KAEG-I [INTL VERSION 2024]: ISA 501 Audit Evidence - Specific Considerations for Selected Items

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KAEG-I [INTL VERSION]: ISA 501 Audit Evidence - Specific Considerations for Selected Items [ISA | KAEGISA501]

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How do we comply with the standards?

ISA 501 Audit Evidence - Specific Considerations for Selected Items

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ISA 501 *Audit Evidence - Specific Considerations for Selected Items*

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

Introduction and Objective

International Standards on Auditing: ISA 501.01-03

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with ISA 330,[1] ISA 500[2] and other relevant ISAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

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1 ISA 330, *The Auditor's Responses to Assessed Risks*

2 ISA 500, *Audit Evidence*

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

(a) Existence and condition of inventory;

(b) Completeness of litigation and claims involving the entity; and

(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Inventory

International Standards on Auditing: ISA 501.04-08

Requirements

Inventory

4. If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; (Ref: Para. A4)

(ii) Observe the performance of management's count procedures; (Ref: Para. A5)

(iii) Inspect the inventory; and (Ref: Para. A6)

(iv) Perform test counts; and (Ref: Para. A7-A8)

(b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)

6. If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised).[3] (Ref: Para. A12-A14)

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3 ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

8. If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)

(b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

ISA Application and Other Explanatory Material: ISA 501.A1-A16

Application and Other Explanatory Material

Inventory

Attendance at Physical Inventory Counting (Ref: Para. 4(a))

A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

A2. Attendance at physical inventory counting involves:

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this ISA) include, for example:

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate.
- Whether the assistance of an auditor's expert is needed. ISA 620[5] deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

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5 ISA 620, *Using the Work of an Auditor's Expert*

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate controls, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.

- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

Observe the Performance of Management's Count Procedures (Ref: Para. 4(a) (ii))

A5. Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or aging inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example, by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Physical Inventory Counting Conducted Other than at the Date of the Financial Statements (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. ISA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.[6]

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6 ISA 330, paragraphs 22 - 23

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in ISA 200,[7] the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

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7 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* paragraph A50

A13. In some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.[8]

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8 ISA 705 (Revised), paragraph 13

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. ISA 505[9] establishes requirements and provides guidance for performing external confirmation procedures.

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9 ISA 505, *External Confirmations*

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.

- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

How do we comply with the Standards?

[ISA | KAEGHDWC]

1 Perform relevant procedures over the quantity and condition of inventory [ISA | 7745]

What do we do?

Perform relevant procedures over the quantity and condition when the entity has inventory

Why do we do this?

The auditing standards require we perform certain procedures in order to obtain sufficient and appropriate audit evidence over inventory held by the entity and/ or third parties.

Execute the audit

What relevant procedures do we perform when the entity has inventory? [ISA | 7745.6730]

We perform the following procedures when the entity has inventory:

- Understand the entity's inventory
- Attend management's inventory count, unless impracticable
- Perform procedures when attending the count if no RMM has been identified over quantities and condition and inventory is a material financial statement caption
- Determine our approach to inventory count attendance for an RMM
- Perform procedures if we are unable to attend
- Perform alternative procedures if attendance is impracticable
- Obtain evidence at third party locations

1.1 Understand the entity's inventory [ISA | 7747]

What do we do?

IF the entity has inventory THEN obtain an understanding of the inventory held, including the entity's approach to inventory counts.

Why do we do this?

We understand the entity's inventory to help us to:

- Identify potential risk(s) of material misstatement (RMMs);
- Determine our approach to attendance at management's inventory count(s) to obtain evidence over quantities and condition of inventory;
- Design audit procedures to respond to identified RMMs or when inventory is a material financial statement caption with no RMM over quantity and condition; and
- Identify whether any additional procedures are necessary (e.g. sending confirmations to third parties).

Execute the audit

What do we understand about the entity's inventory? [ISA | 7747.6870]

We understand the following about the entity's inventory:

What we understand	Guidance
Category of inventory	Understanding the categories of inventory helps us understand the approach for **all** inventory categories and also helps us identify those categories that may have an increased risk of material misstatement. For example, depending on the financial reporting framework, inventory categories may include raw materials, materials and supplies, packaging, work-in-progress (WIP), finished goods, goods held for resale, spare parts, and other.
Nature of inventory	Understanding the nature of inventory helps us determine the susceptibility of inventory to material misstatement due to fraud or error as a consequence of damaged, slow moving or obsolete inventory or loss due to expiration/theft.
Inventory balance and composition	The size relative to materiality and composition of the inventory balance is one of the factors we consider when determining if there is an RMM related to the quantities and condition of inventory. Factors relevant to understanding the composition include: • Whether inventory is specifically identifiable or not, • The number of products/SKUs, • Volume of transactions/movements, and • Whether there are any high value items.
Changes in inventory during the period	We consider planning analytical procedures performed and make inquiries of management to understand:

	• the nature and extent of changes in the types and locations of inventories over the period; • the degree of fluctuation in inventory levels; • any notable developments with inventories that have occurred during the period (e.g. unexpected shortages of inventory reported or unexpected growth in inventory balances).
Locations where inventory is held and whether locations are homogeneous, if applicable	Entities may have similar or different types of inventory in multiple locations at one time. The total inventory balance is considered when identifying RMs. Part of our understanding includes the quantity and value of inventory held at each location. We also think about whether the entity holds any consignment inventories and at which location(s).
Whether inventory is held at a third-party location	Inventory may be maintained at an entity owned location or a third-party warehouse.
Whether a perpetual or periodic inventory system is used	This helps us understand an entity's method of accounting for inventory transactions and is relevant when identifying and assessing RMMs and designing our procedures.
The entity's approach to inventory counts	The entity may perform cycle counts or a complete count at other than period end or a complete count at period end. These approaches may be done for all or a portion of inventory.
How inventory quantities are measured	Some inventory may be measured by simple quantification, such as units and weight, while others may have particular measurements, calculations, or estimates (e.g. WIP). We think about calibration of scales, gauges, meters, etc., if necessary. If the entity approximates inventory quantities, then consider the implications for our approach to inventory count attendance (e.g. whether to involve specialists or software audit tools (SATs)).
Whether the entity uses automated procedures	When management has implemented a series of automated procedures to assist in its count, we understand what information is captured, how that information is transmitted

	(e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.
Whether the entity uses a management specialist	We understand whether management uses a management's specialist to assist with identifying, quantifying and/or assessing the condition of the inventory. See 'Perform specific procedures when using the work of a management's specialist' for additional considerations when the entity uses a management specialist.
Accounting policies or principles that impact recording inventory quantity and condition	We think about how management accounts for its inventory within its financial records. In particular how management accounts for inventory in transit or third-party inventory held on site. We also think about other accounting policies or principles that may be relevant, such as those related to recognition and derecognition of inventory that can impact the scope of the inventory count. For example, whether there are significant quantities of inventory physically on on the balance sheet (e.g. 'bill and hold' sales) or significant inventories recogn sheet but not on-site (e.g. in transit).
Entity's historic count results	We obtain information about the entity's historic count results/variances to help us identify and assess the risks of material misstatement RMMs in the current period. Significant adjustments made to reconcile between the entity's count and inventory list might be an indication that the perpetual inventory records may not be reliable.
Our historical count results	We consider the results of our audit procedures performed over historical counts to help us identify and assess the RMMs. We obtain an understanding of any deficiencies in internal controls identified relevant to the cycle count program. For example, variances between our previous test counts and managements i an indication that the control activities over the existence of inventory are inade

What is WIP? [ISA | 7747.6871]

WIP is an acronym for 'work-in-process' or 'work-in-progress'. WIP represents goods that are in the course of production.

What do we do if the entity has WIP? [ISA | 7747.9202]

If the entity has WIP, we:

- Determine how the entity identifies the stage of completion of WIP;
- Consider the quantity and nature of WIP;
- Identify the accounting records that will be used by management to calculate the WIP amount and, where unfinished items are uniquely identifiable, plan to physically examine items to obtain evidence that supports the recorded stage of completion.

We consider the audit approach specific to WIP inventory as our approach may differ from the planned approach associated with inventory subject to cycle counts (e.g. WIP inventory may not be subject to cycle counts - therefore, management may perform a complete physical inventory count over WIP inventory).

What is a perpetual inventory system? [ISA | 7747.6872]

A perpetual inventory system is a process set up, typically using IT applications, to continuously track inventory quantities by inventory SKU or serial number based on receipts, shipments, and movements throughout the day. Some perpetual inventory systems may synchronize and/or be reconciled to the general ledger on a periodic basis as opposed to happening 'real time'.

What is a "SKU"? [ISA | 7747.6873]

"SKU" stands for "stock keeping unit". It is an identification, for example alphanumeric, of a particular product that allows it to be tracked for inventory purposes.

What is a periodic inventory system? [ISA | 7747.6874]

Periodic systems record all inventory purchases to one account during the accounting period. Cost of goods sold is calculated in a lump sum at the end of the period, by adding total purchases to the beginning inventory and subtracting ending inventory. Ending inventory is determined through a physical count that is performed at the end of the period.

What are the inventory count methods that an entity can perform? [ISA | 7747.6876]

The entity can perform:

- A complete physical inventory count at period end;
- A complete physical count at a date other than period end; or
- Cycle counts.

What is a complete physical inventory count? [ISA | 7747.6877]

A complete physical inventory count is a physical inventory count, other than a cycle count, that occurs on a specific date or point in time where the entire inventory population is subject to a count.

What is a cycle count? [ISA | 7747.6878]

Cycle counts are inventory counts that occur on a periodic basis to count and adjust inventory quantities throughout the period.

What if the entity performs a complete count at each location at various times throughout the year? [ISA | 7747.6879]

Many retailers perform a complete physical count at different store locations at various times throughout the year. We may treat this approach as a cycle count.

Can the entity use more than one inventory count approach? [ISA | 7747.6880]

Yes. In some cases, the entity may subject a portion of their inventory to cycle counting and the remaining portion to a complete physical inventory count. Different inventory count approaches may be used by an entity because populations have different risk profiles or populations have insufficient or inaccurate count results.

What does 'condition of inventory' mean? [ISA | 7747.6881]

Condition of inventory means identifying circumstances that may indicate a reduction in the value of inventory.

What if inventory is stored in bulk containers and is subject to count procedures? [ISA | 7747.6882]

As part of deriving or inspecting the quantity of inventory stored in bulk containers (e.g. tanks or silos), management or we may take a measurement of the height of the contents of these containers by inserting a dipstick or tape into the tank or silo or by reading a gauge. When such an approach is used, there may be certain incremental risks that the engagement team may think about when planning and performing audit procedures related to inventory.

What incremental risks do we think about when inventory is stored in bulk containers and is subject to count procedures that involve measuring the contents? [ISA | 7747.6883]

The following table illustrates the risks we think about and their potential impact on our audit procedures:

Risk	Impact on the planning and performance of audit procedures
Risk of incorrectly converting a height measurement into volume.	An entity's inventory system may maintain quantities of inventory that are expressed in units of volume, such as gallons/liters or cubic feet/ meters. In these cases, it may be necessary for us to measure or obtain the circumference or diameter of the tanks and silos through other procedures. For example, depending on the industry, we think about whether the specifications for tanks or silos are standardized or are certified by relevant regulatory authorities when originally constructed. In order to determine whether management accurately converted the measurements of height into volume we perform procedures such

	as testing the appropriateness of the conversion factors and their application.
Risk of incorrectly converting a measurement into mass or weight.	Inventory quantities may be expressed in mass or weight. It may then be necessary for management to convert an inventory height or volume measurement into a mass or weight measurement. For example, we may perform procedures to test the conversion factors used by management specific to the density of the fluid or crop stored in a tank or silo. In order to determine whether management accurately converted the measurements of height or volume into mass or weight we perform procedures such as testing the appropriateness of the conversion factors and their application.
Risk that products in bulk containers are not what management has claimed.	Two or more products may appear visually similar yet have significantly different unit costs. Depending on the nature of this assessed risk, the engagement team may design audit procedures to obtain reasonable assurance that the specific products in tanks or silos are what management has claimed. For example, in certain industries management and/or we may perform tests to determine whether liquid products stored in tanks have been contaminated with water.

Examples

How might our understanding of inventory affect our audit? [ISA | 7747.6884]

What we understand	Impact on our audit procedures

Inventories are more susceptible to loss (e.g. due to theft or perishability)	This may represent a fraud risk, and/or an increased inherent risk of error over existence or condition of inventory.
Inventories are more susceptible to misidentification (e.g. lacking unique identifiers or several products that are similar)	This may lead to an increased inherent risk over accuracy.
How the entity identifies the stage of completion of WIP	This may be assessed by detailed production plans and lists of included materials attached to the WIP or assessed through estimates (percentage of completion). This may mean we involve a specialist to assist in assessing WIP, identify an estimate or we obtain evidence as to the stage of completion of WIP as part of our attendance at the count.
Complexity and subjectivity of inventory measurement	Counting tangible products (e.g. industrial parts) based on observable quantities on hand may have lower complexity and subjectivity, whereas other products that are not easily counted (e.g. chemicals, precious metals (including purity) or inventory using particular measurements or calculations) may have greater complexity and subjectivity, and necessitate specialist involvement.
The entity uses automated counting procedures	In some cases, automation of inventory management and inventory counting may mean that we cannot gain sufficient appropriate evidence about management's instructions and procedures over the count without testing control activities over these automated procedures as part of our audit.
How inventory is stored	We think about whether inventory is stored in areas that enable management to maintain its condition and away from destruction and spoilage, and the means of storage (e.g. boxes, pallets, crates, etc.). We also think about whether there are any restrictions or difficulties that could limit access to inventory (e.g. because of the way it is stored, or time access restrictions).
Accounting policies	This understanding helps us determine our planned count procedures and whether management's counting process

	and the inventory they plan to count is consistent with its accounting policies.

1.2 Attend management's inventory count, unless impracticable [ISA | 7746]

What do we do?

Attend management's inventory count, unless impracticable, to obtain sufficient and appropriate evidence over the quantities and condition of inventory

Why do we do this?

A physical observation of inventory on-site provides more persuasive audit evidence for:

- inventory existence (quantities);
- condition (whether items are damaged or there are indicators that they are slow moving, obsolete or may have expired as of that date); and
- evidence about other balance sheet and income statement accounts that capture inventory transactions.

Execute the audit

When do we attend the management's inventory count(s)? [ISA | 7746.6859]

We attend management's inventory count(s), unless impracticable when:

- The inventory balance is quantitively material; and/or
- When the following risk has been identified and assessed as a risk of material misstatement (RMM):
  - Quantity of inventory held by the entity is not completely and accurately recorded, the inventory does not exist, or the condition of inventory is not identified.

When may we identify no RMM over quantity and condition of inventory? [ISA | 7746.8360]

When an entity is in the business of selling inventory and the balance is material, this is likely an RMM in the inventory process because it likely has a high volume of activity.

When inventory has lower total dollar value, transactional volume, obsolescence risk, etc., there may be a reasonable basis to conclude that there is a remote risk of material misstatement, depending on materiality and other inherent risk factors, and therefore, not identifying an RMM over quantity and condition may be appropriate.

There may be specific portions of inventory, such as an ancillary location or minor product category, where it may be appropriate to disaggregate and deem that portion as a non- significant account because it may have different risks, processes and control activities.

What do we do if inventory held by the entity is quantitively material, but we have not identified an RMM in relation to quantity and condition? [ISA | 7746.6861]

Unless attendance at management's inventory count is impracticable, we perform procedures in accordance with:

- Perform procedures when attending the count if no RMM has been identified over quantities and condition and inventory is a material financial statement caption.

What does 'impracticable' mean? [ISA | 7746.6862]

Impracticable is not specifically defined but may be due to factors such as the nature and location of the inventory.

> For example, the inventory is located in a war zone and there is a threat to safety in visiting the inventory location.

We expect these situations to be rare and the matter of general inconvenience is not sufficient to conclude that attendance is impracticable.

When we do not attend management's inventory count, we document why it is impracticable to do so and perform procedures in accordance with 'Perform alternative procedures if attendance is impracticable'.

What procedures does "attendance at the inventory count" refer to? [ISA | 7746.6863]

When we refer to "attendance at the inventory count" it means we perform the following procedures:

- Evaluating management's instructions and procedures for recording and controlling the results of the entity's inventory counting;
- Observing the performance of management's counts procedures;
- Inspecting the inventory;
- Performing test counts;
- Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results; and
- Performing procedures over changes in inventory between the count date and the date of the financial statements when our attendance at the inventory count is performed at a date other than the period end.

Can we attend inventory counts virtually using real-time video technology? [ISA | 7746.9173]

Yes, however we consider local laws and regulations to determine whether the use of real-time video technology is permitted.

Where use of real-time video technology is permitted, we can attend some, but not all inventory counts virtually using real-time video technology. Our use of real-time video technology is compliant with the auditing standards if we are able to perform all the same procedures to obtain audit evidence required by the auditing standards as if we were there physically.

What are considerations for determining the number of inventory counts that may be attended virtually vs. in-person? [ISA | 7746.9174]

There are no bright lines to determine the number of inventory counts that may be attended virtually using real-time video technology as compared to the number that is attended in-person. In evaluating the acceptability and extent of the use of virtual real-time video technology to perform

audit procedures, appropriate consideration is given to relevant factors, such as those listed below (not exhaustive) to determine whether we may attend all or a higher proportion of in-person inventory counts compared to use of virtual real-time video technologies.

Higher proportion of virtual attendance	Lower proportion of virtual attendance
Risk assessment	
• Lower inherent risk associated with the existence of inventory • Risk assessment conclusions consistent year-over-year • Previous in-person count(s) performed at the same location • Type of audit engagement (multi-location audit where inventory is dispersed across homogeneous locations) and audit plan (e.g. consistent year over year locations attended)	• The auditor has never attended a count before (at that location or for the entity overall) • Fraud risk or significant inherent risk of error associated with the existence of inventory • Changes in risk assessment conclusion year-over-year • Type of audit engagement (multi-location audit where inventory is non-homogeneous) and audit plan (e.g. changes locations attended)
Nature of inventory	
• Homogeneous inventory population • Low complexity in determining quantities of inventory (individual units) • Low concentration of inventory (multiple locations) • Balance of inventory compared to materiality is lower • Immaterial inventory write-offs in the current or prior period • Low historical shrinkage/waste	• Various types of inventory including work-in-progress inventory • Complexity in determining quantities of inventory (volume/weight-based measurement) • Specialists are needed to determine inventory quantities (significant judgment/ estimation involved) • High concentration of inventory (few locations) • Balance of inventory compared to materiality is higher • Material inventory write-offs in the current or prior period • High/volatile historical shrinkage/waste
Operations/facilities	
• Perpetual inventory system	• Facilities remain open during count procedures (receiving and shipping) or

• Facilities are closed or well-controlled during count procedures (receiving and shipping) • Facilities are well organized and allow for effective and efficient counts • Highly automated warehouse • Counts completed in one day/count session • Segregation of duties are present when counts are conducted • Counts performed by individuals independent of those responsible for maintaining or managing inventory quantities (e.g. internal audit)	movements are not well controlled or considered in count procedures • Inventory to be counted is housed in several different facilities at the location • Count takes multiple days/count sessions to complete • Insufficient count process and guidelines from the entity • The objectivity and competence of the entity's resource who would operate the technology cannot be assessed or is not considered adequate
Internal controls, misstatements and other considerations	
• If applicable, effective process control activities over inventory movements, including the receiving and shipping of inventory and automated process control activities within a perpetual system (assessment of effectiveness on design and implementation and, where applicable, assessment of operating effectiveness will depend on degree of control reliance and auditor judgment) • Effective process control activities over monitoring cycle count programs, if relevant, and the recording of adjustments • Historically, accuracy rates of counts are high • Immaterial book-to-physical adjustments • Other audit procedures (e.g. cut-off testing, search for unrecorded liabilities, revenue procedures) corroborate the existence of inventory	• Ineffective process control activities over inventory movements (current or historical deficiencies) • Ineffective process control activities over monitoring cycle count programs, if relevant, and the recording of adjustments (current or historical deficiencies) • Inconsistent accuracy rates in historical counts • Material book-to-physical adjustments • Limited other audit procedures or disconfirming/contrary audit evidence challenge the existence of inventory

Based on the results of our risk assessment, including consideration of the above, we may determine the use of virtual technologies is not appropriate; or we may determine the use of virtual technologies is appropriate for attending some of the inventory counts, combined with attending inventory counts in-person. We do not plan to attend all inventory counts virtually, unless it is impracticable to attend any inventory counts in-person.

Is real-time video technology a SAT? [ISA | 7746.9175]

No. Video technology used to facilitate a virtual inventory count is not considered a software audit tool.

Who performs the procedures? [ISA | 7746.6864]

The procedures may be split between the KPMG attendee/observer and other KPMG team members who are not attending/observing. We determine who is best placed to execute each procedure based on the facts and circumstances at the entity.

We may also involve specific team members, and specialists as appropriate to assist us in attending/observing inventory counts in accordance with 'Determine whether to involve specific team members and specialists'.

If we do involve specific team members or specialists when we have determined that inventory is material to the financial statements but no RMM relating to quantities and condition of inventory has been identified, then we think about whether the reason for using a specific team member or specialist could be an indication that an RMM exists 'Continue to assess RMMs, and revise audit approach as necessary'.

How do we document our attendance at management's inventory count? [ISA | 7746.6866]

We prepare and communicate instructions to all observers and attendees to direct their procedures before, during, and after their observations and to provide any other information that is relevant to the performance of those procedures.

After the inventory count, we obtain and review the documentation provided by the inventory count observer(s) and attendee(s).

We document our attendance using the relevant Inventory Work Paper.

If management uses an outside inventory firm, do we attend management's inventory count? [ISA | 7746.6867]

Yes, we still attend management's inventory count, even when management engages a third party to conduct the inventory count.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7746.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

Does an independent inventory count (i.e. one performed by us) without attending management's counts comply with auditing standards? [ISA | 7746.6868]

It depends. If we are unable to attend management's inventory count due to unforeseen circumstances or attendance at management's count is impracticable then the standards permit us to perform independent counts to obtain evidence over the quantity and condition of inventory.

However, if we are able to attend management's inventory count and choose not to attend their count, performing an independent count does not comply with the auditing standards. When we perform our own independent count, we are inspecting inventory that is separate from management's own count

procedures. In such cases, we are unable to evaluate management's instructions and procedures for controlling their inventory and observe the performance of management's count procedures.

> For example, if management plans to conduct its inventory count at the end of September, but we plan to conduct our own independent count procedures closer to year end, we still attend the count in September and perform the necessary procedures to comply with the auditing standards.

Examples

What may we consider when determining whether the use of virtual real-time video technology may be appropriate? [ISA | 7746.9176]

The following are high-level examples of entity specific facts and circumstances and auditor considerations that may result in us determining that the use of virtual real-time video technology may be appropriate in part or not at all.

Example 1: Partial use of virtual technologies

The entity uses a perpetual inventory system and holds inventory at 200 homogeneous retail locations fully equipped with WIFI with approximately equal amounts of inventory. The entity performs a complete physical count at each retail location once per year on cycle throughout the year based on a well-established methodology/frequency. Based on an evaluation of the risk characteristics, including consideration that the inventory balance is approximately 50X materiality, historical audit experience (high historical accuracy rates, effective suite of process control activities over inventory movements, familiarity with the retail locations based on historical in-person observations), and a Base inherent risk associated with the inventory, we determine that the use of virtual real-time video technology is appropriate for a portion of our inventory observations and reperformance procedures. We selected 25 locations to obtain evidence in accordance with 'Observe the performance of management's count procedures'. Of the 25 locations, we judgmentally determined to attend 15 in-person and 10 virtually using real-time video technology.

The engagement team reperformed/observed management's count for all 25 of the locations subject to testing. See question 'Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts?' for additional considerations when taking a controls approach and question 'Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts?' for additional considerations when taking a dual-purpose approach.

Example 2: Partial use of virtual technologies

The entity is an industrial manufacturer, uses a perpetual inventory system and holds inventory at 5 non-homogeneous warehouses fully equipped with WIFI. The entity performs annual complete physical inventory counts. Based on an evaluation of the risk characteristics, including consideration that the inventory balance is approximately 15X materiality, historical audit experience (high historical accuracy rates, effective suite of process control activities over inventory, familiarity with the inventory warehouses based on historical in-person observations), a Base inherent risk associated with the inventory, we determine that the use of real-time video is appropriate for a portion of our inventory observations and reperformance procedures. We determined that we would attend the inventory counts at all five locations, three in-person and two virtually using real-time video technology.

Example 3: No use of virtual technologies

The entity uses a perpetual inventory system and holds inventory at 20 non-homogeneous warehouses fully equipped with WIFI. The entity performs annual complete physical inventory counts. Based on an evaluation of risk characteristics, including consideration that the inventory balance is approximately 35X materiality, historical audit experience (uneven accuracy rates, moderate write offs), and an Elevated inherent risk associated with the inventory, we determine that the use of real-time video technology is not appropriate for any portion our inventory observations and reperformance procedures.

1.3 Perform procedures when attending the count if no RMM has been identified over quantities and condition and inventory is a material financial statement caption [ISA | 7749]

What do we do?

IF a risk of material misstatement has not been identified relating to the quantities and condition of inventory but the inventory under the custody and control of management is material to the financial statements, THEN we perform procedures when attending the inventory count.

Why do we do this?

If we do not identify a risk of material misstatement (RMM) relating to the quantities and condition of inventory but the inventory under the custody and control of management is material to the financial statements we are still required by the auditing standards to attend management's inventory count and perform certain procedures to obtain evidence that no risk of material misstatement (RMM) exists. These procedures are performed as part of those we perform in accordance with 'Design and perform substantive procedures for accounts and disclosures with no RMMs'.

Execute the audit

What relevant procedures do we perform when attending the count? [ISA | 7749.8359]

We perform the following procedures when attending the count:

- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

The nature, timing and extent of procedures is designed to reflect the fact that we are obtaining evidence to determine no RMM exists rather than responding an RMM.

When designing substantive procedures for material non-significant accounts (MNSAs), we keep in mind that the objective of these procedures differs from those that are responsive to an identified RMM for a significant account.

> For example, we do not perform a test of detail using a sampling technique that requires the input of our CAR assessment because, by their nature, MNSAs do not involve an RMM and therefore CAR is not assessed.

When may we identify no RMM over quantity and condition of inventory? [ISA | 7749.8360]

When an entity is in the business of selling inventory and the balance is material, this is likely an RMM in the inventory process because it likely has a high volume of activity.

When inventory has lower total dollar value, transactional volume, obsolescence risk, etc., there may be a reasonable basis to conclude that there is a remote risk of material misstatement, depending on materiality and other inherent risk factors, and therefore, not identifying an RMM over quantity and condition may be appropriate.

There may be specific portions of inventory, such as an ancillary location or minor product category, where it may be appropriate to disaggregate and deem that portion as a non- significant account because it may have different risks, processes and control activities.

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7749.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What documentation may the inventory count observer obtain and prepare? [ISA | 7749.9727]

We obtain evidence and prepare documentation as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets and a list of all items we counted
- List of adjustments recorded.

We report results in a timely manner.

1.3.1 Evaluate management's instructions and procedures [ISA | 7750]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7750.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7750.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7750.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7750.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7750.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7750.9814]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and suggests the existence of an unidentified RMM.

We resolve any concerns we may have on the adequacy of the entity's procedures prior to the inventory count and consider whether concerns suggest the existence of an unidentified RMM.

What else do we evaluate when the entity performs cycle counts? [ISA | 7750.6958]

We also evaluate the process surrounding how items are selected to be counted and how differences are investigated and resolved.

What do we evaluate about inventory movements during the count? [ISA | 7750.9815]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count.

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7750.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.3.2 Observe the performance of management's count procedures [ISA | 7751]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the Audit

What do we do when we observe the performance of management's count procedures? [ISA | 7751.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7751.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we observe the entity's process for investigating and recording count differences? [ISA | 7751.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7751.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

1.3.3 Inspect the inventory [ISA | 7752]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7752.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7752.6964]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Determine if there is a previously unidentified risk of material misstatement (RMM) over condition of inventory

- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.3.4 Perform test counts [ISA | 7753]

What do we do?

Perform test counts, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the Audit

How do we perform test counts? [ISA | 7753.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

How do we obtain evidence over the completeness of the count? [ISA | 7753.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.

- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7753.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

> For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7753.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

> For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

What if the entity has work-in-progress (WIP)? [ISA | 7753.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform? [ISA | 7753.6893]

We determine how many test counts to perform including how many locations and which locations to obtain evidence from, if applicable. If the entity performs cycle counts, we determine how many counts to attend and how many items to test at each count we attend. These procedures are performed as

part of those we perform in accordance with 'Design and perform substantive procedures for accounts and disclosures with no RMMs'.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7753.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7753.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7753.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from management's? [ISA | 7753.6897]

If we compare our test count results to management's and we identify a difference, we obtain agreement from entity personnel as to the appropriate quantity and, if management's count is incorrect we record the difference as a misstatement. We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements'.

In addition, if inventory is material but we do not have an RMM over quantity and condition for any inventory balance, we consider whether the difference suggests the existence of an unidentified RMM.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7753.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7753.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7753.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

1.3.5 Determine whether entity's final inventory records accurately reflect count results [ISA | 7754]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the Audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7754.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What additional procedures may we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results for cycle counts? [ISA | 7754.6959]

We evaluate whether the level of adjustments calls into the question the appropriateness of determining inventory quantity and condition through cycle counts.

If more than trivial adjustments are made to adjust inventory quantities as a result of the cycle counts, this challenges the effectiveness of the related process control activities and undermines the assessment that the same results are obtained from the perpetual inventory system as those by annual physical count. In such cases, we think about whether this indicates a previously unidentified risk of material misstatement (RMM) and we determine whether it is necessary for management to perform a complete physical count at or near period end that we would then attend.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7754.6960]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no misstatement. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a potential control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.3.6 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7755]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

What procedures do we perform over changes in inventory when the count is performed at a date other than the period end? [ISA | 7755.6901]

Procedures may include:

- inspecting purchases of inventory during the intervening period to and from perpetual records;
- inspecting sales of inventory during the intervening period to and from perpetual records;
- inspecting inventory goods received and goods dispatched notes between the date of the count and the period end;
- performing analytical procedures to evaluate sales, purchases, gross margin percentages, inventory turnover and/or days sales in inventory;
- inspecting the reconciliation of the final adjusted inventory records at the count date to the general ledger at period end, including testing reconciling items; and
- performing an independent count of inventory held at period end, which provides evidence that changes between the count date and the date of financial statements are properly recorded (otherwise our results would not reconcile to the financial records).

What if the entity has a periodic inventory system and performs a complete physical count other than at period end? [ISA | 7755.8392]

If the entity has a periodic inventory system, then we cannot rely on process control activities or outputs from that system to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. However, if the count is performed sufficiently close to the period end we may be able to rely on this count, if we determine that the risk of material misstatement in movements of inventory in the remaining period is remote.

For example: The inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse is shut. Therefore, we confirm there have been no movements via cut-off testing or the entity's external website indicates that they are shut down during this period.

The following table illustrates the factors we think about to determine nature and extent of procedures to perform when the risk is more than remote:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.

The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

After thinking about these factors, we may:

- Attend management's inventory count other than at period end and perform procedures over changes in inventory; or
- Request that the entity perform a full inventory count at period end and attend that count and perform relevant procedures.

1.4 Determine our approach to inventory count attendance for an RMM [ISA | 7765]

What do we do?

If we have identified a risk of material misstatement related to the quantities and condition of inventory held by entity, THEN determine our approach to inventory count attendance.

Why do we do this?

We perform procedures in order to comply with the auditing standards and to obtain sufficient appropriate evidence in response to the risk of material misstatement (RMM) related to quantities and condition of inventory.

Execute the Audit

What are the approaches to inventory count attendance? [ISA | 7765.8383]

There are 4 possible approaches to inventory count attendance:

- Controls approach only - Our attendance at the count is to evaluate the design and implementation and test the operating effectiveness of relevant process control activities addressing the RMM.
- Substantive only - Our attendance at the count is to perform substantive procedures that are responsive to the RMM.
- Dual-Purpose - Our attendance at the count is to both evaluate the design and implementation and test the operating effectiveness of relevant process control activities and perform substantive procedures that are responsive to the RMM.
- Independent count - We attend management's count to evaluate management's instructions and procedures for recording and controlling the results of the entity's physical counting and observe the performance of management's count procedures. Separately, we perform our own independent count at or close to period end to obtain sufficient appropriate audit evidence over quantity and condition of inventory. The procedures performed at management's count informs our approach to our independent count. When we take this approach, our attendance at management's inventory counts has no impact on our control risk assessment.

When is it appropriate to take the independent count approach? [ISA | 7765.8384]

We may take the independent count approach when:

- Management performs the inventory count at a date (or dates) other than at the period end; and
- We plan and are able to perform an independent count at period end to obtain sufficient appropriate audit evidence over quantity and condition of inventory at period end.

For example, inventory consists of liquid concentrate for carbonated beverages. We determine that we have an RMM over the quantity and condition of the inventory. Management perform counts of the concentrate throughout the year but not at the period end. As all concentrate is held in one location, we can plan to perform our own count of that inventory covering both quantity and condition at the period end. We attend a management count during the year to evaluate management's instructions and procedures and observe the performance of management's inventory count procedures to determine if it's appropriate to perform our test counts at period end. We get our evidence over the RMM through our own independent count at period end.

How do we perform the independent count approach? [ISA | 7765.8385]

We are required by the standards to attend management's count and perform certain procedures in order to:

- evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting; and
- observe the performance of management' count procedures

We obtain our substantive evidence from performing our own independent count at year end. We perform procedures at the independent count in order to:

- Inspect the condition of inventory;
- Perform test counts;
- Determine whether entity's final inventory records accurately reflect actual inventory count results; and
- Obtain evidence that changes in inventory between count date and the period end are properly recorded (otherwise our results would not reconcile to the financial records).

While attending management's count we also consider evidence that indicates that the perpetual system is not reliable (e.g. more than minor adjustments are found because of the lack of effective process control activities over inventory). This is because management is relying on the reliability of the inventory perpetual system for evidence over period end inventory.

