions of audit evidence and appropriateness do not seem to have caused any particular difficulty in the past, and it is suggested that they not be changed.

D. Other Matters for IAASB Consideration

Repetition between ISAs 200, 240, and 500

- D1. The clarified ISAs deal with the issue of reliability of audit evidence, particularly as it relates to the authentication of documentation, in a number of places. In addition to

paragraphs 8, A22 and A23 of redrafted ISA 500, this issue is addressed in the following paragraphs:

Professional skepticism ... includes ... being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. (*ISA 200.A27 – December 2006 version*)

An audit rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. Accordingly, unless the auditor has reason to believe the contrary, for example if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified, the auditor may accept records and documents as genuine. (*ISA 200.A28 – December 2006 version*)

Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (*ISA 240.13*)

As explained in ISA 200, an audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity. (*ISA 240.A9*)

- D2. The IAASB is asked to consider whether these paragraphs should be rationalized, bearing in mind that it would be preferable if any rationalization did not result in changes to ISA 240 as it has only recently been approved and published.

Incorporation of Material from ISA 530

- D3. The ISA 530 Task force has identified a small number of paragraphs to move into ISA 500 and further paragraphs that can be deleted altogether because they repeat material already in ISA 500. The pros and cons of doing this will be discussed under Agenda Item 6. Appendix 1 shows where the ISA 500 Task Force believes these paragraphs could be placed if the Board agrees to move them into ISA 500.

Incorporation of Material from ISA 501

- D4. The clarity redraft of ISA 501, "Audit Evidence—Additional Considerations for Specific Items" is not scheduled for discussion until later in 2007. However, the ISAs 500 and 501 Redrafting Task Forces would like to invite the IAASB's preliminary views on whether elements of ISA 501 should be moved to ISA 500.
- D5. ISA 501, a copy of which is included as Appendix 2, currently has 4 parts dealing with:
- Attendance at Physical Inventory Counting
 - Procedures Regarding Litigation and Claims
 - Valuation and Disclosure of Long-term Investments
 - Segment Information

- D6. The Part dealing with “Procedures Regarding Litigation and Claims” is being considered by the ISA 505 (Confirmations) Task Force. It has been argued that the other three parts offer little in terms of substance to constitute an ISA, and that they should therefore be moved into ISA 500, with ISA 501 being deleted. A contrary view is that moving very detailed guidance like that in ISA 501 into ISA 500 will destroy the balance of ISA 500 as a high level, principles based document that offers a useful oversight of generic audit evidence considerations.
- D7. If there is a strong view that parts of ISA 501 should be moved to ISA 500, then approval of ISA 500 will need to be deferred to a later meeting. The Task Force takes the view, however, that if a small number of additional requirements is necessary for isolated topics they are best kept in a separate ISA. If subsequently it is considered that these should be developed into fuller and more comprehensive guidance, as with the section on confirmations, they should be transferred to a separately developed ISA

Audit Evidence Obtained in Previous Audits

- D8. Paragraph A4 states: “In certain circumstances, audit evidence obtained from previous audits may provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.”
- D9. A similar sentiment was included in an early draft of ISA 330 as a requirement in the following form: “The auditor shall only use audit evidence obtained in previous audits as substantive audit evidence in the current period if the audit evidence and the related subject matter have not fundamentally changed. If the auditor plans to use such evidence, the auditor shall perform audit procedures during the current period to establish its continuing relevance.”
- D10. In the case of the paragraph in ISA 330, the IAASB decided that it should not be a requirement because it is so rare that evidence from substantive procedures would be carried forward from a previous audit. It could be argued, however, that para A4 has broader application, as it relates to all forms of evidence. While acknowledging that ISA 330.14 and .15 contain requirements that deal specifically with using audit evidence obtained in previous audits from tests of control, the IAASB is asked whether it would like A4 elevated to a Requirement in ISA 500?

