

## **ISA (UK) 501 AUDIT EVIDENCE – SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (LECTURE A638 – 13.14 MINUTES)**

There are certain items contained within an audited entity's financial statements which require specific considerations where audit evidence is concerned and these relate to:

- inventory;
- litigations and claims; and
- segment information.

The objective of ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items* is for the auditor to obtain sufficient appropriate audit evidence in relation to:

- (a) the existence and condition of inventory;
- (b) completeness of litigation and claims involving the entity; and
- (c) presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

### **1.1 Inventory (stock and work in progress)**

Where inventory is considered material to the financial statements, the auditor must attend the inventory count (unless impracticable – see later). Attending an inventory count is an observation procedure, primarily to evaluate the effectiveness of management's instructions and whether the inventory count is being carried out in such a way so as to reduce the risk of material misstatement in the closing inventory valuation.

When the auditor attends the inventory count, they have to carry out certain procedures to comply with paragraph 4(a) of ISA (UK) 501 as follows:

- evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
- observe the performance of management's count procedures;
- inspect the inventory; and
- perform test counts.

During the detailed audit fieldwork stage, the auditor will then perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Attending the inventory count can serve as test of controls or substantive procedures depending on the overall risk assessment of the auditor, the planned approach and the specific procedures which have been carried out.

There are a number of factors which the auditor must consider at the planning phase of attending an inventory count, such as:

- 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 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 (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* deals with the 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. ISA (UK) 620 *Using the Work of an Auditor's Expert* deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

### ***Observing management's instructions***

The primary aim where the observation of management's instructions is concerned is to evaluate whether these instructions will reduce the risk of material misstatement. Paragraph A4 of ISA (UK) 501 outlines various factors which the auditor must also consider and whether management's instructions address:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory 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 cut-off date.

### ***Observing management's count procedures***

The objective here is to enable the auditor to obtain audit evidence that management's instructions and count procedures are adequately designed and

implemented so as to reduce the risk of material misstatement in the valuation of inventory. An example would be observing the control over the movement of inventory before, during and after the count.

During such tests, the auditor may obtain information relating to cut-offs to ensure that these have been correctly applied and obtaining details of inventory movement.

### ***Inspecting the inventory***

The auditor must inspect the inventory which will help to satisfy the existence assertion (although this will not necessarily satisfy the rights and obligations assertion). Inventory inspection will also help the auditor to evaluate the condition of the inventory and whether such inventory might need writing down to estimated selling price, for example if the inventory is damaged, obsolete or slow-moving.

### ***Undertaking test counts of inventory***

During the attendance at inventory count, the auditor must undertake test counts. These are usually performed in a two-way direction (sheet to floor and floor to sheet).

Tracing items from the floor to sheet provides the auditor with evidence concerning the completeness and accuracy of the inventory records. Tracing items from sheet to floor provides the auditor with evidence concerning the existence and the condition of inventory.

It is advisable to mark those items of inventory which have been tested by the auditor at inventory attendance to allow them to be checked to the final inventory valuation during the detailed audit fieldwork to ensure they have been included correctly in the final stock valuation.

### ***Inventory count conducted other than at the year-/period-end***

In certain situations, it might be the case that the inventory count is not undertaken as at the year-end (or period-end). For example, an audit client with a 31 December year-end might close down for Christmas a week prior to the financial year-end and hence undertake the inventory count on the last day before the Christmas break.

Where an inventory count is undertaken at a point other than at the balance sheet date, then the auditor must obtain sufficient appropriate audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

If a perpetual inventory system is in place, management may perform physical counts or other tests to ascertain the reliability of the inventory quantity information contained in the stock valuation records. Where differences are noted between the perpetual inventory records and the actual physical count, care must be taken because this might indicate that controls over changes in inventory are not operating as effectively as they should. Factors which should

be considered when designing audit procedures to obtain audit evidence concerning changes in inventory amounts between the date of the count and the balance sheet date include:

- (a) Whether the perpetual inventory records are properly adjusted.
- (b) The reliability of the entity's perpetual inventory records.
- (c) The reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records.

Where the audited entity does not operate a perpetual inventory system, the provisions in paragraphs 22 and 23 of ISA (UK) 330 *The Auditor's Responses to Assessed Risks* are triggered. These two paragraphs provide guidance on substantive procedures which are to be performed at an interim date.

Paragraph 22 says that if 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.

Paragraph 23 of ISA (UK) 330 then goes on to say that if misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified.

Essentially what the auditor is trying to achieve where the inventory count is conducted at a date which is not sequential to the balance sheet date is to establish whether the effectiveness of the design, implementation and maintenance of controls over changes in inventory will reduce the risk of material misstatement in the closing inventory valuation.