If the results of management's count indicates that the perpetual system is not reliable (e.g. more than minor adjustments are found because of the lack of effective process control activities over inventory) then our independent counts at period end may identify material misstatements in the financial records in respect of quantity and/or condition of inventory because of more than minor discrepancies with the perpetual system. See question 'What else do we think about if our count results differ from inventory records?' for additional considerations. In this circumstance, we ask management to take corrective actions and confirm that the action has been taken and/or ask management to perform a complete physical count at period end.

As part of our attendance we also think about whether performing an independent count is feasible and whether any specialist involvement is necessary.

What else do we do when we plan to perform an independent count in addition to attending management's count? [ISA | 7765.8386]

If we intend to inspect the inventory and perform test counts of inventory independent of management at or near period-end, we ask management to accommodate this approach by:

- providing an inventory subledger at the time of count that can be reconciled to the general ledger;
- keeping warehouse/location activity to a manageable level in order to minimize discrepancies to be resolved through additional audit evidence - though the warehouse/location doesn't have to be at a standstill;
- establishing appropriate cut-off that can be observed and tested; and,
- assisting us with the count procedures and in resolving any identified differences.

If we have performed our independent count as of an interim date and concluded as of that date, we perform additional procedures in accordance with the following activities:

- Compare information to identify and investigate items that appear unusual; and
- Perform additional audit procedures over the remaining period.

What else do we consider when we perform an independent count? [ISA | 7765.8387]

We:

- do not select our items on the same basis as management under its cycle count program as that may not be representative of the entire population. Depending on how the cycle count program works, all items may not be available for selection by the entity (e.g. they were counted last month and have zero chance of being selected by the program this month).

  An appropriate sampling method results in each sampling unit in the population having a chance of selection. This may mean that we select a different sample from what the entity is counting as part of their routine procedures.

- perform our count as close to period end as possible to reduce the incremental risk relating to the intervening period.
- perform the test counts over as few consecutive days as possible such that the results are reflective of approximately a single point in time.

How do we determine the approach to inventory count attendance? [ISA | 7765.8389]

We consider the following factors when determining the approach to inventory count attendance:

- Whether the entity has a perpetual or periodic inventory system; and
- Whether the entity performs:
  - A complete physical count other than at period end
  - A complete physical count at period end
  - Cycle count.

The following table indicates the possible approaches that we may take to inventory count attendance based on the above factors:

	Complete Physical Count at period end	Complete Physical Count other than at period end	Cycle count
Perpetual Inventory System	Substantive Controls approach Dual-purpose	Substantive Controls approach Dual-purpose Independent count	Controls approach Dual-purpose Independent count
Periodic Inventory System	See question 'What if the entity has a periodic inventory system and performs a complete physical count at period end?'	See question 'What if the entity has a periodic inventory system and performs a complete physical count other than at period end?'	See question 'Can the entity perform a cycle count if it has a periodic inventory system?'

Can we take a substantive-only approach by performing test counts of management's cycle count program and not test the associated process control activities related to existence of inventory? [ISA | 7765.8393]

No. It is not possible to take a 'substantive-only' approach to testing management's cycle counts without testing process control activities over the risk of material misstatement (RMM) over quantity and condition.

What if the entity has a periodic inventory system and performs a complete physical count at period end? [ISA | 7765.8394]

The entity determines its quantities on-hand by conducting counts at period end. To do so, the entity may either:

- carry out a "single" inventory count at period end.

This means that the entity is relying on the single inventory count at period-end as the basis for determining the quantities and condition of inventory. As there is only a single physical count and there are no reliable inventory records, the entity is not relying on process control activities.

In such circumstances, our test counts are considered to be substantive test of details with a control risk of 'No reliance' (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach').

- carry out a "dual" inventory count at period end.

When a "dual" inventory count is performed, inventory is counted by two different counters and the results of the two counts are compared. If the two counts do not agree, the inventory is recounted to determine the correct count. This second count represents a process control activity designed by management to determine whether the initial inventory count is reliable.

In such circumstances, our test counts could represent either a:

- substantive test of details (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach');
- controls approach (see activity 'Perform procedures for a complete physical count at period end taking a controls approach'); or
- a dual-purpose test (see activity 'Perform procedures for a complete physical count at period end taking a dual-purpose approach').

What if the entity has a periodic inventory system and performs a complete physical count other than at period end? [ISA | 7765.8402]

If the entity has a periodic inventory system, then we cannot rely on process control activities or outputs from that system to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. However, if the count is performed sufficiently close to the period end we may be able to rely on this count, if we determine that the risk of material misstatement in movements of inventory in the remaining period is remote.

For example: The inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse is shut. Therefore, we confirm there have been no movements via cut-off testing or the entity's external website indicates that they are shut down during this period.

The following table illustrates the factors we think about to determine nature and extent of procedures to perform when the risk is more than remote:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.

The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

After thinking about these factors, we may:

- Attend management's inventory count other than at period end and perform procedures over changes in inventory; or
- Request that the entity perform a full inventory count at period end and attend that count and perform relevant procedures.

Can the entity perform a cycle count if it has a periodic inventory system? [ISA | 7765.8396]

No. It is not possible for an entity or us to rely on cycle counts because the entity does not have effective processes and process control activities over inventory receipts and shipments that enable effective cycle count process control activities. Furthermore, we are unable to evaluate whether management can reasonably provide us with accurate data that is substantially the same as if a complete physical count were to occur.

What if the entity uses a combination of complete physical inventory counts and a cycle count? [ISA | 7765.8399]

If the entity uses a combination of complete physical inventory counts and cycle counts over different categories or locations of inventory, it may be necessary to design separate audit tests for the population subject to the complete physical inventory count and the population subject to cycle counting, forming separate conclusions.

If the entity performs a combination of cycle counts and complete physical inventory counts over the same inventory category or location, we apply the principles of this inventory chapter to design an appropriate response.

1.4.1 Perform procedures for a complete physical count at period end taking a substantive approach

[ISA | 7766]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs a complete physical count at period end THEN perform procedures when taking a substantive approach to performing test counts

Why do we do this?

If we are responding to an RMM over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

Execute the Audit

What procedures do we perform when attending the inventory count? [ISA | 7766.6903]

We perform the following procedures when attending the count:

- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts using a substantive approach
- Determine whether entity's final inventory records accurately reflect count results

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7766.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count at period end? [ISA | 7766.8394]

The entity determines its quantities on-hand by conducting counts at period end. To do so, the entity may either:

- carry out a "single" inventory count at period end.

This means that the entity is relying on the single inventory count at period-end as the basis for determining the quantities and condition of inventory. As there is only a single physical count and there are no reliable inventory records, the entity is not relying on process control activities.

In such circumstances, our test counts are considered to be substantive test of details with a control risk of 'No reliance' (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach').

- carry out a "dual" inventory count at period end.

When a "dual" inventory count is performed, inventory is counted by two different counters and the results of the two counts are compared. If the two counts do not agree, the inventory is recounted to determine the correct count. This second count represents a process control activity designed by management to determine whether the initial inventory count is reliable.

In such circumstances, our test counts could represent either a:

- substantive test of details (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach');
- controls approach (see activity 'Perform procedures for a complete physical count at period end taking a controls approach'); or
- a dual-purpose test (see activity 'Perform procedures for a complete physical count at period end taking a dual-purpose approach').

What documentation may the inventory count observer obtain? [ISA | 7766.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7766.9748]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.1.1 Evaluate management's instructions and procedures [ISA | 7756]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7756.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7756.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7756.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7756.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7756.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7756.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7756.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7756.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.1.2 Observe the performance of management's count procedures [ISA | 7757]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the Audit

What do we do when we observe the performance of management's count procedures? [ISA | 7757.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7757.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7757.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?

- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7757.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7757.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

1.4.1.3 Inspect the inventory [ISA | 7758]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7758.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7758.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.1.4 Perform test counts using a substantive approach [ISA | 7759]

What do we do?

Perform test counts using a substantive approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the Audit

How do we perform test counts? [ISA | 7759.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7759.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when attending an inventory count for a substantive approach? [ISA | 7759.6909]

To determine the number of tests counts we perform the activities detailed below:

How we determine the number of test counts to perform	Relevant activity for additional considerations
Audit sampling	Chapter on audit sampling (AS 2315, ISA 530, AU-C 530).
Specific items	'Perform relevant procedures when we use specific item testing'.
Entire population	'Determine the appropriate means of selecting items'.
Multiple locations (for audit sampling)	See activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant'.
Non homogeneous locations	If some locations are non-homogeneous, then we treat them as separate populations and draw conclusions about each non-homogeneous location separately. It may be necessary to use a sub-population performance materiality (SPM) (see activity 'Determine SPM if applicable').

What inventory balance do we base our substantive sample on? [ISA | 7759.6910]

It depends on whether we are using KSP or MUS.

Sampling technique	**Guidance**
KPMG Sampling Plan (KSP)	We can calculate the sample size based on the total book value of the population to be tested. When the entity has a perpetual inventory system in place, we use it to determine the book value of inventory at the start of the count and calculate the sample size. If we are unable

	to get this at the start of the count, we estimate the book value of the population. When the entity has a periodic inventory system, we estimate the book value of the population.
Monetary Unit Sampling (MUS)	MUS uses a detailed list and cannot simply calculate a general sample size. For this reason, we may choose to use an electronic list of inventory from the perpetual inventory system a few days before the count date to import it into our sampling tool. The tool then uses this list to select the items for testing during the count. Where we are concerned that inventory may increase or change between the date of the file we use and the count date, we think about if it is appropriate to use the file. If the entity uses a periodic system, then we cannot use MUS.

What do we think about when determining the sample unit? [ISA | 7759.6911]

In accordance with '[Perform substantive procedures over sample items]' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7759.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we consider risk related to the completeness of inventory? [ISA | 7759.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7759.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7759.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

> For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7759.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

> For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

Can our floor to sheet test counts apply to our substantive sample for our test counts? [ISA | 7759.6917]

It depends.

If we determine our sample size using the KPMG sampling plan (KSP), we may allocate a portion of our sample between 'sheet-to-floor' selections and 'floor-to-sheet' selections.

If we determine our sample size using MUS, we do not allocate the sample. This is because all MUS samples were selected from the inventory records as monetary units. In this case, our 'floor-to-sheet' samples are selected in addition to the 'sheet-to-floor' samples.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7759.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7759.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from management's? [ISA | 7759.6920]

If we compare our test count results to management's and we identify a difference, we obtain agreement from entity personnel as to the appropriate quantity and, if management's count is incorrect we record the difference as a misstatement. We obtain an understanding about the nature and cause

of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7759.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7759.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7759.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

1.4.1.5 Determine whether entity's final inventory records accurately reflect count results [ISA | 7760]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the Audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7760.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7760.6960]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no misstatement. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a potential control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.2 Perform procedures for a complete physical count at period end taking a controls approach [ISA | 7767]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs a complete physical count at period end THEN perform procedures when taking a controls approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we plan to attend management's inventory count and test process control activities, then we design a separate substantive response in accordance with 'Design and perform substantive procedures for each risk of material misstatement'.

Execute the Audit

What procedures do we perform when attending the inventory count? [ISA | 7767.6924]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts using a controls approach
- Determine whether entity's final inventory records accurately reflect count results

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7767.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count at period end? [ISA | 7767.8401]

The entity determines its quantities on-hand by conducting counts at period end. To do so, the entity may either:

- carry out a "single" inventory count at period end.

This means that the entity is relying on the single inventory count at period-end as the basis for determining the quantities and condition of inventory. As there is only a single physical count and there are no reliable inventory records, the entity is not relying on process control activities.

In such circumstances, our test counts are considered to be substantive test of details with a control risk of 'No reliance' (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach').

- carry out a "dual" inventory count at period end.

When a "dual" inventory count is performed, inventory is counted by two different counters and the results of the two counts are compared. If the two counts do not agree, the inventory is recounted to determine the correct count. This second count represents a process control activity designed by management to determine whether the initial inventory count is reliable.

In such circumstances, our test counts could represent either a:

- substantive test of details (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach');
- controls approach (see activity 'Perform procedures for a complete physical count at period end taking a controls approach'); or
- a dual-purpose test (see activity 'Perform procedures for a complete physical count at period end taking a dual-purpose approach').

What documentation may the inventory count observer obtain? [ISA | 7767.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7767.9732]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.2.1 Test relevant process control activities [ISA | 7761]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the audit

What process control activities do we test? [ISA | 7761.6927]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities over a complete physical inventory count at period end? [ISA | 7761.6928]

The following table illustrates the relevant control considerations when evaluating the design of process control activities over a complete physical inventory count at period end:

Control Considerations	Matters to think about
Physical count is designed and performed appropriately	• the design of count instructions • the application of the count instructions • test counts • recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items are counted	• all inventory items/locations, etc. are in fact counted according to the entity's counting policies
Count results are appropriately monitored across locations, if applicable	• Monitoring overall count results (e.g. count exception rates) to determine if further counts are required (depending on count outcomes)

Do we identify a separate process control activity for every control consideration? [ISA | 7761.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

If the entity performs complete physical counts on a periodic basis (monthly/quarterly), how do we define the process control activity frequency? [ISA | 7761.6930]

Entities may count more frequently to meet operational or regulatory objectives, such as timelier identification of causes of shrinkage or required reporting of hazardous chemical levels to a regulatory agency. In these cases, it may be reasonable to assess the final complete physical count as an annual process control activity. This concept would not be applicable to account balances other than inventory.

In some circumstances, there may be more specific financial reporting objectives, such as when there are regular significant count adjustments that may affect costing standards. In these cases, we think about whether to characterize the process control activity with a higher frequency (e.g. monthly or quarterly).

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7761.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7761.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7761.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7761.6934]

Yes, when we test an entity's homogeneous process control activities over its physical counts that are performed over a population of locations.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7761.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and
(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary

evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7761.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7761.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7761.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7761.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7761.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be

designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7761.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What automated control activities we may test? [ISA | 7761.9733]

The automated control activities we may test include but are not limited to:

- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items were counted
- The reporting of count results.

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7761.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
  - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

    In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
  - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.
- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7761.6944]

Fact Pattern

The entity is a textiles manufacturer and has 10 factories. Each factory has its own warehouse to store its inventories. Complete physical counts are performed at each location on one day.

Analysis

The engagement team determines the following:

The number of locations that we obtain audit evidence for	The engagement team has assessed that the inventory count process control activities are homogeneous, and that RAWTC is base. The engagement team selects 3 locations (of the total 10) and obtain audit evidence on the operating effectiveness of the inventory count process control activities (see 'Determine the number of locations to obtain evidence from'). Of the 3 selected locations, the engagement team selects 2 locations for attendance at management's count. These 2 locations will be subject to observation and reperformance and the other 1 will be subject to inquiry and inspection.
The control sample sizes that the engagement team test, to obtain sufficient appropriate audit evidence of the operating effectiveness of process control activities related to the entity's inventory count control	As the inventory count process control activity is a recurring manual control with a base RAWTC, the controls sample size is 25 in accordance with 'Determine the control sample size'. The engagement team allocates the sample size of 25 over the 2 locations (taking into consideration a minimum of 5 occurrences per location). Location 1 was allocated a sample size of 10 and Location 2 was allocated a sample size of 15 based on the relative size of these locations. The engagement team attends the complete physical counts performed at the 2 locations and observes and re-performs management's test counts for a sample of 10 and 15 at location 1 and 2 respectively. The engagement team perform inquiries and inspection on a variety of documentary evidence of the execution of the complete physical counts of the 1 remaining location (i.e. 1 out of the 3), evaluating whether the inventory count process control activities were implemented as designed and operating effectively, consistent with what

	was observed and re-performed when attending the 2 locations.

How do we respond to the use of scanners in an inventory count? [ISA | 7761.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).
- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.
- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

1.4.2.2 Evaluate management's instructions and procedures [ISA | 7850]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7850.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7850.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7850.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7850.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7850.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7850.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7850.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7850.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.2.3 Observe the performance of management's count procedures [ISA | 7762]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the audit

What do we do when we observe the performance of management's count procedures? [ISA | 7762.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7762.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7762.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?

- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7762.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7762.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7762.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

1.4.2.4 Inspect the inventory [ISA | 7851]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7851.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7851.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.2.5 Perform test counts using a controls approach [ISA | 7763]

What do we do?

Perform test counts using a controls approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the audit

How do we perform test counts? [ISA | 7763.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;

- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7763.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when attending an inventory count for a controls approach? [ISA | 7763.6947]

When we are taking a controls approach we determine the number of test counts to perform in accordance with 'Design a control sample'.

Each individual count is a separate process control activity instance, such that counts are a recurring control when determining the number of test counts to perform for the control sample size and our ability to accept deviations.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7763.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we determine the number of locations to obtain evidence from when the inventory count process control activity is homogeneous? [ISA | 7763.6948]

If the homogenous process control activity operates in multiple locations, we determine the locations to obtain evidence from in accordance with 'Determine the number of locations to obtain evidence from'.

How do we determine the number of items to test at each location when inventory is held at multiple locations and the process control activity is homogeneous? [ISA | 7763.6985]

We determine the number of items to test at each location in accordance with 'Allocate the control sample size'.

How do we consider risk related to the completeness of inventory? [ISA | 7763.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7763.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7763.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7763.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What do we do if our count results differ from management's at a complete count? [ISA | 7763.6986]

If we are performing a test of operating effectiveness and we identify a difference between our count and management's, we treat this as a control deviation, provided the process control activities surrounding the count have been completed.

