

**Basis for Conclusions:
ISA 501 (Redrafted), Audit
Evidence—Specific
Considerations for Selected
Items**

*Prepared by the Staff of the International Auditing and
Assurance Standards Board*



**International Federation
of Accountants**

**BASIS FOR CONCLUSIONS:
ISA 501 (REDRAFTED), AUDIT EVIDENCE—SPECIFIC CONSIDERATIONS FOR
SELECTED ITEMS**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 501 (Redrafted), “Audit Evidence—Specific Considerations for Selected Items,” which was approved by the IAASB in September 2008.¹

Background

1. In September 2006, the IAASB agreed the conventions to be used in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB’s Clarity conventions.²
2. The IAASB has undertaken to redraft all of its ISAs in accordance with the Clarity conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 501 is in the latter category.
3. In December 2007, the IAASB issued an exposure draft of proposed ISA 501 (Redrafted)³ (ED-ISA 501). The comment period for ED-ISA 501 closed on March 31, 2008. The IAASB received thirty-nine comment letters from various respondents, including regulators and oversight authorities, IFAC member bodies, national auditing standard setters, audit firms, preparers and users of financial statements, and professional and public sector organizations. Input was also received from IFAC’s Small and Medium Practices Committee. Respondents to ED-ISA 501 generally supported the proposed ISA. A significant majority supported the IAASB’s proposal for removal of materials in the extant ISA 501 with regard to long-term investments and the reasons provided by the IAASB for doing so.
4. The IAASB revised the proposed ISA as a result of the comments received. In addition, the IAASB discussed significant issues in the finalization of ISA 501 (Redrafted) with its Consultative Advisory Group (CAG). The CAG raised no significant concerns about the proposed treatment of these issues with the IAASB. This Basis for Conclusions explains the

¹ See minutes of the September 15-19, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4426>.

² The IAASB’s Clarity conventions, and the authority and obligation attaching to them, are established in ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

³ Proposed ISA 501 (Redrafted), “Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures.”

more significant issues raised by respondents to ED-ISA 501, and how the IAASB has addressed them.

Scope and Objective

5. Paragraph 1 of ED-ISA 501 stated:

This International Standard on Auditing (ISA) deals with the obtaining of sufficient appropriate audit evidence regarding certain assertions and related considerations for specific financial statement account balances and disclosures. It establishes requirements and provides guidance additional to that contained in ISA 330 (Redrafted) and other relevant ISAs.

6. Paragraph 3 of ED-ISA 501 stated:

The objective of the auditor is to obtain sufficient appropriate audit evidence regarding:

- (a) The existence and 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.

7. Several respondents expressed concerns about the title and scope of, and the objective stated in, ED-ISA 501. Some were of the view that the title and stated scope create the impression that the ISA addresses all of the responsibilities of the auditor in relation to the matters addressed, as opposed to certain aspects only. Further, they found these aspects of ED-ISA 501 less clear than the extant ISA in terms of expressing how the ISA relates to other ISAs, in particular the fact that the ISA establishes requirements and provides guidance additional to those found in other ISAs. Some respondents also found the scope paragraph unclear with regard to the specific matters addressed by the ISA. Finally, some were of the view that the proposed objective is too specific.

8. Having regard to the proposed objective and the relatively narrow focus of the extant ISA (including the fact that the extant ISAs do not adopt a risk-based approach), some other respondents also questioned whether it is appropriate for ED-ISA 501 to include an objective, or for it to be retained as a separate standard. They were of the view that it would be more appropriate to view the extant ISA as providing additional requirements and guidance in support of the achievement of the objectives and requirements of other ISAs; as such, ED-ISA 501 should be subsumed into other relevant ISAs.

