IMPORTANCE OF INVENTORY

Inventory is important to the audit for many reasons:

In many companies, it is likely to be a very material figure (and is included both in the Statement of Financial Position and the Statement of Profit or Loss).

Inventory valuation may be extremely difficult, especially where the Inventory is specialist or where there is work-in-progress.

Where Inventory items are small and valuable, there is a high risk of theft.
Inventory values may be heavily reliant on a year-end Inventory count (which auditors are likely to attend)

Inventory items may not all be at the client premises

Where Inventory is moving near the year-end, the precise date of a sale or purchase may be hard to assess (and may not tie in with the invoice date)

Valuation of WIP and overhead allocation can be subjective

Issue of slow moving and obsolete stock - saleability affected by demand and competition - pharmaceuticals become out of date.

Third party inventory

Physical controls and susceptibility to theft, false sales, movement between different locations.

IAS 2 - Inventories and IAS 11 - Construction Contracts.

Timing of inventory counts and reliability of roll forward procedures if count not at year end.

Degree of fluctuations in inventory levels

As a result, Inventory is often audited by relatively senior members of the audit team.
Inventory Counting Procedures

The Inventory count is an extremely useful piece of audit evidence, so wherever Inventory is a material figure, auditors are likely to attend at least 1 Inventory Count per year.

By attending, auditors can assess the quality of the count. As an Inventory Count is a form of internal control, Inventory Count attendance by the auditor is therefore primarily a TEST OF CONTROL.

The auditor will assess such issues as:

- How Inventory sheets are controlled, to ensure that none are lost
  - Stock sheets serially numbered
  - Control and return of all stock sheets,
  - Sheets completed in ink and signed
  - details to be shown on stock sheets, recording quantity, condition,
  - Record details of last forms used
  - Recording of quantity, condition and stage of production of WIP
  - Recording of number of last GRN and GDN and internal transfer slips (cut-off)
  - Reconciliation of count to inventory record and investigation and correction of differences

- The structure of counting teams i.e. teams of two counters
- Whether initial counts are being checked by a separate counting team
- How the count is planned, to ensure that all areas are counted once and only once - avoid double counting
Whether counting staff are provided with instructions and are following those instructions

Whether staff are counting areas that they have normal responsibility for

How they are dealing with Inventory that is moving during the count

Also, while attending, the auditors can carry out SUBSTANTIVE procedures:

- Test Completeness, by selecting items of Inventory that can be physically seen, and tracing them to the Inventory count sheets
- Test Existence, by selecting items of Inventory from the Inventory count sheets, and physically confirming their existence
- Test Accuracy, by noting the condition and age of the Inventory, and the completeness of work-in-progress
- Test Cut-Off by noting the last GRN and GDN numbers
- Where Inventory items are at other locations, the auditor may require written confirmation of items held from a third party

**Different Types Of Inventory-Count**

Many companies perform a full year-end count. However, other methods exist:

**Year End Count:** Happens as close the Year End as possible and in general it operates as the company’s control to ensure that all the inventory on hand is counted and agreed to the Year end balance. Is disruptive to the client operations as trading is likely to be suspended during the count
**Continuous Inventory Counting** involves counting part of the Inventory every few weeks or months, so that over the course of the year all items are counted at least once. Auditors may attend one or more of these counts to establish whether the counts are reliable, and whether errors are properly adjusted on the Inventory system records. Perpetual/Continual counts are less disruptive to the trading operations of the business than a full year-end inventory count.

It may not always be possible for a company to carry out a full year-end count, so they may count a few days before or after the actual year-end. Auditors may need to perform “roll-back/forward” tests on goods movements between the count and the year-end. Acceptable provided records of inventory movements in the intervening periods are maintained such that movements can be examined and substantiated.

**Assertions**

For Inventory, the most important assertions to test are those where the risk of error or misstatement is greatest. As inventory is an asset, it is liable to be overstated so as to boost total assets and increase profits by reducing costs of sale.