> For example, if management's initial count differs from the system amount and the quantity counted by the auditor, and the difference is above an error rate that would be subject to the research and recount process control activity, we allow that recount to occur before informing management of the deviation. While the deviation in the initial count process control activity still requires our assessment, the recount control may identify the error and act as a compensating control that effectively mitigates the exception.

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

If we identify control deviations, we perform procedures in accordance with 'Perform relevant procedures when control deviations are identified'. We may be able to tolerate control deviations in accordance with 'Determine the effect of control deviations'.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7763.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7763.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7763.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

Examples

How do we determine if a control deviation exists? [ISA | 7763.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

1.4.2.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7764]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7764.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7764.6988]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no control deviation. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.3 Perform procedures for a complete physical count at period end taking a dual-purpose approach [ISA | 7768]

What do we do?

IF we are responding to an RMM and the entity performs a complete physical count at period end THEN perform procedures when taking a dual-purpose approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we attend the test count taking a dual-purpose approach then we obtain both controls and substantive evidence in response to the RMM. For additional considerations for dual-purpose tests see 'Consider performing a dual-purpose test'.

Execute the audit

What procedures do we perform when attending the inventory count? [ISA | 7768.7265]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts using a dual-purpose approach
- Determine whether entity's final inventory records accurately reflect count results

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7768.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count at period end? [ISA | 7768.8391]

The entity determines its quantities on-hand by conducting counts at period end. To do so, the entity may either:

- carry out a "single" inventory count at period end.

This means that the entity is relying on the single inventory count at period-end as the basis for determining the quantities and condition of inventory. As there is only a single physical count and there are no reliable inventory records, the entity is not relying on process control activities.

In such circumstances, our test counts are considered to be substantive test of details with a control risk of 'No reliance' (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach').

- carry out a "dual" inventory count at period end.

When a "dual" inventory count is performed, inventory is counted by two different counters and the results of the two counts are compared. If the two counts do not agree, the inventory is recounted to determine the correct count. This second count represents a process control activity designed by management to determine whether the initial inventory count is reliable.

In such circumstances, our test counts could represent either a:

- substantive test of details (see activity 'Perform procedures for a complete physical count at period end taking a substantive approach');
- controls approach (see activity 'Perform procedures for a complete physical count at period end taking a controls approach'); or
- a dual-purpose test (see activity 'Perform procedures for a complete physical count at period end taking a dual-purpose approach').

What documentation may the inventory count observer obtain? [ISA | 7768.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7768.9732]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.3.1 Test relevant process control activities [ISA | 7769]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the audit

What process control activities do we test? [ISA | 7769.6927]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities over a complete physical inventory count at period end? [ISA | 7769.6928]

The following table illustrates the relevant control considerations when evaluating the design of process control activities over a complete physical inventory count at period end:

Control	Matters to think about

Considerations	
Physical count is designed and performed appropriately	• the design of count instructions • the application of the count instructions • test counts • recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items are counted	• all inventory items/locations, etc. are in fact counted according to the entity's counting policies
Count results are appropriately monitored across locations, if applicable	• Monitoring overall count results (e.g. count exception rates) to determine if further counts are required (depending on count outcomes)

Do we identify a separate process control activity for every control consideration? [ISA | 7769.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

If the entity performs complete physical counts on a periodic basis (monthly/quarterly), how do we define the process control activity frequency? [ISA | 7769.6930]

Entities may count more frequently to meet operational or regulatory objectives, such as timelier identification of causes of shrinkage or required reporting of hazardous chemical levels to a regulatory agency. In these cases, it may be reasonable to assess the final complete physical count as an annual process control activity. This concept would not be applicable to account balances other than inventory.

In some circumstances, there may be more specific financial reporting objectives, such as when there are regular significant count adjustments that may affect costing standards. In these cases, we think about whether to characterize the process control activity with a higher frequency (e.g. monthly or quarterly).

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7769.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts

are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7769.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7769.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7769.6934]

Yes, when we test an entity's homogeneous process control activities over its physical counts that are performed over a population of locations.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation

and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7769.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and
(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7769.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7769.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7769.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7769.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7769.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7769.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What automated control activities we may test? [ISA | 7769.9733]

The automated control activities we may test include but are not limited to:

- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items were counted
- The reporting of count results.

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7769.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
  - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

    In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
  - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.
- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7769.7318]

Fact Pattern

The entity a textiles manufacturer and has 10 factories. Each factory has its own warehouse to store its inventories. Complete physical counts are performed at each location on one day.

Analysis

The engagement team determines the following:

The number of locations that we obtain audit evidence for	The engagement team has assessed that the inventory control activities and populations are homogeneous, and that RAWTC is base. The engagement team selects 3 locations (of the total 10) and obtain audit evidence on the operating effectiveness of the inventory count process control activities in accordance with 'Determine the number of locations to obtain evidence from'. Of the 3 selected locations, the engagement team selects 2 locations for attendance at management's count. These 2 locations will be subject to observation and

	reperformance and the other 1 will be subject to inquiry and inspection.
The control sample sizes that the engagement team test, to obtain sufficient appropriate audit evidence of the operating effectiveness of process control activities related to the entity's inventory count control	As the inventory count process control activity is a recurring manual control with a base RAWTC, the controls sample size is 25 in accordance with 'Determine the control sample size'. The engagement team allocates the sample size of 25 over the 2 locations (taking into consideration a minimum of 5 occurrences per location). Location 1 was allocated a sample size of 10 and Location 2 was allocated a sample size of 15 based on the relative size of the locations. The engagement team attends the complete physical counts performed at the 2 locations and observes and re-performs management's test counts for a sample of 10 and 15 at location 1 and 2 respectively. The engagement team perform inquiries and inspection on a variety of documentary evidence of the execution of the complete physical counts of the 1 remaining location (i.e. 1 out of the 3), evaluating whether the inventory count process control activities were implemented as designed and operating effectively, consistent with what was observed and re-performed when attending the 2 locations.
The substantive sample size	The substantive sample size will be allocated between the 2 locations where attendance is planned. It is NOT appropriate to allocate a portion of the substantive sample to the location not attending as inspection of documentary evidence is not sufficient appropriate audit evidence from a substantive perspective. If the substantive sample is greater than the process control activity sample, the additional sample size is allocated to the locations attended. For example, if the substantive sample size is 60, it would not be appropriate to allocate 10 to location 1, 15 to location 2 and 35 items

	to location 3. Rather, the sample size of 60 is allocated to location 1 and 2: • Location 1 would have 10 management test counts subject to re-performance and 25 substantive test counts (i.e.15 additional independent test counts) • Location 2 would have 15 management test counts subject to re-performance and 35 substantive test counts (i.e. an additional 20 independent test counts). The engagement team may choose to apply both our substantive testing and process control activities testing to the larger sample size if they wish. In this case, the engagement team allocates the dual-purpose sample size over the 2 locations.

How do we respond to the use of scanners in an inventory count? [ISA | 7769.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).
- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.
- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant

PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

1.4.3.2 Evaluate management's instructions and procedures [ISA | 7852]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7852.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;

- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7852.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7852.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7852.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7852.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7852.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7852.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When

inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7852.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.3.3 Observe the performance of management's count procedures [ISA | 7853]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the audit

What do we do when we observe the performance of management's count procedures? [ISA | 7853.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7853.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7853.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7853.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7853.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7853.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

1.4.3.4 Inspect the inventory [ISA | 7854]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7854.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7854.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.3.5 Perform test counts using a dual-purpose approach [ISA | 7770]

What do we do?

Perform test counts using a dual-purpose approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the audit

How do we perform test counts? [ISA | 7770.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7770.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform for a dual-purpose approach? [ISA | 7770.7347]

When we perform a dual-purpose test, we determine the sample size for the process control activity test (see activity 'Perform test counts using a controls approach') and substantive test (see activity 'Perform test counts using a substantive approach') separately. Each individual count is a separate process control activity instance, such that the counts are a recurring control when determining the number of test counts to perform for the control sample size and considering if we can accept deviations.

> For example, if our sample size determined for process control activity testing is 25 items, and our substantive testing sample size is 100 items, then we only apply our control testing procedures and substantive to 25 items and only the substantive procedures to the remaining 75 samples.

However, we may choose to apply both our substantive testing and process control activities testing to the larger sample size if we wish. This may be appropriate for an inventory count where we perform the same procedure for both purposes.

For additional considerations when determining sample sizes see the chapter on Audit Sampling (ISA 530).

What do we think about when determining the sample unit? [ISA | 7770.6911]

In accordance with 'Perform substantive procedures over sample items' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7770.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we consider risk related to the completeness of inventory? [ISA | 7770.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7770.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7770.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

> For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7770.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

> For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

Can our floor to sheet test counts apply to our substantive sample for our test counts? [ISA | 7770.6917]

It depends.

