The audit of inventories

Why is it important? Easiest assets to manipulate

- **Misstatement affect reported profit**: misstatement of inventory balances has a direct effect on reported profit.
- **Inventories identification**: some inventories can be very difficult for an auditor to identify stock of gas reserve. Need an **expert** to estimate the quantity- ISA 620” using the work of an expert.
- **Inventories difficult to establish**: the quantities of inventory held at a specific given moment may be difficult to establish. It may not be possible to cease inventory movements during the inventory count and **cut off** may be hard to establish with precision.
- **Valuation**: difficult for certain products e.g. antiques-no active markets, hospital which is working 24/24 hours.
- **Inventory losses**: from pilferage, wastage, obsolescence, damage, dormant stock.
- **Inventories may be intangible**: some very significant work in progress balances may be **intangible** in nature.

Risks associated with inventory

- **Inadequate or inappropriate inventory held**: to meet the demands of sales and production e.g. stock out
- **High inventory levels** resulting in poor cash flow and financial loss.
- **Inaccurate or incomplete record** of inventory movements resulting in lack of awareness of the actual inventory position and difficulties in meeting customer needs.
- **Lack of security** over inventory resulting in loss, theft or misappropriation.
- **Obsolete inventory** held or incorrectly supplied to customers, resulting in financial loss and damage to reputation.

Physical inventory counts

The 2 methods of carrying out inventory counts are:

1. **Periodical**: made at or close to the year end.
2. **Perpetual**: counting on a **continuous** basis over the whole year.
   - Each item is physically inspected at **least once a year**, and more frequently in the case of items liable to loss.
   - **Adequate records** are kept up to date.
   - The **records are amended and signed as a result of physical inspection** and that there are appropriate reports and **investigation procedures for discrepancies**.
Organization of counting - client procedures

It is the responsibility of management to count inventory.

1. **Permanent organization** of the stores:
   - Location and records of goods: goods are kept in bins or on racks, with complete description of each item stated in the bin cards.(in and out)
   - Goods are protected against deterioration.
   - Restriction of access to stores: to avoid misappropriation.
   - Goods held for third parties, and slow moving, obsolete inventories, etc are identified and separated.
   - Stores area should be tidy.

2. **Instructions** for counting

Comprehensive stocktaking instructions are laid down for the undertaking of the stock take. Management should implement the following controls when carrying out an inventory count:

   - All stocktaking staff must be fully familiar with stock to enable them to identify damaged or sub standard goods.
   - Areas of responsibilities.
   - A responsible officer must be responsible for the issue and collection of all stock sheets.
   - Stock sheets should be sequentially numbered.
   - All stock sheets must be signed by the stock taker.
   - Any changes on the stock sheets must be initialed by stocktaker.
   - No stock movement during the stock take, keep a special bay for dispatch/receipts during stocktake.
   - Staff should record the condition of the items in stock.
   - Staff should count the stock in a systematic way.
   - The stocktake must be supervised by senior official within the organization.
   - Assistance of internal auditor.
   - Those staff involved in the stocktake must not be responsible for the day to day custody of the items.
   - Proper procedures for reconciliation of the physical stocktake with the stock records.

**The auditor and the inventory count**

**Auditor’s attendance at counting**

ISA 501: ‘when inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by the attendance at physical inventory counting unless impracticable.’
Attendance enables the auditor to:

- Inspect inventory.
- Observe compliance to proper stock count procedures in order to provide evidence as to the reliability of the stock count exercise.

Where the count is not attended on the date planned due to unforeseen circumstances the auditor should take or observe some physical counts on an alternative date if possible.

**Note: it is client responsibility to carry out the stock count where the auditor can perform test counts on sample basis.**

**AUDITORS RESPONSIBILITIES AND DUTIES FOR A STOCK COUNT**

1) **Before the count: planning**

- **Review and planning:** review prior year’s working papers, familiarize themselves with the nature volume and location of inventories, consider the controlling and recording procedures over inventory and the timing of the count.
- **Problem identification and reliance:** identify problem areas in relation to the system of internal control and decide whether reliance can be placed on internal auditors.
- **Risk and materiality:** assess inherent, control and detection risks and establish materiality.
  - Inventory held by third parties: arrange third party confirmation of inventories held by third parties—depending on materiality, the auditors should also consider the integrity and independence of the third party and whether it is necessary to arrange for other auditors to observe the count or whether it is sufficient to obtain another auditor’s report on the adequacy of the third party’s systems or merely to inspect relevant documentation held at client place.
  - **Expert assistance:** if the nature of the inventories is specialized then the auditor will need to arrange expert help.
  - **Counting instructions:** examine the client’s counting instructions: if found to be inadequate, the matter should be discussed with the client with a view to improving them prior to the inventory count.

