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Agenda Item 12

Committee: IAASB

Meeting Location: Washington

Meeting Date: December 10–14, 2007

Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures

Objective of Agenda Item

1. To approve proposed ISA 501 (Redrafted), “Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures,” as an exposure draft.

Task Force Composition

2. The members of the task force are:

Craig Crawford (Chair) IAASB Member

Marcel Phiejffer IAASB Member

Matters for IAASB Consideration

3. Specific matters for IAASB consideration are noted in the Appendix of this Agenda Item.

Material Presented

(Note: Agenda Item 12-A will be used for purposes of the discussion at the meeting.)

Agenda Item 12-A Proposed ISA 501 (Redrafted) – Clean
(Pages 3581 – 3590)

Agenda Item 12-B Proposed ISA 501 (Redrafted) – Mapped (Mark-up from Extant)
(Pages 3591 – 3602)

Agenda Item 12-C Proposed Disposition of the Present Tense – Extant ISA 501
(Pages 3603 – 3610)

Agenda Item 12-D Mapping Document – Extant ISA 501
(Pages 3611 – 3618)

Action Requested

4. The IAASB is asked to review the proposed ISA 501 (Redrafted) shown in Agenda Item 12-A, having regard to matters identified in the Appendix of this Agenda Item and the mapping documents presented in Agenda Items 12-B through 12-D, and to approve the proposed ISA as an exposure draft.

APPENDIX

Matters for IAASB Consideration

A. FORM OF OBJECTIVE, AND ITS RELATIONSHIP TO THE SCOPE OF THE ISA AND REQUIREMENTS

1. Extant ISA 501, “Audit Evidence – Additional Consideration for Specific Items,” addresses a number of unrelated topics, and focuses on certain assertions in relation to those topics. There is no overarching requirement in the ISA or for its individual parts.
2. The Task Force proposes an objective that directs the auditor to obtain sufficient appropriate audit evidence regarding specific assertions about, and the presentation and disclosure of, the specified financial statement items. The objective is therefore quite specific, though not in terms of the means by which it is to be achieved. The requirements, as redrafted to now include those procedures arising from the disposition of the present tense in the extant ISA, provide the necessary direction to achieve the objective. The objective is consistent with the draft objective formulated by the Clarity Task Force. See paragraph 3 in Agenda Item 12-A.
3. The IAASB also is asked to note that the proposed redrafted scope paragraph refers specifically to assertions, thereby aligning it with the proposed objective. See paragraph 1 in Agenda Item 12-A.

A.1 *Objective for Litigation and Claims*

4. The IAASB is asked to note that while the proposed objective regarding litigations and claims (see paragraph 3(b) of Agenda Item 12-A) refers to the completeness assertion, there also is partial coverage of the valuation assertion in the requirements. The Task Force does not believe that it would be appropriate to draft the objective in a manner to include the valuation assertion as it would result in the objective being too broad in relation to the requirements that support its achievement¹. Further, although there are requirements that indirectly result in obtaining audit evidence with respect to the valuation of litigation and claims or their effect on the financial statements, the focus of those requirements is nevertheless on completeness in so far as it related to identifying material litigation and claims.
5. However, to make clear the intended scope of the objective and related requirements, the Task Force has drafted essential explanatory material to recognize that the audit evidence obtained from performing the required procedures also may provide evidence relevant to other assertions. See essential explanatory material to paragraph 9 in Agenda Item 12-A.

¹ That is, to achieve an objective that makes reference to, or subsumes, the valuation assertion for litigations and claims would require that the ISA include procedures similar to those of proposed ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures,” where, for example, the accounting for the litigation or claims involves estimation uncertainty.

B. REFERENCE TO “WHEN MATERIAL TO THE FINANCIAL STATEMENTS”

6. The phrase ‘when material to the financial statements’ is included in each of the main extent bold-type paragraphs related to inventory, long-term investments, and segment information.
7. The ISAs ordinarily are drafted to apply to material matters only, on the basis of a proper application of the materiality and risks assessment ISAs. This is the reason for excluding references to ‘material’ in other ISAs. Accordingly, it could be argued that it is unnecessary and inconsistent to retain the reference to ‘material’ in this ISA.
8. The Task Force believes, however, that such reference is appropriate in light of the procedural nature of the standard. Further, it believes that the extant wording should be retained to avoid any inadvertent change in practice or the scope of the requirements.

C. INVENTORY

C.1 Condition of Inventory

9. Paragraph 5 of the extant ISA requires that the auditor obtain sufficient appropriate audit evidence regarding the existence *and condition* of inventory [*emphasis added*]. However, there are no extant requirements or guidance that explains what is expected of the auditor.
10. The Task Force believes that the extant ISA needs to be clarified by explaining that the auditor should inspect the inventory when attending the entity’s physical inventory count and by providing additional guidance in terms of how those procedures assist the auditor in identifying, for example, obsolete, damaged or ageing inventory. The alternative would be to remove the reference to ‘condition of inventory’, thereby focusing the ISA solely on the existence of inventory. This would, however, represent a weakening relative to the extant standard. See paragraphs 4(b) and A5 in Agenda Item 12-A.

