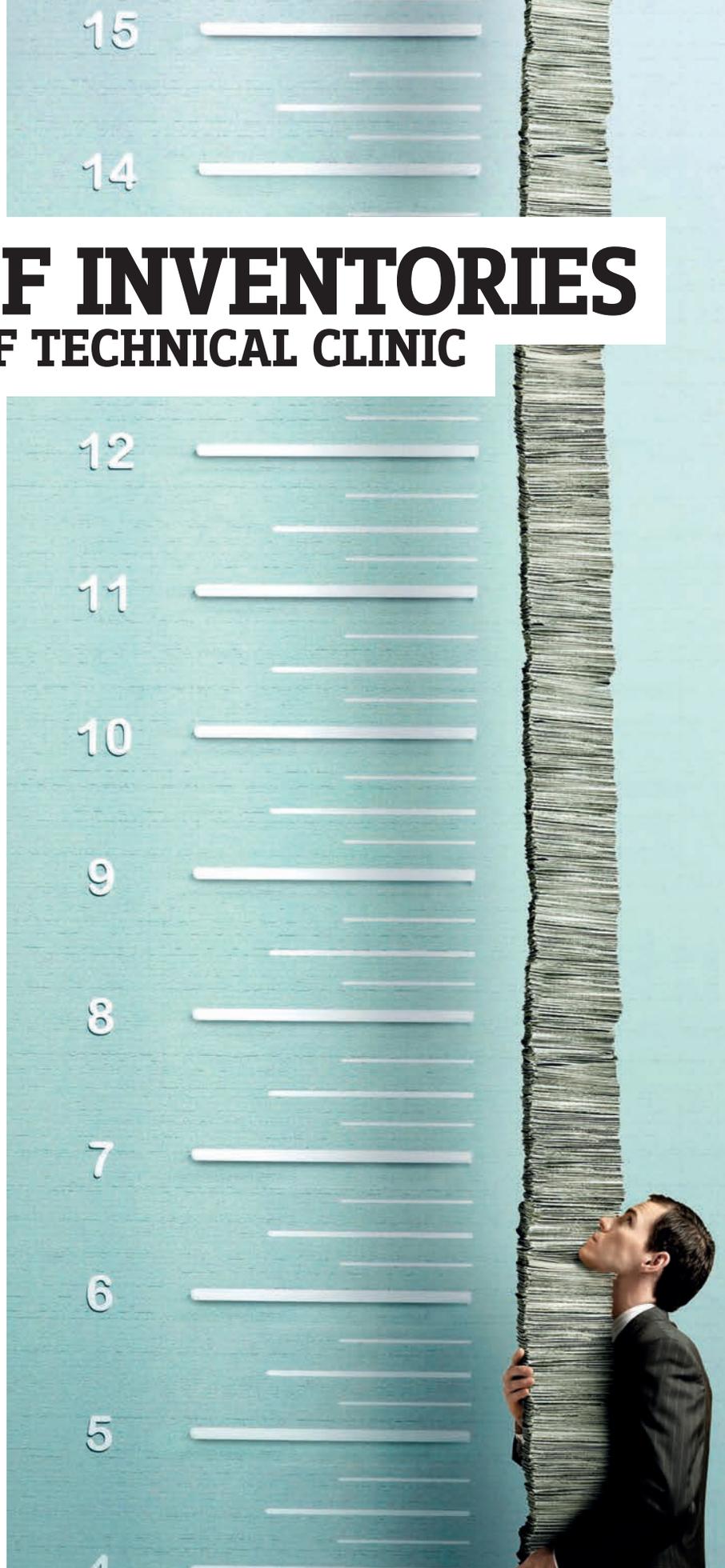


AUDIT OF INVENTORIES HIGHLIGHTS OF TECHNICAL CLINIC

For a manufacturing or trading company, the inventory balance is usually a material item on the balance sheet. This poses several challenges to practitioners in the audit of inventories. What are some of these challenges? And why is the deficiency in the audit of inventories a common practice monitoring programme (PMP) finding for firms which audit non-public interest entities (non-PIE)? These questions and more got an airing in a technical clinic organised by ICPAS. The three-hour session was facilitated by Luar Eng Hwa, Managing Partner, EH Luar & Co. We bring you some of the highlights of the discussion.

Q What are the difficulties faced by practitioners in the audit of inventory? Why is the audit of this financial statement area so tough?

A Inventory is generally considered a high risk account balance because it has a direct impact on profit. For companies whose principal activities are mainly trading, import or export of goods and manufacturing, there will be high volume of inventory movements which creates the risk of misstatement of this account balance. It can get really complicated when documents and accounting records are not properly maintained, especially when the auditor has to attend to year-end inventory count before or



after year-end which involves multiple locations.