IAASB Decision

9. The IAASB did not intend to change, or to imply that there is a change, to the general scope of the extant ISA or its relationship to other ISAs. Based on the responses received, it agreed that further redrafting would be appropriate to make ISA 501 (Redrafted) more clearly reflect the intent of the extant ISA 501. Specifically, the IAASB agreed the following:

- To amend the scope paragraph to set out clearly the interrelationship between ISA 501 (Redrafted) and other relevant standards, and to make clear the specific matters dealt with in the ISA. See paragraph 1 of ISA 501(Redrafted).
 - To amend the proposed title of the ISA to make clear that the ISA addresses specific audit evidence considerations for selected items.
10. The IAASB felt that it was not appropriate to reposition the content of ED-ISA 501 to other relevant ISAs, for example ISA 330 (Redrafted)⁴ or ISA 500 (Redrafted).⁵ To do so would have the effect of unbalancing those ISAs, which address considerations relevant to all aspects of the audit, thereby diminishing the overarching nature of these ISAs. Nor did the IAASB feel that it was inappropriate to specify an objective in ISA 501 (Redrafted). The purpose of the extant ISA is to draw the auditor's attention to the selected financial statement account balances and disclosures, and to establish requirements relevant to obtaining sufficient appropriate audit evidence about them. As such, the IAASB concluded that it is appropriate to establish an objective of the auditor accordingly.

Specificity of Required Procedures

11. Several respondents expressed concern about how the IAASB applied its Clarity conventions in relation to the elevation (or not) of statements in the present tense in the extant ISA to requirements. The comments suggested that the IAASB had too narrowly interpreted the intent of the extant ISA, thereby resulting in an overly procedural standard with requirements that are essentially 'how-to' guidance. These concerns were raised in relation to:
- Paragraph 4 of ED-ISA 501, which set out audit procedures required when attending physical inventory counting;
 - Paragraph 8 of ED-ISA 501, which addressed audit procedures to be performed when inventory under the custody and control of a third party is material to the financial statements; and
 - Paragraph 9 of ED-ISA 501, which set out audit procedures required in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement.
12. The respondents were of the view that the original intent of the ISA in respect of these items is to mandate the performance of selected procedures relating to the specific items rather than requiring how these audit procedures should be carried out. Further, a few respondents questioned whether all requirements are applicable in all cases, or are not already covered by other in other ISAs.
13. In contrast, other respondents expressed support for the IAASB's treatment of guidance in the extant ISA 501 expressed in the present tense.

⁴ ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

⁵ ISA 500 (Redrafted), "Audit Evidence."

IAASB Decision

14. In developing ED-ISA 501, the IAASB acknowledged that the extant ISA is a procedural standard and that this should affect decisions regarding the specification of requirements. The IAASB re-affirmed its view that the procedures elevated as requirements in ED-ISA 501, in general but particularly in relation to paragraphs 4 and 9, are applicable in virtually all cases, and that they appropriately clarify what is expected in order to achieve the stated objective. Further, the majority of the IAASB felt that the original intent of the required procedures in ED-ISA 501 would become less clear if the requirements are expressed more generally or in a less direct manner. See paragraphs 4, 8 and 9 of ISA 501 (Redrafted).
15. Nevertheless, the IAASB revisited the procedures elevated as requirements in the context of the criteria and the various views of respondents. The IAASB agreed the following:
 - To reposition paragraph 10(b) of ED-ISA 501 (which was a proposed requirement based on grey text in the extant ISA 501) as guidance. Paragraph 10(b) required that the auditor meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims when considered necessary. However, as noted by some respondents, it is conditional on the judgment of the auditor and therefore not a requirement applicable in virtually all cases. See paragraph A24 of ISA 501 (Redrafted).
 - To remove paragraph 12 of ED-ISA 501 (which was a proposed requirement based on grey text in the extant ISA 501). Paragraph 12 required that the auditor obtain audit evidence about the status of litigation and claims involving the entity up to the date of the auditor's report. However, as noted by some respondents, this imperative is covered by ISA 700 (Redrafted)⁶ and ISA 560 (Redrafted).⁷