C.2 Attendance is Impracticable

11. Paragraph 7 of the extant ISA states: “Where attendance is impracticable, 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.” The Task Force is of the view that the extant requirement is unclear and indirect and, accordingly, requires redrafting for clarity.
12. The Task Force recognizes that the IAASB generally prefers to see ISA requirements take a proactive stance (i.e., direct the auditor to think first about what might be possible), and that the explanation of the obvious reporting consequences of a failure to achieve a requirement should be treated as application material. However, the Task Force believes that the scenario addressed by this requirement is one where alternative audit procedures may not, in many cases, provide the auditor with sufficient appropriate audit evidence. Accordingly, to balance the tone of the requirement, the Task Force has provided for both the action expected of the auditor as well as the consequence of an inability to obtain sufficient appropriate audit evidence. This treatment is consistent with paragraphs 6 and 9 of proposed ISA 510 (Redrafted), “Opening Balances – Initial Audit Engagements.” See paragraph 7 in Agenda Item 12-A.

C.3 Confirming Inventory under Custody/Control by 3rd Party

13. Paragraph 18 of the extant ISA states: “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.”
14. It has been noted to the Task Force that this area has been problematic in practice and to redrafting the material as application material (that is, to move from “would ordinarily” to something like “may”) would represent a weakening relative to the extant standard. Accordingly, the Task Force believes that this audit procedure should be included as a requirement. See paragraph 8(a) in Agenda Item 12-A.
15. However, the Task Force does not believe it appropriate to mandate a confirmation request. Doing so would be inconsistent with the position taken by the Board in its discussions on proposed ISA 505 (Revised and Redrafted), “External Confirmations.” Accordingly, the Task Force concluded that it would be appropriate to balance the requirement by providing the auditor direction as to the alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory under the custody and control of a third party. See paragraph 8(b) in Agenda Item 12-A.

D. LITIGATION AND CLAIMS

16. The Task Force has elevated as a requirement, amongst other procedures, the reference in the first bullet of extant paragraph 32 to obtaining representations from management regarding litigations and claims involving the entity. The completeness of the information provided by management to the auditor regarding litigation and claims is a difficult assertion on which to obtain sufficient appropriate audit evidence, and the risk that a matter is overlooked, unintentionally or otherwise, by management suggests that obtaining written representations would be appropriate in the circumstances. The proposed treatment is consistent with proposed ISA 250 (Redrafted), “The Auditor’s Responsibilities Relating to Laws and Regulations in an Audit of Financial Statements.” See paragraph 14 in Agenda Item 12-A.

E. LONG-TERM INVESTMENTS

E.1 Ability and Intent

17. With the exception of obtaining written representations (discussed below), the Task Force has elevated the material in extant paragraph 39 regarding the obtaining of audit evidence as to management’s intent and the entity’s ability to hold investments on a long-term basis. The Task Force believes that this consideration is important to determining whether an investment is in fact a long-term investment and, consequently, the appropriate accounting treatment. However, the Task Force accepts that intent and ability may not be a universal concept in all national accounting standards and, accordingly, it has provided for this in the redrafting of the requirement. See paragraph 15(a) in Agenda Item 12-A.

18. Because the extant ISA provides little guidance regarding audit procedures to obtain audit evidence with respect to ability and intent, the Task Force has also introduced new guidance material consistent with that in proposed ISA 540 (Revised and Redrafted). See paragraph A20 in Agenda Item 12-A.

E.2 Written Representations

19. Paragraph 39 of the extant ISA refers to the obtaining of written representations regarding management's ability and intent to hold investments on a long-term basis. The issue of whether to require representations on such matters has been debated in the contexts of proposed ISA 540 (Revised and Redrafted) and proposed ISA 580 (Revised and Redrafted), "Written Representations," with the conclusion that (though a matter of practice) it is not necessary to require that such representations be obtained. Accordingly, the Task Force has not elevated the material in extant paragraph 39 relating to written representations.

E.3 Accounting for Impairments and Framework Neutrality

20. Paragraph 41 of the extant ISA describes the auditor's considerations with respect to circumstances where the value of an investment is below the carrying amount recorded for a long-term investment or there is uncertainty about the recoverability of the carrying amount of the investment.
21. The Task Force has drafted a general requirement directing the auditor to address the appropriateness of the amounts recorded in the financial statements for long-term investments – See paragraph 15(b) of Agenda Item 12-A. The Task Force has not, however, elevated the specific matters referred to in extant paragraph 41 on the basis that they are determinations that depend on the requirements of the applicable financial reporting framework. As such, they do not appear to be general auditing considerations which merit elevation.
22. In addition, because estimation may be required in determining the valuation of long-term investments included in the financial statements, the Task Force believes that reference to proposed ISA 540 (Revised and Redrafted) should be made in the application material. See paragraph A23 in Agenda Item 12-A.

F. OTHER MATTERS

F.1 Title

23. The title and paragraph 1 of the extant ISA present the ISA as an extension of extant ISA 500, "Audit Evidence." However, proposed ISA 500 (Redrafted), "Considering the Relevance and Reliability of Audit Evidence," changes substantially the orientation of extant ISA 500. The Task Force is of the view that the linkage that may have existed previously is no longer relevant. Accordingly, the title has been changed, and the reference to ISA 500 has been deleted.

F.2 Definitions

24. Extant ISA 501 does not contain any definitions, for example for such terms as ‘inventory’, ‘perpetual inventory system’, ‘long-term investment’, or ‘segment information’. The IAASB Glossary of Terms also does not define these terms, except for ‘segment information’ (defined as “Information in the financial statements regarding distinguishable components or industry and geographical aspects of an entity” which is inconsistent and incomplete with respect to revised IAS 14).
25. The Task Force is of the view that the ISA need not define such terms. Such terms are generally well-understood accounting terms, they are not used in the requirements of other ISAs, and the IAASB Glossary of Terms indicates that reference should be made to the Glossary of Terms published by the IASB for accounting terms not defined in IAASB pronouncements.