

1 Attendance at stocktakes (Lecture A692 – 4.49 minutes)

The December 2019 reporting season is almost upon us and auditors will be considering the planning for their December year end audits, particularly attendance at the client's stock count.

Auditors are required to attend stock counts when the value of stock and work in progress is material to the financial statements. Attendance at stock counts is dealt with in ISA (UK) 501 *Audit Evidence – Specific Considerations for Selected Items*. It should be noted that the previous Practice Note 25 which dealt with attendance at stocktaking was withdrawn in December 2018 because much of this guidance is now dealt with in ISA (UK) 501.

The overarching objective to attending the stock count is for the auditor to gather evidence to cover the following assertions:

- existence;
- valuation;
- completeness; and
- rights and obligations.

1.1 Objective of ISA (UK) 501

ISA (UK) 501 requires the auditor to:

- attend the physical stock count (unless impracticable), if inventory is material to the financial statements; and
- perform procedures on the final inventory records to determine whether they accurately reflect the count results.

It is not the responsibility of the auditor to carry out the stock count. The auditor's responsibility is to evaluate management's instructions and procedures for the count; observe the performance of the count; inspect the inventory and perform test counts.

1.2 Prior to the stock count

Before the auditor attends the stock count, they must undertake an element of planning which would normally include:

- performing analytical procedures and discussing any significant variances with management;
- discussing stocktaking arrangements and procedures with management;
- familiarising themselves with the nature of the inventory, volume, identification of high value items and the general accounting method of stock valuation;
- considering the location of the stock;
- considering the quantity and nature of work in progress, quantity of stocks held by third parties and whether an auditor's expert may be required;

- considering the internal controls relating to stocks to identify problems areas (e.g. problems in relation to cut-offs);
- considering whether any internal audit function exists and deciphering the extent to which reliance can be placed on internal audit;
- reviewing the results of previous stock counts; and
- reviewing the prior year audit working papers.

Paragraph 4 of ISA (UK) 501 requires the auditor to attend the stock count if the value of the stock at the balance sheet date is (likely to be) material to the financial statements. Primarily the attendance at stock count is that of an observation test, i.e. to observe whether the procedures adopted by management would reduce the risk of material misstatement in the final stock valuation.

The auditor is required to obtain sufficient and appropriate audit evidence regarding the existence and condition of the inventory, in addition to other procedures, unless physical attendance at the stock count is impracticable.

1.3 During the inventory count

Auditors should attend the inventory count whilst the count is underway as one of the objectives is to ensure that management's instructions are being carried out correctly. Auditors must also ensure that:

- inventory 'teams' are in place so that one person counts whilst another person records the quantities on the 'rough' stock sheets;
- no movements of inventory take place during the count;
- sequentially numbered count sheets and a sequence check is performed of these stock sheets once the count is complete;
- count sheets show the description of the goods but do not show the quantities expected to be counted; and
- damaged and/or obsolete items are separately identified so they can be valued appropriately.

The auditor will usually use an audit programme to undertake the work; however, the auditor should carry out some substantive procedures during the audit which often include:

- selecting a sample of items from the inventory count sheets and physically inspecting the items in the warehouse (this verifies **existence**);
- selecting a sample of physical items from the warehouse and tracing to the inventory count sheets to ensure that they are recorded accurately (this verifies **completeness**);
- enquiring of management whether goods held on behalf of third parties are segregated and recorded separately (this verifies **rights and obligations**);
- inspecting the inventory being counted for evidence of damage or obsolescence that may affect estimated selling price (this verifies **valuation**);
- recording details of the last deliveries prior to the year end. This information will be used in final audit procedures to ensure that no further amendments have

been made thereby overstating or understating inventory (this verifies **completeness and existence**);

- obtaining copies of inventory count sheets at the end of the inventory count, ready for checking against the final inventory listing after the inventory count (this verifies **completeness** and **existence**); and
- attending the inventory count (if one is to be performed) at the third party warehouses (this verifies **completeness** and **existence**).

The timing of the stock count is a critical factor to consider. For example, the client may have an accounting reference date of 31 December, but the year end inventory count may not be undertaken on this particular day (it may be carried out before or after 31 December) and therefore additional procedures may need to be carried out by the auditor, such as roll-back or roll-forward procedures.

The auditor must consider the controls in place over the count. For example, whether the teams carrying out the inventory count are objective and have the necessary experience; what controls the client has over the stock and the susceptibility of stock to theft or deterioration; the degree of fluctuation in stock levels and whether there are any inherent difficulties when it comes to estimates included in the stock valuation.

Sources of evidence relating to the existence of stocks are:

- evidence from audit procedures relating to the reliability of accounting records upon which the stock valuation in the financial statements is based;
- evidence from tests of controls over stock, including the counting procedures; and
- substantive evidence from physical inspections at the stock count.

Where the entity does not maintain detailed stock records, the quantification of stock is likely to be based on a full, physical stock count at the balance sheet date, or very close to the balance sheet date. Evidence to satisfy the existence assertion is therefore greater when the stock count is carried out at the year end, or at a date very close to the year end. This could well provide sufficient and appropriate audit evidence; however the auditor must also be satisfied that the records of stock movement are also reliable in the intervening periods.

1.4 After the inventory count

The auditor is required to carry out certain procedures after the inventory count, which are normally carried out during the detailed audit fieldwork on the financial statements. Such procedures include:

- tracing the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year end and to ensure that any errors identified during counting procedures have been rectified (this verifies **completeness**);

- casting the list to ensure arithmetical accuracy and agree the total valuation to the financial statements and relevant disclosures (this verifies **completeness** and **classification**);
- inspecting purchase invoices for a sample of inventory items to agree their cost (this verifies **valuation**);
- inspecting purchase invoices to ensure the goods are in the name of the client (this verifies **rights**);
- inspecting post year end sales invoices for a sample of inventory items to determine if estimated selling price is reasonable. This will also assist in determining if inventory is held at the lower of cost and estimated selling price less costs to complete and sell (this verifies **valuation**);
- inspecting the ageing of the inventory items to identify old and/or slow-moving amounts that may require an allowance and discussing these with management (this verifies **valuation**);
- recalculating work in progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption (this verifies **valuation**);
- tracing the goods received immediately prior to the year end to year end creditors and inventory balances (this verifies **completeness** and **existence**);
- tracing goods despatched immediately prior to the year end to the nominal ledger to ensure the items are not included in stock and sales (and debtors where relevant) have been recorded (this verifies **completeness** and **existence**);
- calculating inventory turnover/days ratio and comparing this to the prior year to assess whether inventory is being held longer and therefore requires a provision to bring the value down to the lower of cost and estimated selling price less costs to complete (this verifies **valuation** and is an analytical procedure); and
- calculating gross profit margins and comparing this to the prior year. The auditor should investigate any significant differences which may highlight an error in cost of sales and closing stock (this verifies **valuation** and is an analytical procedure).

1.5 Stock held at third parties

Where a third party holds stock on behalf of the client the auditor should obtain external confirmation from the third party of the quantity and condition of the goods to confirm **rights** and **obligations**.

If the goods held by the third party are material, the auditor should attend the inventory count to verify **existence** of the inventory.

The auditor may also obtain a report from the third party's auditors confirming the reliability of the internal controls at the third party.