Segment Information

16. Extant ISA 501 includes requirements and guidance pertaining to obtaining sufficient appropriate audit evidence regarding the presentation and disclosure in accordance with the applicable financial reporting framework. This material, redrafted in accordance with the Clarity conventions, was included in paragraphs 14 and A24-A25 of ED-ISA 501. Several respondents were of the view that the requirements and application material on auditing segment information should be removed from the ISA, or substantively revised. It was argued that developments in financial reporting frameworks (specifically IFRS 8, "Operating Segments" effective 1 January 2009 with early adoption permitted) bring into question the continuing relevance of the material in the extant ISA.

IAASB Decision

17. The IAASB concluded that the material in extant ISA 501 and ED-ISA 501 addressing segment information is of continuing relevance and that it is appropriate for it to be retained in ISA 501 (Redrafted). While the specific requirements in the applicable financial reporting

⁶ ISA 700 (Redrafted), "Forming an Opinion and Reporting on Financial Statements."

⁷ ISA 560 (Redrafted), "Subsequent Events."

framework may change the accounting approach to determining segment information, the principle of obtaining sufficient appropriate audit evidence regarding the presentation and disclosure of segment information as required by the ISA remains applicable. Further, the proposed requirement for the auditor to obtain an understanding of the methods used by management in determining segment information, to evaluate and test the application of such methods, and to perform audit procedures appropriate in the circumstances, remain relevant and applicable to the audit of segment information. The deletion of the material would therefore be justified only if the requirements and guidance were potentially misleading. The IAASB is of the view that this is not the case.

Other Specific Matters

Respondents also raised the following significant issues relating to specific parts of the ISA:

Inventory

Inventory under the Custody and Control of a Third Party

18. Paragraph 8 of ED-ISA 501 required that, when inventory under the custody and control of a third party is material to the financial statements, the auditor shall *either* perform confirmation procedures *or* perform inspection or other audit procedures appropriate in the circumstances. A few respondents were of the view that the ISA unnecessarily restricts the auditor from performing both procedures, which, in the auditor's judgment, may be appropriate in some cases.
19. The IAASB agreed that the intent of the extant ISA is to allow for the use of either direct confirmation, performance of other audit procedures, or both, as appropriate. This would be consistent with paragraph 18 of the extant ISA, and the guidance in paragraph A15 of ED-ISA 501. The IAASB amended the requirement accordingly. See Paragraph 8 in ISA 501 (Redrafted).

Condition of Inventory

20. Paragraph 4 of ED-ISA 501 required that the auditor obtain sufficient appropriate audit evidence about the existence *and condition* of inventory. Several respondents were of the view that reference to 'condition' should be removed from the ISA. They argued that 'condition' it is not an assertion, nor are there any requirements or guidance that assist the auditor in determining what is required to obtain sufficient appropriate audit evidence about the 'condition' of inventory. Some respondents suggested that the term be replaced by valuation or similar, or that additional guidance be developed.
21. The requirement to obtain sufficient appropriate audit evidence about the condition of inventory is included in the extant ISA 501. Accordingly, the IAASB concluded that it cannot be deleted without weakening the extant ISA. The IAASB also concluded that it is inappropriate to change to 'valuation' as valuation of inventory is beyond the scope of the extant ISA.

Cutoff Procedures

22. One respondent was of that view that management's cutoff procedures are important to the auditing of the existence of inventory and therefore should be addressed by the requirements of the ISA.
23. Paragraph A4 of ED-ISA 501 makes reference to the relevance of cutoff in the auditor's evaluation of management's instructions and procedures over the movement and receipt of inventory. Matters relating to cutoff are also addressed in general and in specific in other relevant ISAs. The IAASB is of the view that introduction of specific requirements relating to the auditing of management's cutoff procedures is not warranted and out of the scope of this project to redraft ISA 501.

Litigation and Claims

Procedures to Become Aware of Litigation and Claims

24. Paragraph 9 of ED-ISA 501 contained the audit procedures to be performed by auditors in order to become aware of litigation and claims involving the entity. A few respondents were of the view that the review of legal expenses by the auditor as addressed in paragraph A17 of ED-ISA 501 should be included as a requirement.
25. The IAASB concluded that review of legal expenses should be restated as part of the requirements of the auditor in becoming aware of litigation and claims. The IAASB was of the view that it is a common procedure performed, and while the required audit procedures include the review of minutes of meetings of those charged with governance and correspondences with the entity's external legal counsel, these may not contain all the information pertinent to the audit of litigation and claims involving the entity. Accordingly, corroboration of further audit evidence by reviewing legal expense is essential to achieving the objective of the ISA. See paragraph 9(c) of ISA 501 (Redrafted).
26. The IAASB further agreed that the material on examining source documents regarding the entity's legal expenses is appropriately stated as guidance as it was of the view that the need to examine source documents is dependent on circumstances as well as the outcome of the auditor's review of the entity's legal expenses. See paragraph A20 of ISA 501 (Redrafted).

Direct Communication with Entity's External Legal Counsel

27. Paragraph 10 of ED-ISA 501 required that the auditor seek direct communication with the entity's external legal counsel through a letter of inquiry when there is a risk of material misstatement regarding litigation and claims identified or the auditor believes other litigation and claims may exist. Some respondents commented that in certain jurisdictions, legal counsels are not permitted (for example, by the professional bodies to which they belong) to respond to general inquiry letters (as distinct from letters of specific inquiry) from auditors even though the letters are prepared by management and contain management's clearance for the legal counsel to disclose the necessary information. The respondents were of the view that these situations should be taken account of in the ISA.

28. Additionally, some respondents indicated that there may also be a blanket prohibition on legal counsels (for example, by the professional bodies to which they belong) responding to inquiry letters from auditors of any form. Respondents commented that in these cases, the ISA should permit the performance of alternative audit procedures. Separately, some respondents questioned the applicability of the requirement in instances when litigation and claims are handled by internal legal counsels.
29. The IAASB agreed that the ISA should accommodate differences that exist in jurisdictions that are beyond the control of the auditor and which influence the auditor's ability to comply with the requirements of the ISA. Accordingly, it agreed to the following:
 - To include additional guidance explaining that local circumstances may give rise to non-responses from legal counsel to letters of general inquiry. See paragraph A23 of ISA 501(Redrafted).
 - To amend the requirement in paragraph 10 of ED-ISA 501 to allow for the performance of alternative audit procedures by the auditor in the event the external legal counsel is prohibited by law, regulation or the respective legal professional body from communicating directly with the auditor. See paragraph 10 of ISA 501(Redrafted).
30. The IAASB is also of the view that the extant ISA 501 was primarily written with external legal counsel in mind (for example, paragraph 9(a) of ED-ISA 501 required "inquiry with management and others within the entity where applicable including the in-house legal counsel"). Accordingly, it concluded that any change to the scope and requirements of the ISA which would result in a deviation from the original intent of the ISA is inappropriate in this project to redraft the ISA.

Segment Information

31. Paragraph 14 of ED-ISA 501 (which was a proposed requirement based on grey text in the extant ISA 501) required the performance of analytical procedures to obtain audit evidence regarding the presentation and disclosure of segment information. Some respondents were of the view that analytical procedures are not necessarily performed in all cases. Furthermore, it was raised that under some circumstances, it is either impractical or inefficient to perform these procedures in face of other more efficient audit procedures.
32. While the IAASB is of the view that analytical procedures are a common audit procedure performed by auditors when auditing segment information, it agreed that it is not essential to give greater prominence to analytical procedures over other procedures that may be equally or more effective in the circumstances. Accordingly, the IAASB redrafted paragraph 14 of ED-ISA 501 to achieve a more neutral presentation. See paragraph 13 of ISA 501 (Redrafted).