



ICPAS QUALITY ASSURANCE

Practical Guidance 1

INVENTORY OBSOLESCENCE



INTRODUCTION

1. Market conditions during an economic downturn could bring about decrease in consumer demand, thereby increasing the risk of excess or obsolete inventories or inventories with carrying amounts in excess of net realisable values due to declining selling prices.
2. Such conditions bring about a heightened audit risk for the auditors, especially in the area of inventory valuation.
3. This Practice Guidance aims to provide some practical considerations to auditors when assessing the adequacy and reasonableness of inventories write-down and allowance for inventory obsolescence estimated by management in addressing the valuation assertion.

GUIDING PRINCIPLE

4. Financial Reporting Standard (FRS) 2 "Inventories" establishes that inventories shall be measured at the lower of cost and net realisable value (paragraph 9). Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale (paragraph 6).
5. FRS 2 also states that the practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use (paragraph 28).
6. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period. Estimates of net realisable value also take into consideration the purpose for which the inventory is held (FRS 2, paragraphs 30 and 31).
7. Singapore Standard on Auditing (SSA) 540 "Audit of Accounting Estimates", paragraph 8 requires the auditor to design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances. The auditor should also review the continuing appropriateness of formulae used by management in the preparation of accounting the estimates (SSA 540, paragraph 18).

PRACTICAL APPLICATION

8. As part of the audit planning and risk assessment procedures, the auditor is required to gain an understanding of the general economic environment, the company's business (including significant business and industry developments affecting the company), the nature of inventories held by the company, etc in accordance with Singapore Standards on Auditing SSA 300 "Planning an Audit of Financial Statements" and SSA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment".

General economic environment

9. Consumer demand is usually correlated to the prevailing economic conditions and may significantly reduce during an economic downturn. This in turn may lead to excess or obsolete inventory or inventory with carrying amounts in excess of net realisable values and affect the risk of material misstatement of inventory valuation. As such, auditors need to give careful consideration to areas where there could be a heightened audit risk such as relating to allowance for inventory obsolescence or inventories write-down to net realisable values.

Industry developments

10. Regulations imposed by government authorities can also have an impact on the assessment of inventory obsolescence. For example, the Singapore Customs require all cigarettes in Singapore to be labeled with SDPC (Singapore Duty Paid Cigarettes) with effect from 1 January 2009 which could have an impact on the saleability of cigarettes without the SDPC label. Auditors should be kept updated with such regulations and enquire about management's response and action plans so that any corresponding risk of obsolescence are identified and considered when assessing the adequacy and reasonableness of inventory obsolescence provided by management.

Nature of inventories

11. The nature of inventories is also an important factor for the auditors to consider in assessing the

adequacy and reasonableness of the allowance for inventory obsolescence. Perishable products like fresh fruits and vegetables which have a relatively short shelf life and electronic products such as computers and mobile phones in a fast changing technological environment are subject to a higher risk of obsolescence. On the other hand, generic items like spare parts and hardware generally have longer shelf lives and a lower risk of obsolescence if they are properly stored and handled with due care.

12. Special arrangements with suppliers, if any, could also help mitigate the risk of inventory obsolescence. For example, unsold magazines at bookstores which can be returned to publishers or inventories purchased from a holding company which can be returned unconditionally if unsold.

Observation during inventory count

13. Another avenue which the auditor can gather audit evidence of whether there is any inventory obsolescence is from the physical inventory count which the auditor attend.
14. The auditor should keep a look out on the condition of the inventories during the count. Signs of inventory obsolescence include discoloured, dented, dusty, rusty or expired goods, which should be brought to the attention of management for appropriate follow-up actions to be taken when accounting for them in the books.

Company's provisioning policy for slow-moving inventories

15. If management has an internal provisioning policy for slow-moving and obsolete inventories, the auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence when assessing the reasonableness of the provisioning policy in accordance with SSA 540.
16. For example, if management maintains an ageing report of the inventories based on which provisioning for obsolescence is determined, the auditor should as part of assessing the reasonableness of the provisioning policy, review the accuracy and integrity of the ageing report to ensure that underlying data are captured accurately. SSA 500 "Audit Evidence", paragraph 11 states that in order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate.

17. SSA 540, paragraph 16 states that in evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:
 - Reasonable in light of actual results in prior periods.
 - Consistent with those used for other accounting estimates.
 - Consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

18. SSA 540, paragraph 18 states that the auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting the estimates. Such a review would reflect the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor. Hence, it is important for the auditor to challenge management's provisioning policy each year.

Subsequent events

19. In gathering audit evidence for the net realisable value of the inventories, the auditor would also verify the selling price of the inventories sold after the financial year end to ascertain that inventories are correctly recorded at the lower of cost and net realisable value.

Overall review at the end of the audit

20. SSA 520 "Analytical Procedures", paragraph 2 states that the auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit. Such analytical procedures could include comparisons of the company's financial information such as the inventory turnover (by products) and ageing of inventories with comparable information for prior periods or anticipated results of the entity or similar industry information or with other entities of comparable size in the same industry. Deterioration in inventory turnover or ageing as compared to prior periods could indicate that potential obsolete or surplus inventories issues exist for which more detailed follow-up actions should be taken.

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PRACTICAL GUIDANCE

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