# PROPOSED INTERNATIONAL STANDARD ON AUDITING 501 (REDFRAED)
## AUDIT EVIDENCE – SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS 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 specific considerations by the auditor with respect to inventory, litigations and claims involving the entity and segment information in an audit of financial statements. Application of the ISA assists the auditor in obtaining sufficient appropriate audit evidence in accordance with ISA 330 (Redrafted), ISA 500 (Redrafted) and other relevant ISAs. It addresses certain, but not all, assertions and related considerations which may be relevant when obtaining sufficient appropriate audit evidence with respect to the specific financial statement account balances and disclosures addressed. It establishes requirements and provides guidance additional to that contained in ISA 330 (Redrafted) and other relevant ISAs. [ISSUE A]

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 the following matters when the related financial statement account balances or disclosures are material to the financial statements:

   (a) The existence and physical condition of inventory;

   (b) The completeness of litigation and claims involving the entity; and

   (c) The presentation and disclosure of segment information 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 physical condition by, unless impracticable, attendance at the entity’s physical inventory count (or counts) and:

   (Ref: Para. A1-A3, A6) [ISSUE B]

   (a) Attendance at physical inventory counting, unless impracticable, and evaluating whether it management’s instructions and procedures for—and the recording of and controlling—the results thereof are properly conducted and controlled of the entity’s physical inventory count; and (Ref: Para. A4-A9)

   (b) Observing management’s count procedures, inspecting the inventory, and performing test counts; and (Ref: Para. A5-A7)

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1 ISA 330 (Redrafted), “The Auditor’s Response to Assessed Risks.”
2 ISA 500 (Redrafted), “Audit Evidence.”
(eb) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: Para. A810)

5. If the entity’s physical inventory counting 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, 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. (Ref: Para. A911-A130)

6. If the auditor is unable to attend the entity’s physical inventory count on the date as planned due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions.

7. If attendance at the entity’s physical inventory count is impracticable, or if the entity does not perform a physical inventory count, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and physical condition of inventory by performing alternative audit procedures. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with [proposed] ISA 705 (Revised and Redrafted).3 (Ref: Para. A141-A163) [ISSUE B]

8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and physical condition of that inventory by performing one or more of the following either:

   (a) Request confirmation from the third party as to the quantities and physical condition of inventory held on behalf of the entity, or (Ref: Para. A174)

   (b) Performing 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. A185)

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to become aware of and identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A19-A21) [ISSUE C]

   (a) Inquiry of management and, where applicable, others within the entity, including, where applicable, in-house legal counsel, those responsible for legal matters; and

   (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity’s and its external legal counsel; and

   (c) Reviewing legal expense accounts and, as necessary, examining related source documents. (Ref: Para. A16-A18)

10. When the auditor assesses a risk of material misstatement regarding litigation or claims that

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have been identified, or when the auditor believes audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs, seek direct communication with the entity’s external legal counsel. The auditor shall do so through a letter of general inquiry or specific inquiry, prepared by management and sent by the auditor, requesting the entity’s external legal counsel to communicate directly with the auditor.

(b) When considered necessary, meet with the entity’s external legal counsel to discuss the likely outcome of the litigation or claims. (Ref: Para. A22) [ISSUE C]

11. The auditor shall modify the opinion in the auditor’s report in accordance with [proposed] ISA 705 (Revised and Redrafted) when:

(a) Management refuses to give the auditor permission to communicate or meet 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 paragraph 10(a), as requested, and the auditor is unable to obtain sufficient appropriate audit evidence by applying performing alternative audit procedures. (Ref: Para. A26)

12. 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 the date of the auditor’s report. (Ref: Para. A23) [ISSUE C]

Written Representations

123. 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 the financial statements have been disclosed to the auditor and appropriately recognized dealt with in the financial statements and disclosed to the auditor.

Segment Information

134. When segment information is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the its presentation and disclosure of segment information in accordance with the applicable financial reporting framework by performing analytical procedures and other audit procedures appropriate in the circumstances, including: (Ref: Para. A24) [ISSUE D]

(a) Obtaining an understanding of the methods used by management in determining segment information, and; (Ref: Para. A28)

(i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
Where appropriate, testing the application of such the methods used by management in determining segment information; and (Ref: Para. A25)

(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

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Application and Other Explanatory Material

Inventory

Attendance at the Entity’s Physical Inventory Counting (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, if applicable 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 involves enables the auditor to:

- Inspecting the inventory to determine ascertain its existence and evaluate its physical condition, and performing test counts; and,
- Observing compliance with management’s instructions and procedures for recording and controlling the results of the physical inventory count; and,
- Obtaining audit evidence as to the reliability of management’s procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor’s risk assessment, planned approach and the specific procedures carried out. [ISSUE B]

A3. Matters relevant in planning attendance at the entity’s physical inventory counting (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 the physical inventory counting.
- The timing of the physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- 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. ISA 600 (Revised and Redrafted) deals with the

5 ISA 600 (Revised and Redrafted), “Special Considerations – Audits of Group Financial Statements (Including the Work of the Component Auditors)."
involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor’s expert is needed. [Proposed] ISA 620 (Revised and Redrafted)\(^6\) deals with the use of an auditor’s expert to assist the auditor to obtain sufficient appropriate audit evidence.