**Existence**

Inventories recorded in the Accounts may not exist if they have been stolen (especially if they are small, high value items).

**Accuracy/Valuation**

Inventories should be recorded at the lower of cost or Net Realisable Value (NRV).

In a manufacturing company, cost will be made up of many elements - materials, labour, and absorbed overheads - and this increases the chance of error (deliberate or otherwise).

Cost will also be complicated where there is work-in-progress, or specialist items.
Inventories will be overvalued if their NRV has fallen below cost without adjustments being made. In industries where fashion or technology change quickly, sales prices may fall quickly.

A similar problem arises where products "go off", for example with food.

**Cut-Off**

Cut-off may be a problem, especially where there are many goods movements around the year-end.
Substantive Audit Procedures Used in relation to Inventory

Existence

Attend a physical inventory count at year end and complete the inventory count audit programme.

The effectiveness of inventory counting procedures should be tested by direct observation, supported by inspection of documents and re-performance of test counts.

Take copies of inventory sheets and compare with the final inventory figures to ensure that there have been no additions or omissions.

If inventory count is carried out before the balance sheet date, perform a roll forward calculation, taking opening balance and movements during the period to arrive at the expected closing balance.

Completeness

Ensure that any inventory held by third parties on behalf of the client are included in the final inventory figure.

Final Audit Work on Cut Off

Select the final 10 Goods Despatch Notes (GDN's) of the year and trace the corresponding sales invoices to ensure they are recorded in pre year-end sales.
Repeat this process for Goods Received Notes (GRN’s) and purchase invoices.

Select the first 10 GDN’s and GRN’s of the new year, and trace to invoices to ensure not recorded before the year-end

**Final Audit Work on Accuracy**

**Cost**

Cost should comprise all costs of purchase ((including taxes, transport, and handling) net of trade discounts received), costs of conversion ((including fixed and variable manufacturing overheads), and other costs incurred in bringing the inventories to their location and condition.

- In a non-manufacturing company, agree cost to purchase invoices
- For a manufacturer, all elements of the cost card should be verified:
  - Agree materials prices to recent purchase invoices
  - Verify materials quantities by observation, discussion with production staff, or by inspecting stores requests
  - Agree labour rates to payroll
  - Verify labour hours quantities by observation, discussion with production staff, or by reference to timesheets
  - Consider reasonableness of overhead absorption method (e.g. by comparison with prior year methods)
  - Analyse absorbed overheads to ensure overheads absorbed are production only and on basis of normal production levels.

- Obtain a copy of the reconciliation between the closing inventory figure per the inventory control account in the nominal ledger and the inventory listing. Obtain explanations for any large or unusual reconciling items and agree the inventory
figure per the control account to the inventory figure in the financial statements.

**Final Audit Work on Accuracy - NRV**

For a sample of Inventory items, ensure NRV > Cost by analysis of sales prices achieved after year-end (or shortly before year-end if necessary).

For items noted as damaged, or obsolete, during Inventory Count, consider reasonableness of any provisions made by client (damaged items may have since been repaired and sold, so the auditor should inspect records of repair work done and costs incurred)

**Final Audit Work on Rights and Obligations**

For a sample of items, inspect purchase invoices to confirm that company’s name is present.

Where items are held at a separate location, obtain written confirmation from the relevant third party that the items exist, are in good condition, and belong to the client.

Where items have been bought (or sold) under a consignment Inventory, demonstrator, sale or return, or similar agreement, consider which party has the substance of ownership as at the year-end.
Identify inventory items belonging to third parties and ensure they are excluded from the final inventory summary.

**Final Audit Work on Disclosure**

Agree opening Inventory to last year’s closing Inventory figure.

Agree breakdown of Inventory items (raw materials, work-in-progress etc) to account balances in the nominal ledger.

Ensure correct disclosure of inventory pledged as security for liabilities of the client or third parties.