E. Material Presented (Note: Agenda Item 5-B will be used for the discussion at the meeting.)

- | | |
|--------------------------------------|---|
| Agenda Item 5-A
(Pages 385 – 392) | Proposed ISA 500 (Redrafted) – Clean for approval |
| Agenda Item 5-B
(Pages 393 – 402) | Proposed ISA 500 (Redrafted) – Mark-up, after major deletions |
| Agenda Item 5-C
(Pages 403 – 412) | Proposed ISA 500 (Redrafted) – Mapping, including major deletions |
| Agenda Item 5-D
(Pages 413 – 416) | Proposed ISA 500 (Redrafted) –Disposition of Present Tense |

F. Action Requested

F1. The IAASB is asked to:

- (a) Offer preliminary views on whether parts of ISA 501 should be moved into ISA 500; and
- (b) Unless there is a strong view that parts of ISA 501 should be moved to ISA 500, to approve Proposed ISA 500 (Redrafted) in Agenda Item 5-A, for issue as an Exposure Draft.

APPENDIX 1

Placement of paragraphs that may be moved from ISA 530 “Audit Sampling”

The ISA 530 Task Force has identified the following paragraphs to move into ISA 500. This Appendix shows where the ISA 500 Task Force believes these paragraphs should be placed if the Board agrees to move them. The original placement of these paragraphs, and the modifications to their original text, is explained in the ISA 530 papers at Agenda Item 6.

The following text would be inserted after paragraph 7 of Agenda Item 5-A

Selecting Items for Testing to Obtain Audit Evidence

- 7.1 When designing tests of controls and tests of details, the auditor shall determine appropriate means of selecting items for testing in order to be satisfied that the method or methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the audit procedure. (Ref A21.1)
- 7.2 The means available to the auditor are:
- (a) Selecting all items (100% examination); (Ref A21.2)
 - (b) Selecting specific items; (Ref A21.3-A21.4) and
 - (c) Audit sampling. (See ISA 530, “Audit Sampling”)
- 7.3 When designing tests of controls, the auditor shall identify the characteristics or attributes that indicate performance of a control, as well as possible deviation conditions. When designing tests of details, the auditor shall identify the conditions that constitute a misstatement. The auditor shall determine what conditions constitute a deviation or misstatement by reference to the objectives of the audit procedure and make an assessment of the expected rate of deviation or expected misstatement in the population to be tested.

The following text would be inserted after paragraph A21 of Agenda Item 5-A

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 7.1)

A21.1 The application of any one or combination of the means of selecting items for testing identified in paragraph 7.2 may be appropriate in particular circumstances.

Selecting All Items (Ref: Para. 7.2 (a))

A21.2 The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of

controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective. In this circumstance the use of computer-assisted audit techniques (CAATs) may be appropriate.

Selecting Specific Items (Ref: Para. 7.2 (b))

A25.3 The auditor may decide to select specific items from a population. In making this decision, factors the auditor might consider include, for example, the auditor's understanding of the entity, the assessed risk of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk, as defined in ISA 530 "Audit Sampling and Other Means of Testing". Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount. The auditor may decide to examine items whose values exceed a certain amount so as to verify a large proportion of the total amount of class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity, the nature of transactions, and internal control.
- Items to test control activities. The auditor may use judgment to select and examine specific items to determine whether or not a particular control activity is being performed.

A25.4 While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population. The auditor may need to obtain sufficient appropriate audit evidence regarding the remainder of the population when that remainder is material.

APPENDIX 2

INTERNATIONAL STANDARD ON AUDITING 501 AUDIT EVIDENCE—ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

(Effective for audits of financial statements for periods
 beginning on or after December 15, 2004)*

CONTENTS

	Paragraph
Introduction	1-3
Part A: Attendance at Physical Inventory Counting	4-18
Part B: Superseded by ISA 505 (paragraphs 19-30 have been deleted)	
Part C: Procedures Regarding Litigation and Claims	31-37
Part D: Valuation and Disclosure of Long-term Investments	38-41
Part E: Segment Information	42-45

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance additional to that contained in ISA 500, “Audit Evidence” with respect to certain specific financial statement account balances and other disclosures.
2. Application of the standards and guidance provided in this ISA will assist the auditor in obtaining audit evidence with respect to the specific financial statement account balances and other disclosures addressed.
3. This ISA comprises the following parts:
 - (a) Attendance at Physical Inventory Counting.
 - (b) Superseded by ISA 505—Part B has been deleted.
 - (c) Inquiry Regarding Litigation and Claims.
 - (d) Valuation and Disclosure of Long-term Investments.
 - (e) Segment Information.

Part A: Attendance at Physical Inventory Counting

4. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.
5. **When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable.** The auditor's attendance serves as a test of controls or substantive procedure over inventory depending on the auditor's risk assessment and planned approach. Such attendance enables the auditor to inspect the inventory, to observe compliance with

the operation of management's procedures for recording and controlling the results of the count and to provide audit evidence as to the reliability of management's procedures.