**Evaluating Physical Inventory Counting Management’s Instructions and Procedures** (Ref: Para. 4(a))

**A4.** Whether physical inventory counting and the recording of the results thereof are properly conducted and controlled depends on the adequacy of the design and implementation of management instructions and procedures for recording and controlling the physical inventory count. [ISSUE B]

**A5.** 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 applicable, 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.

**Observing Management’s Count Procedures, Inspecting Inventory, and Performing Test Counts** (Ref: Para. 4(b))

**A6.** Audit procedures to obtain audit evidence about whether management instructions and count procedures are adequately designed and implemented, and directly about the existence and physical condition of inventory, include: [ISSUE B]

- Observing management’s count procedures;

- Inspecting inventory; and

- Performing test counts.

**A7.** Observing management’s count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management’s instructions and count procedures, for example, instructions and counting procedures relating to the control over the movement of inventory before, during and after the counting, 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.

A86. Inspecting inventory when attending the entity’s physical inventory counting 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.

A97. When performing test counts, audit evidence about the completeness and the accuracy of management’s physical inventory count records may be obtained by for example by tracing items selected from management’s count records to the physical inventory, and tracing items selected from the physical inventory to management’s count records, provides audit evidence about the completeness and the accuracy of those records.

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

A108. When attending the entity’s physical inventory count, in addition to recording the auditor’s test counts, the auditor may obtaining copies of management’s completed physical inventory count records assists 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)

A119. For practical reasons, the entity’s physical inventory counting 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 counting 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 counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. ISA 330 (Redrafted) establishes requirements and provides guidance on substantive procedures performed at an interim date.

A120. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain determine the period-end inventory balance, the auditor may consider the following relevant matters in evaluating the reliability of the inventory quantity information included in the entity’s perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively. [ISSUE B]

A13. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded are as follows:

• Whether the perpetual inventory records are properly adjusted.
• Reliability of the entity’s perpetual inventory records.
The reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records.

Whether the perpetual inventory records are properly adjusted.

Attendance at the Entity’s Physical Inventory Counting is Impracticable (Ref: Para. 7)

A14. In some cases, attendance at the entity’s physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety or well-being of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in ISA 200 (Revised and Redrafted), the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A15. In some cases where attendance is impracticable, 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 about the existence and physical condition of inventory.

A16. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and physical condition of inventory by performing alternative audit procedures. In such cases, ISA 705 (Revised and Redrafted) requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.

Inventory Under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A174. [Proposed] ISA 505 (Revised and Redrafted) establishes requirements and provides guidance for performing external confirmation procedures.

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

A175. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and independence-objectivity 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. Examples of other audit procedures include:

• Attending, or arranging for another auditor to attend, the third party’s physical counting of inventory, if practicable.

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8 [Proposed] ISA 705 (Revised and Redrafted), paragraphs 7, 9 and 10 and 12.

• 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)

A196. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A2047. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, 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 the entity. [ISSUE C]

A2148. 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. ISA 540 (Revised and Redrafted) establishes requirements and provides guidance relevant to the auditor’s consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Communication with the Entity’s External-Legal Counsel (Ref: Para. 10-11(a))

A2249. 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.

A2340. In some cases, the auditor may seek direct communication with the entity’s legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity’s external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A2441. If it is considered unlikely that the entity’s external legal counsel will respond appropriately to a letter of general inquiry, for example, if the professional body to which the external legal

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10 ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”
counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes: [ISSUE C]

(a) A list of litigation and claims;

(b) Where available, 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.

Meeting with the Entity’s External Legal Counsel (Ref: Para. 10(b))

A25. In certain circumstances, the auditor also may judge it necessary to meet with the entity’s external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- 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.

Status of Litigation and Claims Up to the Date of the Auditor’s Report (Ref: Para. 12)

A26. In accordance with [proposed] ISA 700 (Redrafted), the auditor is required to date the auditor’s report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor’s 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.

Segment Information (Ref: Para. 134)

A27. Depending on the applicable financial reporting framework, the entity may be required, or be 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 perform 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. 134(a))

A285. Depending on the circumstances, example of matters that may be relevant when 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 include, for example: [ISSUE D]

- 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.