### ***Attendance at inventory count is impracticable***

Where inventory is deemed material to the financial statements, then the auditor must make every attempt to attend the inventory count to observe the effectiveness of the count. There are occasions, however, when it is deemed impracticable for the auditor to attend the inventory count, for example because the location of the inventory may pose a threat to the auditor. Reasons of impracticability are quite rare and the UK ISA does acknowledge that general inconvenience would not be a valid reason for the auditor not to attend the inventory count. In addition, factors such as difficulty, time or cost involved are also not considered to be valid reasons not to attend the inventory count.

Where valid reasons do exist that give rise to the auditor not being able to attend the inventory count, then alternative audit procedures could be deployed. For example, inspection of documentation on the subsequent sale of specific items of inventory which have been purchased prior to the physical inventory counting may provide audit evidence towards satisfying the existence and condition of inventory.

Where it is not possible to obtain sufficient appropriate audit evidence relating to the existence and condition of inventory through alternative audit procedures, the audit opinion will need to be modified due to a scope limitation (insufficient evidence).

### ***Inventory under the custody and control of a third party***

Where inventory is under the custody and control of a third party, the provisions in ISA (UK) 505 *External Confirmations* will be triggered where external confirmations are considered necessary (see Section 10 of these notes).

Where the auditor has concerns about the integrity and objectivity of the third party, other audit procedures will more than likely be necessary in addition to, or instead of, external confirmations. Such procedures could include:

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

## ***1.2 Litigation and claims***

Auditors are required to obtain sufficient appropriate audit evidence relating to the completeness of litigations and claims involving the audited entity. Quite often litigation can be contentious and disclosure of certain litigation and claims in the financial statements might be viewed as seriously prejudicial and hence can be quite a sensitive area for auditors (in some cases input from the entity's lawyers might be necessary where disclosures might prove prejudicial).

Paragraph 9 of ISA (UK) 501 says that the auditor shall design and perform audit procedures so as to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Such procedures involve:

- (a) inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

- (b) reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) reviewing legal expense accounts.

These procedures are not exhaustive and the auditor should also undertake other procedures, such as using information they have obtained via risk assessment procedures which have been carried out as part of obtaining an understanding of the audited entity and its environment.

There is an interaction between ISA (UK) 501 and ISA (UK) 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. This will happen where audit evidence relating to litigations and claims give rise to a risk of material misstatement which may call into question valuation or measurement issues relating to litigation and claims. Where this happens, then the provisions in ISA (UK) 540 provides guidance relevant to the auditor's consideration of litigation and claims which require accounting estimates or related disclosures within the financial statements.

#### ***Reviewing legal expense accounts***

The auditor must consider whether it is appropriate to review legal expense accounts which might provide evidence concerning litigation and legal claims. Many 'off-the-shelf' audit programmes often include a test to review the nominal ledger accounts for such expense accounts during the audit of provisions and contingencies and hence in many cases this test will be carried out as a matter of routine.

#### ***Communicating with the entity's external legal counsel***

The auditor may consider it appropriate to enter into dialogue with the entity's legal counsel to obtain sufficient appropriate audit evidence concerning potentially material litigation and claims. Such communication will more than likely need the client's consent. In some cases, however, external legal counsel might not respond to a *general* enquiry from the auditors because they are prohibited from so doing by the Law Society. It might be more beneficial, therefore, to seek direct communication through a letter of *specific* inquiry. A letter of specific inquiry includes:

- (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 external 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 external legal counsel to be incomplete or incorrect.

In rarer cases, it might be considered necessary for the auditor to meet with the audited entity's external legal counsel to discuss the likely outcome of the litigation or claims. Such meetings would be judged necessary where:

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

- (b) The matter is complex.
- (c) There is disagreement between management and the entity's external legal counsel.

Where such meetings are judged necessary, management's permission will be needed, but in the UK permission may be denied by those charged with governance.

The auditor is also required to date the auditor's report no earlier than the date on which they have obtained sufficient appropriate audit evidence on which to base their audit opinion. As a result, the auditor might need to obtain updated information from the entity's external legal counsel.

### **1.3 Segment information**

Certain entities might be required to disclose segment information (such as those reporting under EU-adopted IFRS to comply with IFRS 8 *Operating Segments*).

The auditor's responsibility in respect of the presentation and disclosure of segment information is in respect of the financial statements taken as a whole. Therefore, the auditor is not required to express an opinion on the segment information presented on a stand-alone basis.

The *Application and other explanatory material* at paragraph A27 outlines examples of matters which may be relevant when obtaining an understanding of the methods used by management to determine such segmental information and whether these methods will enable disclosure of segment information to be compliant with the financial reporting framework. Such matters include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profit 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.