The audit of inventory does not stop at inventory count. The auditor is also required to check the allocation and assignment of costs to inventory based on the management's inventory flow assumption, identify obsolete or slow-moving items, and test-check that the inventory is stated at the lower of cost and net realisable value. An understanding of the company's business operation and the market condition for the demand of the company's product is therefore important for the auditor to make that judgement call. The key challenge arises when the management and auditor are embroiled in protracted debates as to whether or not there is a need to provide for inventory obsolescence or to write-down the inventory value and if so, by how much.

Therefore, every step to be undertaken during the audit work on inventories over (a) quantities, (b) existence and condition of

stock, (c) ownership, (d) valuation, and (e) presentation and disclosure in financial statements must be carefully considered.

Q Will it then make sense if the audit team obtained a confirmation of inventory balance at year-end and skip the observation of inventory count altogether?

A The answer is a definite "No!" The main objectives in observation of inventory count are (1) to obtain evidence of the existence and condition of the inventory and the security of its storage, (2) to observe how the client company conducts the inventory count, (3) to test the accuracy of the counting, and (4) to obtain information for checking at later stages, such as last goods received and despatched documents.

The observation of inventory count is to enable the auditor to check whether the inventory count procedures (provided by the management) are properly followed, and to conduct test counts to check that the procedures and internal controls over stock-take are satisfactory. Without attending the inventory count, how will the auditor determine the existence, completeness and accuracy of the count records, in particular those pertaining to the high-value items?

As far as possible, the management and auditor should plan ahead for inventory count to be performed as at year-end date. In the event the management is unable to schedule inventory count as at year-end date, the auditor should highlight to the management that roll-forward/backward procedures on inventory quantities test counted during the

physical inventory count to the financial year-end position need to be performed by the management. The auditor should then audit this information provided by the management.

Q One of the common audit issues in the audit of inventory is devising audit procedures to test the unit cost. There is always the issue of inappropriate work being performed by the auditor in this area. Why is this so?

A To address this issue, the auditor needs to know the costing method adopted by the company. Is the company using first-in-first-out (FIFO) or weighted average cost (WAC) to account for the cost of inventory?

The FIFO method assumes that the inventory items which were purchased or produced first are sold first, and consequently the items remaining in the inventory at the end of the period are those most recently purchased or produced. The WAC method determines the cost of each item from the WAC of similar items at the beginning of a period, and the cost of similar items purchased or produced during the period.

In performing unit cost testing for inventories under the FIFO cost formula, other than test-checking that the inventory items are moving in FIFO manner, the auditor needs to vouch to respective supplier invoices for the unit cost stated in the inventory list. If there are discrepancies in the samples tested for unit cost, the auditor needs to consider projecting the misstatement to the population to obtain a broad view of the scale of misstatement instead of disregarding it as immaterial without proper investigation into the reason for misstatement.

THE AUDITOR MUST MAKE SURE THAT ALL THE WORK PERFORMED AS WELL AS THE DISCUSSIONS ARE PROPERLY DOCUMENTED AND REFERENCED TO INDICATE THAT WORK HAS BEEN DONE.

Quality Assurance

For the testing of inventories under the WAC formula, the auditor should request for the detailed movements of inventories for the selected samples and verify against the relevant supporting documents such as the supplier invoices (for purchases) and sales invoices (for sales) and perform re-computation of the WAC for those items selected. Often, companies rely on their inventory systems to calculate the WAC of inventories. Unless the integrity of the inventory system has been tested and verified, the auditor should not rely solely on the WA costing generated by the inventory system and deem it appropriate.

Q Why is there a need to check that the inventory is stated at the lower of cost and net realisable value? Can we not just check that the samples selected are stated at cost?

A No, because FRS 2 *Inventories* paragraph 9 establishes that inventories shall be measured at the lower of cost and net realisable value.

The cost of inventories includes cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition. The cost of inventories may not be recoverable if the inventories are damaged, obsolete or if their selling price

has fallen. The practice of writing inventories down 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. The auditor should therefore check sales after year-end to make sure inventories are not carried at more than its net realisable value.

Q Having considered how to test unit cost, what about the testing of net realisable value? If there are no subsequent year-

end sales for the samples selected, can the auditor consider tracing to current year's sales or consider replacing the samples without subsequent year-end sales to complete the testing?

A When there is a long time lapse from the year-end to audit report date, tracing to current year's sales may not be appropriate as the sample itself may suggest existence of slow-moving inventory. The auditor can choose an appropriate alternative sample to replace the original sample. This does not mean that no work needs to be performed on the original sample! The original sample where there are no subsequent sales are exceptions noted and needs to be investigated, and with the disposition properly documented.

The auditor will need to perform further work to analyse whether there is any risk of stock obsolescence other than the

original sample, by reviewing the company's inventory ageing list and discussing with the management (preferably the sales manager or sales director), and assess the reasonableness of their assessment. After considering all these, the auditor must make sure that all the work performed as well as the discussions are properly documented and referenced to indicate that work has been done. Remember, no documentation equals no work done.

Q What are some of the practical considerations to the auditors when assessing the adequacy and reasonableness of inventories write-down and allowance for inventory obsolescence estimated by the management in addressing the valuation assertion?

A As part of the audit planning and risk assessment procedures, the auditor is required to gain an understanding of industry developments and changes in the economic environment affecting the inventories held by the company. The demand by customers is usually correlated with the prevailing economic conditions and may be significantly affected during an economic downturn, especially if the demand for the product is elastic.

The nature of inventories is also an important factor for the auditor to consider when assessing 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 of equipment generally

EVERY STEP TO BE UNDERTAKEN DURING THE AUDIT WORK ON INVENTORIES OVER QUANTITIES, EXISTENCE AND CONDITION OF STOCK, OWNERSHIP, VALUATION AND PRESENTATION AND DISCLOSURE IN FINANCIAL STATEMENTS MUST BE CAREFULLY CONSIDERED.

have a longer shelf life and lower risk of obsolescence if they are properly stored and handled with care, provided that the equipment continues to be used in the market.

Special arrangement with suppliers, if any, could also mitigate the risk of inventory obsolescence. An example would be items purchased from a holding company which can be returned unconditionally if unsold.

Relating back to inventory count observation, the auditor should keep a look out for the condition of the inventories during the inventory count. Signs of inventory obsolescence include discoloured, dented, dusty, rusty or expired goods and should be brought to the attention of the management for appropriate followup action. The auditor, however, should be mindful that observation of the physical inventory usually only provides limited evidence on the valuation assertion.

Q If the management has an internal provisioning policy for slow-moving and obsolete inventories, that is, it relies on the inventory ageing report to provide for obsolete inventory, can the auditor then place reliance on the management representation without corroborative work performed?

A By simply relying on the management representation is not sufficient work done. The auditor is required to review and check the reasonableness of the company's internal provisioning policy.

The auditor should corroborate audit evidence by checking the accuracy of the inventories ageing report, on a sample basis for each ageing bracket, and check that the underlying data provided by the management are captured accurately before evaluating the

management's assumptions on the provision.

Additionally, the auditor should check if provision is made for inventories that are over 180 days by the management. Why 180 days? The management may explain it thus, "The assumption is based on sales trend and inventory turnover days for the past year." Merely documenting the management's representation is not sufficient work done. The auditor should corroborate the management's representation by performing a review of the past year's sales trend and inventory turnover days to conclude on the reasonableness of the management's assumption.

Q There is always this dilemma among practitioners. Can they not just give a qualified audit opinion if they cannot agree with the view of the management or are faced with the issue of scope limitation?

A A qualified opinion should not be the first solution. The auditor has to consider the extent of scope limitation and whether alternative/additional audit procedures can be performed.

A common example would be a scenario where the auditor is unable to attend the stock-take because the auditor was appointed after the financial year-end. At first glance, this seems like a scope limitation. However, the auditor has to consider if alternative/additional procedures could be performed to ascertain the inventory balance as at year-end. An example of such a procedure is observing a current physical stock-take and test-checking the roll-back reconciliation to the year-end inventory quantities. The inventory roll-back reconciliation should be prepared by the management.

If the auditor is able to obtain

sufficient appropriate audit evidence (as mentioned earlier) regarding the year-end inventory balance, the audit opinion need not be modified. However, if the management is unable to reconcile the current physical inventory count with the year-end inventory quantities, or significant time has lapsed since the financial year-end, the auditor may have to modify the auditor's report as a result of the scope limitation. To express a qualified opinion or a disclaimer opinion is dependent on the financial impact of the scope limitation, whether it is material and pervasive to the overall financial statements. It is fair to say that the auditor should have explored/exhausted all possible solutions with the management, before deciding to issue a modified audit report.

The auditor shall promptly communicate with those charged with governance (TCWG) when he expects to modify the audit opinion. This enables the auditor to give notice to TCWG the intended modification and reasons for modification, seek TCWG's acknowledgement and for TCWG to explain/provide further information on the circumstances.

The auditor should also inform TCWG of the ramifications of a modified report. Such communication with the management should be adequately minuted with a copy provided to TCWG. An official letter highlighting the reasons for a modified opinion, type of opinion and ramifications to the directors should be furnished to TCWG. For SMEs, TCWG would be the directors of the company.

In conclusion, a qualified opinion is never a short-cut to completing an audit engagement. **CPA**

This article was written by Magdalene Ang, Quality Assurance Manager, ICPAS.