6. **If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and, when necessary, perform audit procedures on intervening transactions.**
7. **Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation.** For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.
8. In planning attendance at the physical inventory count or the alternative procedures, the auditor considers the following:
 - The risks of material misstatement related to inventory.
 - The nature of the internal control related to inventory.
 - Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
 - The timing of the count.
 - The locations at which inventory is held.
 - Whether an expert's assistance is needed.
9. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.
10. If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.
11. When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement at different locations.
12. The auditor would review management's instructions regarding:
 - (a) The application of control activities, for example, collection of used stocksheets, accounting for unused stocksheets and count and re-count procedures;
 - (b) Accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment; and
 - (c) Whether appropriate arrangements are made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.
13. To obtain audit evidence that management's control activities are adequately implemented, the auditor would observe employees' procedures and perform test counts. When performing test counts, the auditor performs procedures over both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory and items selected from the physical inventory to the count records. The auditor considers the extent to which copies of such count records need to be retained for subsequent audit procedures and comparison.

14. The auditor also considers cutoff procedures including details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date.
15. For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the entity has designed and implemented controls over changes in inventory. The auditor would determine whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.
16. When the entity operates a perpetual inventory system which is used to determine the period end balance, the auditor would evaluate whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.
17. The auditor performs audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts.
18. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on materiality of this inventory the auditor would also consider the following:
 - The integrity and independence of the third party.
 - Observing, or arranging for another auditor to observe, the physical inventory count.
 - Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded.
 - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

Part B: Superseded by ISA 505 (paragraphs 19-30 have been deleted)

Part C: Procedures Regarding Litigation and Claims

31. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements.
32. The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may result in a material misstatement of the financial statements. Such procedures would include the following:
 - Make appropriate inquiries of management including obtaining representations.
 - Review minutes of those charged with governance and correspondence with the entity's legal counsel.
 - Examine legal expense accounts.
 - Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.
33. **When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's legal counsel.** Such communication will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are

reliable. When the auditor determines that the risk of material misstatement is a significant risk, the auditor evaluates the design of the entity's related controls and determines whether they have been implemented. Paragraphs 108-114 of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" provides further guidance on the determination of significant risks.

34. **The letter, which should be prepared by management and sent by the auditor, should request the entity's legal counsel to communicate directly with the auditor.** When it is considered unlikely that the entity's legal counsel will respond to a general inquiry, the letter would ordinarily specify the following:
- A list of litigation and claims.
 - Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
 - A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's legal counsel to be incomplete or incorrect.
35. The auditor considers the status of legal matters up to the date of the audit report. In some instances, the auditor may need to obtain updated information from entity's legal counsel.
36. In certain circumstances, for example, where the auditor determines that the matter is a significant risk, the matter is complex or there is disagreement between management and the entity's legal counsel, it may be necessary for the auditor to meet with the entity's legal counsel to discuss the likely outcome of litigation and claims. Such meetings would take place with management's permission and, preferably, with a representative of management in attendance.
37. **If management refuses to give the auditor permission to communicate with the entity's legal counsel, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion.** Where the entity's legal counsel refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative audit procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

Part D: Valuation and Disclosure of Long-term Investments

38. **When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.**
39. Audit procedures regarding long-term investments ordinarily include obtaining audit evidence as to whether the entity has the ability to continue to hold the investments on a long term basis and discussing with management whether the entity will continue to hold the investments as long-term investments and obtaining written representations to that effect.
40. Other audit procedures would ordinarily include considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the investments up to the date of the auditor's report.
41. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

Part E: Segment Information

42. **When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its presentation and disclosure in accordance with the applicable financial reporting framework.**
43. The auditor considers segment information in relation to the financial statements taken as a whole, and is not ordinarily required to apply audit procedures that would be necessary to express an opinion on the segment information standing alone. However, the concept of materiality encompasses both quantitative and qualitative factors and the auditor's procedures recognize this.
44. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit procedures as appropriate in the circumstances.
45. The auditor would discuss with management the methods used in determining segment information, and consider whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and perform audit procedures over the application of such methods. The auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, comparisons with budgets and other expected results, for example, operating profits as a percentage of sales, and the allocation of assets and costs among segments including consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies.