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Organización Internacional de Comisiones de Valores  
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Organizaçào Internacional das Comissões de Valore

June 12, 2008

Mr. James M. Sylph  
Executive Director, Professional Standards  
International Auditing and Assurance Standards Board  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, NY 10017

Email address: Edcomments@ifac.org

***Re: Proposed Redrafted International Standard on Auditing 501, "Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures"***

Dear Mr. Sylph:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Exposure Draft of proposed redrafted international standard on auditing ISA 501, *Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures* (the ED). As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing, and professional standards.

Members of SC 1 seek to further IOSCO's mission through thoughtful consideration of accounting, auditing and disclosure concerns, and pursuit of improved global financial reporting. As we review proposed auditing standards, our concerns focus on whether the standards are sufficient in scope and adequately cover all relevant aspects of the area of audit being addressed, whether the standards are clear and understandable, and whether the standards are written in such a way as to be enforceable.

Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

#### **Relationship of the ED to the IAPs**

We note that the Board has preliminarily decided as part of its 2009-2011 Strategic Plan that it will review the International Auditing Practice Statements (IAPs) to determine whether they should be withdrawn or revised. Since both ISA 501 and many of the IAPs include guidance for auditors related to selected financial statement account balances, assertions, and/or disclosures (for example, ISA 501

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addresses audit procedures related to inventory, litigation and segments and the IAPSs address audit procedures related to derivative financial instruments, inter-bank confirmations, and environmental matters, among others), and since ISA 501 was not revised as part of the ED but only redrafted, we believe the Board should consider revising ISA 501 in the future as well, after determining the future role of the IAPSs. As part of this, we recommend that the Board consider whether any of the topical guidance in the IAPSs for which no ISA currently exists, such as derivatives, should be incorporated into ISA 501.

### Title

The standard only addresses some of the assertions and related considerations for the account balances discussed (for example, existence of inventory is addressed, but not valuation or rights and obligations). Therefore, in order to be consistent with the actual scope of the standard, we do not believe that the title of the ED should refer to “Balances.” By referring to “Balances,” we are concerned that the title may be misleading and could lead to an incorrect interpretation that the requirements in the standard are fully inclusive of the responsibilities of the auditor in completing audit procedures in these areas (see our comments below under “Scope” for further specifics). Since the standard establishes requirements and provides guidance *additional* to that contained in other relevant ISAs, we believe that the title of extant ISA 501 is more informative and on point than the title of the proposed standard. We also suggest that the term “Selected” rather than “Specific” items would be more appropriate since only a few of the many specific items that could be included in a standard are addressed. Our suggested title revision therefore is as follows:

ISA 501, Audit Evidence – **Additional Considerations for Selected Items Regarding Specific Financial Statement Account Balances and Disclosures**

In the event that the Board would be reluctant to return to the more limited title of the extant ISA 501, including our suggested change from “Specific” to “Selected,” we believe it would be preferable to refer to audit evidence regarding “Assertions” rather than “Balances,” for the reason cited above. Our suggested title revision in this instance tracks the scope and is as follows:

ISA 501, Audit Evidence Regarding **Certain Assertions and Related Considerations for Specific Financial Statement Account Balances and Disclosures**

### Scope

While we recognize that this standard has been redrafted and not revised, we would like to express concerns regarding the scope of the ED as it relates to inventory and litigation and claims.

#### *Inventory*

Although paragraph 1 states that the standard deals with “certain assertions and related considerations” and paragraph 4 highlights “existence and condition,” we are concerned that a reader might get the impression that the procedures in paragraphs 4 - 8 are all that is required for an audit of inventory, especially since the section title is simply “Inventory.” Therefore, we recommend that the Board clarify that the standard: 1) does not cover all necessary audit procedures related to inventory; 2) only covers procedures related to physical inventory observations and inventory held at third parties; and 3) does not cover all relevant assertions related to inventory (for example, rights and obligations). As part of doing so, we recommend that the Board indicate that the ISA does not deal with other important auditing

procedures that generally are required to obtain sufficient appropriate audit evidence for inventory balances.

In addition, we find the ED to be written as if a full physical inventory is always performed, without acknowledging that some companies that utilize perpetual inventory approaches may instead perform periodic cycle counts. We believe the standard should address this and provide guidance to auditors on how to observe such cycle counts, because it is a different process. Along these same lines, we believe the standard should include some discussion of the auditor's evaluation of management's controls around the existence and condition of inventory. For example, as a starting point for incorporating guidance around cycle counts into the standard, we recommend language acknowledging that some companies may have inventory controls or methods of determining inventories that would obviate the need for an annual physical count of each item of inventory (and then provide guidance to the auditor for such situations).

Further, paragraph 7 describes what the auditor shall do if attendance at the entity's physical inventory count is impracticable. We note that the ED makes no similar mention of what the auditor shall do if management does not take an inventory count (i.e., neither an annual nor cycle). We therefore recommend that the beginning of paragraph 7 be modified as follows (see below under "Requirements" for our further comments on paragraph 7):

**"If attendance at the entity's physical inventory count is impracticable, or if the entity does not perform a physical inventory count,"**

Please also see our comments later in this letter under "Requirements" regarding paragraphs 6 and 7 and the use of the terms "impracticable" and "unforeseen circumstances."

### *Litigation and Claims*

In paragraphs 9 through 12, the ED describes a number of limited procedures regarding litigation and claims. We have two comments regarding this section: First, there is significantly more guidance that could be provided on the topic, especially given the practice issues that exist in many jurisdictions related to auditors' considerations of litigation and claims (see, for example, our comment on paragraph 11(b) in Appendix B). As the Board considers the future role of the IAPSSs, we recommend that the Board also consider whether additional guidance is necessary to address many of the practice issues that exist regarding litigation and claims.

Second, we also believe it would be helpful if the Board would elaborate on whether the term "claims" refers only to claims for damages that are asserted in a court process or if the term is intended to cover insurance claims as well.

### **Requirements**

#### *Inventory*

- In general, we believe that something that is explicitly mentioned in an objective ought to have an explicit requirement to support it. As it relates to inventory, the objective of the ED in paragraph 3(a) includes "The existence and *condition* of inventory (*emphasis added*)," but the requirements do not appear to contain anything specific regarding condition of inventory. We note that paragraph 4(b) includes "inspecting the inventory," but we do not believe that this

adequately covers condition.<sup>1</sup> Therefore, we recommend that the Board bring language from paragraph A6 (or similar language regarding condition) into paragraph 4(b) (or elsewhere in the Requirements section) to fully provide a requirement that supports the objective in paragraph 3(a).<sup>2</sup>

- Paragraph 6 refers to “unforeseen circumstances” that preclude the auditor from attending the entity’s physical inventory count, but the ED does not provide any examples of such “unforeseen circumstances.” We believe that when such circumstances arise, attendance at the entity’s physical inventory becomes “impracticable” as described in paragraph 7. However, the auditor’s required response in paragraphs 6 and 7 differs, which suggests that a clear distinction between “unforeseeable” and “impracticable” circumstances exists.

Per paragraph 6, “...the auditor shall make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions.” Per paragraph 7, “...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 opinion in the auditor’s report....”

We suggest that the IAASB consider whether such a distinction is necessary, and if considered necessary, clarify what is meant by “impracticable” versus “unforeseen circumstances,” as we are unsure of the need for both paragraphs 6 and 7 - could these two paragraphs be combined with benefit to clarity? We do not think it would be useful for auditors and others to spend time debating whether something was “unforeseen” versus “impracticable” when the focus should be on (1) attending the entity’s physical count if possible, and (2) if not present at such a count, performing whatever procedures are needed to obtain sufficient appropriate audit evidence regarding existence and condition of inventory.

- We also note that no mention is made of cutoff procedures in the requirements section of this ISA, when one would think that obtaining information about management’s cutoff would be important in auditing the existence of inventory.

### *Segment Information*

Paragraph 14 requires auditors to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information by performing analytical procedures, which represents a change in the flexibility that exists in the present tense statements in extant ISA 501. We do not believe that this elevation to make analytical procedures the sole fixed requirement is appropriate, as 1) analytical procedures are not always the best way to test presentation and disclosure assertions, and 2) there are circumstances in which analytical procedures are unnecessary (for example, when segment information is based on subsidiary financial information that has been audited). We also believe that the phrase “where appropriate” in paragraph 14(b) is redundant with the phrase “appropriate in the circumstances” in the first sentence. We therefore recommend that paragraph 14 be modified as follows:

“The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting

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<sup>1</sup> Paragraph 4(b) states that the auditor shall obtain sufficient appropriate audit evidence by “observing management’s count procedures, inspecting the inventory, and performing test counts.”

<sup>2</sup> Paragraph A6 states, “Inspecting inventory when attending the entity’s physical inventory count assists the auditor in...identifying, for example, obsolete, damaged or ageing inventory.”

framework by performing ~~analytical procedures and other~~ audit procedures appropriate in the circumstances, such as including:

- (a) Obtaining an understanding of the methods...; **and**
- (b) ~~Where appropriate, t~~Testing the application of the methods used by management in determining segment information; **and/or**
- (c) Performing analytical procedures or other audit procedures.”

### **Application and Other Explanatory Material**

We believe the following application and other explanatory material should be elevated to requirements:

#### *Inventory: Attendance at the Entity’s Physical Inventory Count – Final Inventory Records*

Paragraph A8 states that the auditor *may* obtain copies of management’s completed physical inventory count records. We believe that auditors should be required to obtain (or at least review) copies of management’s completed physical inventory count records at some point in the audit.

#### *Inventory: Physical Inventory Count Conducted Other Than At The Date of The Financial Statements*

Paragraph A10 states that in evaluating the reliability of inventory quantities included in an entity’s perpetual inventory records, the auditor “may consider” (1) the reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records and (2) whether the perpetual inventory records are properly adjusted. In the supplement to the ED, the Board explains that this paragraph was not included as a requirement because it merely provides guidance on the application of the paragraph 5 requirement in the context of a client’s perpetual inventory system. We disagree that these considerations are optional in perpetual inventory system situations, regardless of the timing of the testing. Consequently, we believe that paragraph A10 should either be elevated to a conditional requirement or the Board should explain more clearly in the standard how this guidance reflects the application of the paragraph 5 requirement in the context of a client’s perpetual inventory system.

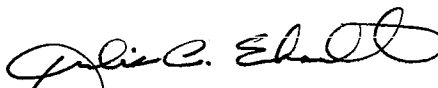
#### *Litigation and Claims: Completeness of Litigations and Claims*

Paragraph A17 notes that an auditor “may consider” reviewing legal expense accounts and examining source documents such as invoices for legal expenses in designing procedures to become aware of litigation and claims. We believe that review of such accounts and examination of such documents would facilitate the identification of litigation and claims in virtually all audits. Therefore, it is not apparent why such a procedure is not a requirement in this ISA. If not elevated to a requirement, we believe the coverage of this procedure should be enhanced in the application and other explanatory material section. In addition, we find mention that the auditor may consider reviewing post-year-end disbursements to be missing from paragraph A17. Therefore, we recommend adding it in this section of application and other explanatory material as an additional tool for use in becoming aware of litigation and claims involving the entity.

In addition to the general comments we have made in the preceding text, Appendix A contains our responses to the questions in the Explanatory Memorandum accompanying ISA 501, and Appendix B contains additional comments.

Thank you for the opportunity to comment on this ED. If you have any questions or need additional information regarding this comment letter, you may contact me or Susan Koski-Grafer at 202-551-5300, or any member of the IOSCO Standing Committee No. 1 Auditing Subcommittee.

Sincerely,

A handwritten signature in black ink, appearing to read "Julie A. Erhardt". The signature is fluid and cursive, with a large initial "J" and "E".

Julie A. Erhardt

Chair

IOSCO Standing Committee No. 1

## **Appendix A: Responses to Request for Specific Comments in the Exposure Draft**

- 1. Do you agree with the proposal to remove the requirement and guidance on auditing the valuation and disclosure of long-term investments?**

We agree with the Board's proposal based upon the rationale articulated in the Explanatory Memorandum.

- 2. Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?**

We believe that the objectives as stated in the ED are appropriate.

- 3. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors?**

We generally believe that the criteria identified by the IAASB for determining whether a requirement should be specified have been applied appropriately and consistently; however, please see our specific comments elsewhere in this letter.

## Appendix B: Additional Comments

### Requirements

#### *Inventory*

In paragraph 8, we agree with the change to not mandate confirmation requests for all circumstances. However, we suggest the following revision to more clearly emphasize that the focus is on the auditor obtaining sufficient appropriate audit evidence, whether confirmation or some other appropriate procedure is utilized:

“When inventory under the custody and control of a third party is material to the financial statements, the auditor shall **either obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by:**

- (a) Requesting confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity; or
- (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.~~

#### *Litigation and Claims*

- Paragraph 11(b) requires the auditor to modify the opinion on the auditor’s report in accordance with proposed ISA 705 (Revised and Redrafted), *Modifications to the Opinion in the Independent Auditor’s Report*, when the entity’s external legal counsel refuses to respond “appropriately” to the auditor’s letter of inquiry and alternative audit procedures can not be performed. Given the practice issues that exist in many jurisdictions related to auditors’ considerations of legal responses, we believe that additional guidance should be provided in the Application Material on what constitutes an “appropriate” vs. “inappropriate” legal response under the standard.<sup>3</sup>
- In order to be consistent with the rest of the ED (such as, paragraphs 3, 4, 7, 8, and 14), we recommend inserting “sufficient appropriate” in front of “audit evidence” in paragraph 12, so that it reads as follows: “The auditor shall obtain **sufficient appropriate** audit evidence about the status of litigation and claims... up to the date of the auditor’s report.”

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<sup>3</sup> For example, we believe guidance concerning the distinction between a lawyer’s refusal to respond (which would be a limitation on the scope of the audit sufficient to preclude an unmodified opinion) and their inability to respond concerning the likelihood of an unfavorable outcome of litigation and claims or the amount or range of potential loss because of inherent uncertainties (which may or may not preclude an unmodified opinion) would be a relevant starting point for the development of further guidance around appropriate responses in ISA 501.



**Application and Other Explanatory Material**

*Inventory: Physical Inventory Count Conducted Other Than At The Date of The Financial Statements*

Since paragraph A9 relates to substantive testing at an interim date, we recommend that the Board consider adding a discussion and/or reference to paragraph 23 of ISA 330, *The Auditor's Response to Assessed Risks*.<sup>4</sup>

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<sup>4</sup> Paragraph 23 of ISA 330 states, "When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing: (a) Substantive procedures, combined with tests of controls for the intervening period; or (b) If the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end."