2) **During the counting**

When the auditor attends stocktake, he will carry out the following:

- Observation that the controls within the stocktaking instructions are being adhered to.
- Stock is counted systematically by client’s staff.
- Ensure that there is no movement of stock to be counted by the stock count teams.
- If stock is recorded by weight, weight a sample.
• If stock is in sealed boxes, the auditor must open a sample of boxes to confirm the quantity in each box.
• Inspection of goods to make notes of damaged or obsolete stock.
• The gathering of cut off details such as goods received notes and delivery notes numbers to be followed up after stock take.
• Ensure exclusion of third party stock.

3. **After the counting**

There are 3 objectives after stocktake:

**Existence**

- Follow up all test count.
- Ensure exclusion of third party stock.
- Ensure exclusion of damaged or obsolete stock.
- Ensure all stock sheets have been accounted for.
- Perform cut off tests.
- Investigate any significant differences between the physical stocktake and the stock record.

**Valuation**

**Analytical review**

**Cut off procedures**

Cut off highlights the fact that the balance sheet date divides two accounting periods, and the purpose of the correct cut off procedures is to ensure the correct allocation of all transaction to the period to which they relate.

**Cut off tests- stocktake at year end**

**Sales cut off**

• Select sales invoices before the year end ensuring that the number sequence was complete.
• Match these sales invoices to the corresponding dispatch notes before the year end.
• If a sales invoice has been issued but no dispatch not has been raised, the stock must be excluded from the stocktake and treated as third party stock.
• Accordingly, the sales account and debtors ledger must be updated as well as the stock record.
• Similarly a sample of dispatch notes should be matched to corresponding sales invoices and the sales record to detect cases of understatement.
• The above tests will be repeated for sales just after the year end.

**Purchases cut off**

• Select a sample of GRN and ensure completeness of population by checking sequential numbering.
• Ensure that the GRN can be matched with an invoice and that the purchase ledger and purchases account has been updated. If not, a provision for accrual should be made.
• Ensure that the stock record has been updated accordingly.
• Similarly the purchase invoices will be matched with GRN to detect cases where goods have not yet been received.
• The above tests will be repeated for goods received after the year end to ensure that they have not been included in the year end stocktake and that the corresponding invoice has been included in the following year results.

**Cut off tests- stocktake before year end (two cut off dates)**

If the stocktake is to be performed before the year end, the auditor will have to perform two separate sets of cut off tests.

• Ensuring physical cut off to the stock records.
• Check purchase accruals and debtors to be performed at the year end.

**Purchases cut off**

• Select a sample of sequentially numbered GRN before the stocktake date and ensure a like entry has been made in the stock records.
• Select some sequentially numbered GRN after the stocktake to ensure that these deliveries were not entered into the stock records until after the stocktake date.

**Sales cut off**

• Select a sample of sequentially numbered DN before the stocktake date and ensure that a corresponding entry had been made in the stock records.
• Similarly, the test will be repeated for despatches after the stock date.
Inventory valuation procedures

Raw materials and consumables

- Ascertain what elements of cost are included e.g. carriage in, duties. Etc
- If standard costs are used, enquire into basis of standards, how these compare with actual costs and how variances are treated.
- Test check cost prices used with purchase invoices received in the month(s) prior to counting.
- Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a net realizable value.

Work in progress

- Ascertain how the various stages of process are measured and if estimates are made, on what basis they are made.
- Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and review this basis with the available costing and financial information.
- Ensure that any material costs exclude any abnormal wastage factors.

Finished goods and goods for resale.

- Enquire into what costs are included, how these have been established and ensure that the overhead included is based on normal costs and is reasonable in relation to the information disclosed by the draft FS.
- Test check prices on inventory lists with official sales price list, bearing in mind any trade discounts which are normally granted off the list prices.
- Ensure that inventories are valued at net realizable value if this is less than cost. For any such items, also check back and see if the relevant partly processed inventories and raw materials have also been written down.
- Follow up any items which is obsolete, damaged, slow moving ascertain the possible realizable value of such items.
- Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete.