

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 501
(REDRAFTED) (CLEAN)****AUDIT EVIDENCE REGARDING SPECIFIC FINANCIAL STATEMENT ACCOUNT
BALANCES AND DISCLOSURES**

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

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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the obtaining of sufficient appropriate audit evidence regarding certain assertions and related considerations for, and the presentation and disclosure of, specific financial statement account balances and disclosures. It establishes requirements and provides guidance additional to that contained in ISA 315 (Redrafted),¹ ISA 330 (Redrafted)² and other relevant ISAs, expanding on how the auditor's responsibilities therein are applied in an audit of financial statements.

Effective Date

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

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding:
 - (a) The existence and condition of inventory in the financial statements;
 - (b) The completeness of litigation and claims involving the entity;
 - (c) The valuation and presentation and disclosure of long-term investments in the financial statements in accordance with the applicable financial reporting framework; and
 - (d) The presentation and disclosure of segment information in the financial statements in accordance with the applicable financial reporting framework.

Requirements

Inventory

4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding its existence and condition by, unless impracticable, attendance at the entity's physical inventory count (or counts) and: (Ref: Para. A1-A3)
 - (a) Evaluating management's instructions and procedures for recording and controlling the results of the entity's physical inventory count, including, where applicable, those used to estimate physical quantities; (Ref: Para. A4)
 - (b) Inspecting the inventory and observing management's count procedures; (Ref: Para. A5-A6)
 - (c) Performing test counts; and (Ref: Para. A7)
 - (d) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: Para. A8)

¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

² ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

5. If the entity's physical inventory count is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4:
 - (a) Perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded; and
 - (b) If the entity maintains a perpetual inventory system which is used to determine the period end inventory balance, perform additional audit procedures to evaluate:
 - (i) The reasons for any significant differences between the physical count and the perpetual inventory records; and
 - (ii) Whether the entity's inventory records are properly adjusted. (Ref: Para. A9)
6. If the auditor is unable to attend the entity's physical inventory count on the date planned due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date and, when necessary, perform audit procedures on intervening transactions.
7. If attendance at the entity's physical inventory count is impracticable, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. If it is not possible to do so, the auditor shall modify the auditor's opinion in accordance with [proposed] ISA 705 (Revised and Redrafted).³ (Ref: Para. A10-A11)
8. If inventory is under the custody and control of a third party, the auditor shall:
 - (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity; or (Ref: Para. A12)
 - (b) Perform inspection or other audit procedures appropriate in the circumstances to obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory. (Ref: Para. A13)

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to become aware of litigation and claims involving the entity which may give rise to a risk of material misstatement, including:
 - (a) Inquiry of management and others within the entity, including, where applicable, in-house legal counsel; and
 - (b) Review of minutes of those charged with governance and correspondence with the entity's external legal counsel. (Ref: Para. A14-A15)

Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant assertions, such as valuation or measurement, regarding litigations and claims. [Proposed] ISA 540 (Revised and Redrafted)⁴ establishes requirements and provides guidance relevant to the

³ [Proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report," paragraphs 10 and 12.

⁴ [Proposed] ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

- auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.
10. When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified or when the auditor believes that unidentified litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs:
 - (a) Seek direct communication with the entity's external legal counsel through a letter of general inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor; and
 - (b) When considered necessary, meet with the entity's external legal counsel to discuss the likely outcome of litigation and claims. (Ref: Para. A16-A18)
 11. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, the letter shall specify the following:
 - (a) A list of litigation and claims;
 - (b) Management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
 - (c) 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.
 12. If:
 - (a) Management refuses to give the auditor permission to communicate with the entity's external legal counsel; or
 - (b) The entity's external legal counsel refuses to respond appropriately to the letter of inquiry, referred to in paragraphs 10 and 11, and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative audit procedures,

the auditor shall modify the auditor's opinion in accordance with [proposed] ISA 705 (Revised and Redrafted).⁵
 13. The auditor shall obtain audit evidence about the status of litigation and claims involving the entity which may give rise to a risk of material misstatement up to, and including, the date of the audit report. (Ref: Para. A19)
 14. The auditor shall request management, and where appropriate, those charged with governance, to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing financial statements have been disclosed to the auditor and appropriately dealt with in the financial statements.

Long-term Investments

15. When long-term investments are material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding their valuation and presentation and disclosure

⁵ [Proposed] ISA 705 (Revised and Redrafted), paragraphs 10 and 12-16.

in the financial statements in accordance with the applicable financial reporting framework, by designing and performing audit procedures to:

- (a) Where relevant under the applicable financial reporting framework, evaluate management's intent and the entity's ability to hold the investments on a long-term basis; and (Ref: Para. A20-A22)
- (b) Determine the appropriateness of the amounts recorded and related disclosures in the financial statements. (Ref: Para. A23)

Segment Information

16. When segment information is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding its presentation and disclosure in the financial statements in accordance with the applicable financial reporting framework, by: (Ref: A24)
- (a) Obtaining an understanding of the methods used by management in determining segment information, and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and (Ref: A25)
 - (b) Performing audit procedures appropriate in the circumstances. (Ref: A26)

* * *

Application and Other Explanatory Material

Inventory

Attendance at the Entity's Physical Inventory Count (Ref: Para. 4)

- A1. 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 and to ascertain the reliability of the entity's perpetual inventory system, if applicable.
- A2. The auditor's attendance at the entity's physical inventory counting serves as a test of controls or substantive procedure over inventory depending on the auditor's risk assessment and planned audit approach. Such attendance enables the auditor to:
- Inspect the inventory to determine its existence and evaluate its condition, and perform test counts.
 - Observe compliance with management's instructions and procedures for recording and controlling the results of the physical inventory count.
 - Obtain audit evidence as to the reliability of management's procedures.
- A3. Matters relevant in planning attendance at the entity's physical inventory count (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this ISA) include, for example:
- 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 physical inventory count.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate.
- Whether the assistance of an auditor's expert is needed.

Management's Instructions and Procedures (Ref: Para. 4(a))

A4. Matters relevant in evaluating management instructions and procedures for recording and controlling the results of the physical inventory count include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The 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.
- The procedures used to estimate physical quantities, where necessary, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

Inspecting Inventory and Observing Management's Count Procedures (Ref: Para. 4(b))

- A5. Inspecting inventory when attending the entity's physical inventory count assists the auditor in determining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.
- A6. Observing management's count procedures assists the auditor in obtaining audit evidence that management's instructions and count procedures, for example those relating to the control over the movement of inventory before, during and after the count, are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Test Counts (Ref: Para. 4(c))

- A7. When performing test counts, audit evidence about the completeness and the accuracy of management's physical inventory count records may be obtained by tracing items selected from those count records to the physical inventory, and tracing items selected from the physical inventory to management's count records.

Final Inventory Records (Ref: Para. 4(d))

- A8. When attending the entity's physical inventory count, in addition to recording the auditor's test counts, the auditor may obtain copies of management's completed physical inventory count records to assist the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

***Physical Inventory Counting Conducted Other Than At The Date of The Financial Statements* (Ref: Para. 5)**

- A9. For practical reasons, the entity's physical inventory count may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory count or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of a physical inventory count at a date other than the date of the financial statements is appropriate for audit purposes.

***Attendance at the Entity's Physical Inventory Count is Impracticable* (Ref: Para. 7)**

- A10. Attendance at the entity's physical inventory count may be impracticable due to, for example, the nature and location of the inventory. In some such cases, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count, may provide sufficient appropriate audit evidence of the existence and condition of inventory.
- A11. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, the auditor is required to modify the auditor's opinion as a result of the scope limitation.⁶

Inventory Under the Custody and Control of a Third Party**Confirmation (Ref: Para. 8(a))**

- A12. [Proposed] ISA 505 (Revised and Redrafted)⁷ establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

- A13. Depending on the circumstances, for example the materiality of the inventory under the custody and control of a third party or information obtained about the integrity and independence of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party, for example:
- Attending, or arranging for another auditor to attend, the third party's physical count of inventory, if practicable.

⁶ [Proposed] ISA 705 (Revised and Redrafted), paragraph 10 and 12.

⁷ [Proposed] ISA 505 (Revised and Redrafted), "External Confirmations."

- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

- A14. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed or provided for in the financial statements.
- A15. In addition to the procedures identified in paragraph 9, the auditor may consider reviewing legal expense accounts and examining related source documents such as invoices for legal expenses. Further, the use of information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment may also assist the auditor to become aware of litigation and claims involving an entity

Communication with the Entity's External Legal Counsel (Ref: Para. 10)

- A16. Direct communication with the entity's external legal counsel assists the auditor 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 reasonable.
- A17. In certain circumstances, the auditor may consider it necessary to meet with the entity's external legal counsel to discuss the likely outcome of litigation and claims, for example where:
- The auditor determines that the matter is a significant risk (see also paragraph A18).
 - The matter is complex.
 - There is disagreement between management and the entity's legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

- A18. ISA 315 (Redrafted) establishes requirements and provides guidance on the determination of significant risks. When the auditor has determined that a significant risk exists, the auditor is required to obtain an understanding of the entity's controls, including control activities, relevant to that risk.⁸

⁸ ISA 315 (Redrafted), paragraphs 26-27.

Status of Litigation and Claims Up to, and Including, the Date of the Audit Report (Ref: Para. 13)

A19. Audit evidence about the status of litigation and claims up to, and including, the date of the audit report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Long-Term Investments*Intent and Ability* (Ref: Para. 15(a))

A20. The valuation and presentation and disclosure of long-term investments in accordance with the applicable financial reporting framework may depend on management's intent and the entity's ability to hold the investments on a long-term basis. Management often documents plans and intentions relevant to such investments and the financial reporting framework may require it to do so. The auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorizations, minutes, etc.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statement and up to, and including, the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

A21. [Proposed] ISA 580 (Revised and Redrafted)⁹ establishes requirements and provides guidance regarding the use of written representations. In accordance with that ISA, the auditor may conclude that it is necessary to obtain written representation regarding management's intent and the entity's ability to hold the investments on a long-term basis.

Considerations Specific to Public Sector Entities

A22. In the public sector, the entity's ability to hold investments on a long term basis may be influenced by the intentions and decisions of other levels of government, of which management may or may not be aware.

Appropriateness of Recorded Amounts and Related Disclosures (Ref: Para. 15(b))

A23. The applicable financial reporting framework may require adjustment to the carrying amounts of long-term investments where the estimated value of an investment does not exceed its carrying amount, or where there is uncertainty about whether the carrying amount will be recovered, and may require related disclosures. Audit procedures may include obtaining related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amounts of the investments up to, and including, the date of the auditor's report. [Proposed] ISA 540 (Revised and

⁹ [Proposed] ISA 580 (Revised and Redrafted), "Written Representations."

Redrafted) establishes requirements and provides guidance relevant to the auditor's consideration of accounting estimates where there is estimation uncertainty.

Segment Information (Ref: Para. 16)

A24. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to apply audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

Understanding of the Methods Used by Management (Ref: Para. 16(a))

A25. Matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and designing and performing audit procedures to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information include, for example:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Audit Procedures (Ref: Para. 16(b))

A26. Audit procedures regarding segment information may consist of, for example:

- Testing the application of the methods used by management in determining segment information.
- Analytical procedures.
- Other audit procedures as appropriate in the circumstances.