

SA 501 (AAS 34)

AUDIT EVIDENCE – ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 2005)*

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Standard on Auditing (SA) 501*, "Audit Evidence – Additional Considerations For Specific Items" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"¹, which sets out the authority of SAs.

* Issued in March, 2005.

¹ Published in the July 2007 issue of the Journal.

Audit Evidence – Additional Considerations For Specific Items

Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities, audit procedures and provide additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures. Application of the standards and guidance provided in this SA will assist the auditor in obtaining audit evidence with respect to the specific financial statement amounts and other disclosures. This SA comprises the following parts:

Part A: Attendance at Physical Inventory Counting

Part B: Inquiry Regarding Litigation and Claims

Part C: Valuation and Disclosure of Long-term Investments

Part D: Segment Information

Part A: Attendance at Physical Inventory Counting

2. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.

Definitions

3. Definitions regarding "Inventory" are given in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Institute of Chartered Accountants of India, and are adopted for the purposes of this SA².

4. Physical verification of inventories is the responsibility of the management of the entity. Management ordinarily establishes procedures under which inventory is physically counted at least once in a year (end of the year, generally, or as near the end of the year as possible) to serve as a

² Paragraph 3 of the Accounting Standard (AS) 2, "Valuation of Inventories", states as follows:

"3. The following terms are used in this Statement with the meanings specified:

Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

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basis for 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, due to factors such as the nature and location of the inventory. The attendance at such physical inventory counting will enable 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 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 where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.

7. Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation. For example, the auditor should examine a sample of documents evidencing the movement of inventory into and out of stores shortly before and after the cut – off date, and verify whether the inventory represented by those documents were included or excluded, as appropriate during the inventory count.

8. In planning attendance at the physical inventory count or the alternative procedures, the auditor would consider the following:

- ◆ The nature of the accounting and internal control systems used regarding inventory.
- ◆ Inherent, control and detection risks, and materiality related to inventory.
- ◆ Whether adequate procedures are established and proper instructions issued for physical inventory counting.
- ◆ The timing of the count.

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- ◆ The locations at which inventory is held and its nature.
- ◆ Whether an expert's assistance is needed.

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 and the assessment of inherent and control risk at different locations.

9. The auditor would review management's instructions regarding:

- (a) The application of control procedures, for example, collection of used stock-sheets, accounting for unused stock-sheets, tagging and count and re-count procedures;
- (b) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, inventory owned by a third party, for example, on consignment and inventory in transit; and
- (c) Appropriate arrangements made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

10. The auditor would also consider cut-off procedures including details of the movement of inventory just prior to, during and after the count to ensure that such movements are appropriately included and/or excluded, as applicable from such inventory. For example,

- (a) goods purchased but not received are included in the inventories; and
- (b) goods sold but not despatched are excluded from the inventories.

11. 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 inventory 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.

12. 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.

13. To obtain assurance that management's procedures are adequately implemented, the auditor would observe physical verification procedures performed by the employees and perform test counts. When performing

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counts, the auditor would test both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory sheets and items selected from the physical inventory to the count records. Where tagging method of physical count of inventory is used, the auditor would verify the tag reconciliation prior to the counting or before finalising the count. The auditor would consider the extent to which copies of such count records need to be retained for subsequent audit procedures, testing and comparison.

14. 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 control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.

15. When the entity operates a perpetual inventory system, which is used to determine the period end balance, the auditor would assess 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.

16. The auditor performs audit procedures over the final inventory listing to assess whether it accurately reflects actual inventory counts.

17. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:

- ◆ The conduct of the third party in the past with the entity 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 accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded.
- ◆ Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.

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- ◆ Subsequent receipt of goods from third parties.

Management Representations

18. The auditor should obtain a written representation from management concerning:

- (a) the completeness of information provided regarding the inventory; and
- (b) assurance with regard to adherence to laid down procedures for physical inventory count.

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19. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

Part B: Inquiry Regarding Litigation and Claims

Definitions

20(a) "Litigation" means a lawsuit or legal action including all proceedings therein.

(b) "Claims" means a right to payment or right to an equitable remedy for breach of performance.

21. 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.

22. The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include the following:

- ◆ Make appropriate inquiries of management including obtaining representations.

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- ◆ Review board /committee minutes and correspondence with the entity's lawyers.
- ◆ Examine legal and other relevant expense accounts.
- ◆ Use any information obtained regarding the entity's business including information obtained from discussions with in-house legal department, if any.

23. When litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims. 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.

24. The letter seeking direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims should be prepared by management. The auditor should maintain control over the process of preparation and sending of the letter. The letter should request the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to communicate directly with the auditor. 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 lawyer confirm:
 - the reasonableness of management's assessments;
 - provide the auditor with further information if the list is considered to be incomplete or incorrect; and
 - provide updated information as and when requested by the auditor upto the date of the audit report.

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25. 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 lawyers.

26. In certain circumstances, for example, where the matter is complex or there is disagreement between management and the entity's lawyers and such other professionals to whom the entity engages for litigation and claims, it may be necessary for the auditor to meet with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims 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.

27. If management refuses to give the auditor permission to communicate with the entity's lawyers, this would constitute a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion as the case may be. Where a lawyer or a professional refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

Management Representations

28. The auditor should obtain a written representation from management concerning the completeness and adequacy of information provided regarding the identification of litigation and claims, estimates of financial implications, including costs, etc.

Part C: Valuation and Disclosure of Long-Term Investments

29. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for valuation and disclosure of long term investments.

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Definitions

30. Definition regarding “Long Term Investments” is given in Accounting Standard (AS) 13, “Accounting for Investments”, issued by the Institute of Chartered Accountants of India and is adopted for the purposes of this SA.³

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

32. Audit procedures regarding long-term investments ordinarily include obtaining audit evidence with respect to their ownership and existence 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.

33. Other procedures would ordinarily include:

- (a) In the case of quoted securities, 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 securities up to the date of the auditor's report.
- (b) In case of unquoted securities, ascertaining the method adopted by the entity for determining the value of such securities as at the year end. The auditor should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as Profit Earning capacity Value method, break-up value method, capitalisation of yield method, yield to maturity method, etc.
- (c) In the case of investments other than in the form of securities, ensuring that the market value has been ascertained on the basis of authentic market reports, and /or based on expert's opinion, if warranted.

34. 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

³ Paragraph 3 of Accounting Standard (AS) 13, “Accounting for Investments”, states as follows:

“3. The following terms are used in this Statement with the meanings assigned:

A Current Investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

A long term investment is an investment other than a current investment.”

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whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

Management Representations

35. The auditor should obtain a written representation from management regarding :

- (a) the completeness of information provided regarding valuation and disclosure of long term investments;
- (b) the valuation of long term investments in the financial statements including adequacy of provision for diminution in such values, wherever required; and
- (c) the intention of the management to continue to hold long-term investments as long-term investments.

Audit Conclusions and Reporting

36. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence, valuation of long term investments or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

Part D: Segment Information

37. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for appropriate disclosure of segment information.

Definitions

38. “Segment Information” means the information to be disclosed in respect of reportable segments as given in Accounting Standard (AS) 17, “Segment Reporting”, issued by the Institute of Chartered Accountants of India or as defined in the financial reporting framework applicable to the entity.

39. When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its disclosure in accordance with the applicable identified financial reporting framework.

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40. The auditor considers segment information in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express an opinion on the segment information standing alone. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit tests appropriate in the circumstances.

41. 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 test 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.

Management Representations

42. The auditor should obtain a written representation from management concerning:

- (a) the completeness of information regarding segments and disclosure thereof; and
- (b) appropriateness of the selected segments based on risks and returns; and
- (c) the organizational structure of an enterprise and its internal financial reporting system and any deviations therefrom.

Audit Conclusions and Reporting

43. If the auditor is unable to obtain sufficient appropriate audit evidence concerning segment information or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

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Effective Date

44. This Standard on Auditing becomes operative for all audits related to accounting periods beginning on or after 1 April 2005.

Compatibility with the International Standard on Auditing (ISA) 501

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 501, "Audit Evidence – Additional Considerations for Specific Items" except the following:

- (a) Due to practical reasons, paragraph 23 of the SA requires that when litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers. The auditor need not necessarily communicate with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims in case the auditor is able to obtain the sufficient appropriate audit evidence regarding the identification of litigation and claims involving the entity which may have a material effect on the financial statements. The ISA on the other hand requires that the auditor should communicate with the entity's lawyers to obtain 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.
- (b) Each part of the SA contains the requirements related to obtaining the management representations [see paragraphs 18, 28, 35 and 42]. There is, however, no such requirement in the ISA.