If we determine our sample size using the KPMG sampling plan (KSP), we may allocate a portion of our sample between 'sheet-to-floor' selections and 'floor-to-sheet' selections.

If we determine our sample size using MUS, we do not allocate the sample. This is because all MUS samples were selected from the inventory records as monetary units. In this case, our 'floor-to-sheet' samples are selected in addition to the 'sheet-to-floor' samples.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7770.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7770.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What do we do if our count results differ from management's at a complete count? [ISA | 7770.6986]

If we are performing a test of operating effectiveness and we identify a difference between our count and management's, we treat this as a control deviation, provided the process control activities surrounding the count have been completed.

> For example, if management's initial count differs from the system amount and the quantity counted by the auditor, and the difference is above an error rate that would be subject to the research and recount process control activity, we allow that recount to occur before informing management of the deviation. While the deviation in the initial count process control activity still requires our assessment, the recount control may identify the error and act as a compensating control that effectively mitigates the exception.

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

If we identify control deviations, we perform procedures in accordance with 'Perform relevant procedures when control deviations are identified'. We may be able to tolerate control deviations in accordance with 'Determine the effect of control deviations'.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7770.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7770.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7770.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

Examples

How do we determine if a control deviation exists? [ISA | 7770.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

1.4.3.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7855]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7855.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7855.6988]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no control deviation. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.4 Perform procedures for a complete physical count at a date other than period end taking a substantive approach [ISA | 7771]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs a complete physical count at date other than period end THEN perform procedures when taking a substantive approach to performing test counts

Why do we do this?

If we are responding to an RMM over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

Execute the audit

What procedures do we perform when attending the inventory count? [ISA | 7771.7381]

We perform the following procedures when attending the count:

- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts using a substantive approach
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7771.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count other than at period end? [ISA | 7771.8402]

If the entity has a periodic inventory system, then we cannot rely on process control activities or outputs from that system to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. However, if the count is performed sufficiently close to the period end we may be able to rely on this count, if we determine that the risk of material misstatement in movements of inventory in the remaining period is remote.

> For example: The inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse is shut. Therefore, we confirm there have been no movements via cut-off testing or the entity's external website indicates that they are shut down during this period.

The following table illustrates the factors we think about to determine nature and extent of procedures to perform when the risk is more than remote:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

After thinking about these factors, we may:

- Attend management's inventory count other than at period end and perform procedures over changes in inventory; or

- Request that the entity perform a full inventory count at period end and attend that count and perform relevant procedures.

What documentation may the inventory count observer obtain? [ISA | 7771.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7771.9748]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.4.1 Evaluate management's instructions and procedures [ISA | 7772]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the audit

How do we evaluate management's instructions and procedures? [ISA | 7772.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);

- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7772.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7772.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7772.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7772.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7772.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7772.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7772.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.4.2 Observe the performance of management's count procedures [ISA | 7773]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the Audit

What do we do when we observe the performance of management's count procedures? [ISA | 7773.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7773.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7773.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7773.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7773.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

1.4.4.3 Inspect the inventory [ISA | 7856]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7856.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7856.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.4.4 Perform test counts using a substantive approach [ISA | 7857]

What do we do?

Perform test counts using a substantive approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the Audit

How do we perform test counts? [ISA | 7857.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7857.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when attending an inventory count for a substantive approach? [ISA | 7857.6909]

To determine the number of tests counts we perform the activities detailed below:

How we determine the number of test counts to perform	Relevant activity for additional considerations
Audit sampling	Chapter on audit sampling (AS 2315, ISA 530, AU-C 530).

Specific items	'Perform relevant procedures when we use specific item testing'.
Entire population	'Determine the appropriate means of selecting items'.
Multiple locations (for audit sampling)	See activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant'.
Non homogeneous locations	If some locations are non-homogeneous, then we treat them as separate populations and draw conclusions about each non-homogeneous location separately. It may be necessary to use a sub-population performance materiality (SPM) (see activity 'Determine SPM if applicable').

What inventory balance do we base our substantive sample on? [ISA | 7857.6910]

It depends on whether we are using KSP or MUS.

Sampling technique	Guidance
KPMG Sampling Plan (KSP)	We can calculate the sample size based on the total book value of the population to be tested. When the entity has a perpetual inventory system in place, we use it to determine the book value of inventory at the start of the count and calculate the sample size. If we are unable to get this at the start of the count, we estimate the book value of the population. When the entity has a periodic inventory system, we estimate the book value of the population.
Monetary Unit Sampling (MUS)	MUS uses a detailed list and cannot simply calculate a general sample size. For this reason, we may choose to use an electronic list of inventory from the perpetual inventory system a few days before the count date to import it into our sampling tool. The tool then

	uses this list to select the items for testing during the count. Where we are concerned that inventory may increase or change between the date of the file we use and the count date, we think about if it is appropriate to use the file. If the entity uses a periodic system, then we cannot use MUS.

What do we think about when determining the sample unit? [ISA | 7857.6911]

In accordance with 'Perform substantive procedures over sample items' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7857.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we consider risk related to the completeness of inventory? [ISA | 7857.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7857.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7857.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

> For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7857.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

> For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

Can our floor to sheet test counts apply to our substantive sample for our test counts? [ISA | 7857.6917]

It depends.

If we determine our sample size using the KPMG sampling plan (KSP), we may allocate a portion of our sample between 'sheet-to-floor' selections and 'floor-to-sheet' selections.

If we determine our sample size using MUS, we do not allocate the sample. This is because all MUS samples were selected from the inventory records as monetary units. In this case, our 'floor-to-sheet' samples are selected in addition to the 'sheet-to-floor' samples.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7857.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7857.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from management's? [ISA | 7857.6920]

If we compare our test count results to management's and we identify a difference, we obtain agreement from entity personnel as to the appropriate quantity and, if management's count is incorrect we record the difference as a misstatement. We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7857.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7857.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7857.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

1.4.4.5 Determine whether entity's final inventory records accurately reflect count results [ISA | 7858]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the Audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7858.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7858.6960]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no misstatement. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a potential control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.4.6 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7774]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the

balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

What procedures may we perform to obtain audit evidence about whether changes in inventory between the count date and the period end are properly recorded? [ISA | 7774.10000]

Based on our assessment of the persuasiveness of the evidence necessary we may perform one or more to the following:

- inspecting purchases of inventory during the intervening period to and from perpetual records;
- inspecting sales of inventory during the intervening period to and from perpetual records;
- inspecting inventory sales and purchases for proper cut-off at period end;
- inspecting the reconciliation of the final adjusted inventory records at the count date to the general ledger at period end, including testing reconciling items;
- performing independent test counts at period end (as accurate counts at the period end provide evidence that changes are appropriately recorded);
- performing substantive analytical procedures (SAPs) to evaluate sales, purchases, gross margin percentages, inventory turnover and/or days sales in inventory; or
- other procedures as appropriate.

In addition to the substantive procedures performed, we may also test process controls activities over inventory movements.

We determine the persuasiveness of the evidence necessary by thinking about the following factors:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.

The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

We think about whether it is possible to gain sufficient appropriate audit evidence over the intervening period without process controls activities testing over inventory movements. The more persuasive the evidence needs to be, the less likely we can obtain sufficient appropriate audit evidence from substantive testing alone and process controls activities testing will be necessary.

What are examples of process control activities over inventory movements? [ISA | 7774.7207]

Examples of process control activities over inventory movements include:

- Process control activities over shipping of goods (e.g. three-way-match for sales)
- Process control activities over receiving goods (e.g. three-way-match for purchases)
- Process control activities over inventory adjustments made throughout the period
- Automated process control activities over the perpetual inventory system, such as control activities that systematically update quantities upon effective execution of the three-way matches
- Process control activities over estimating inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses.

Over what population do we perform our procedures? [ISA | 7774.8468]

We test the movements in the total inventory balance in the intervening period. We may use audit sampling, specific items, 100% testing or a substantive analytical procedure (SAP) only or in combination with tests of process control activities over inventory movements.

Over what population do we perform our procedures when there are multiple locations? [ISA | 7774.7218]

The following approaches may be appropriate:

- Testing the total roll-forward activity for all locations that management counted from the dates of management's counts through period end.
- Testing the roll-forward activity for a sample of locations that management counted from the dates of management's counts through period end, i.e. applying multiple location sampling approach to the roll-forward activity similarly as we would apply such approach to the inventory balances (see activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant').
- Selecting a single date as of or prior to the earliest count performed by management, if counts are performed at different dates, and testing all inventory activity, including any adjustments made as a result of any differences of any count, for all locations from that date through period end.

What else do we do when the count is performed at a date other than at period end? [ISA | 7774.7219]

When we perform substantive procedures as at an interim date, we perform procedures in accordance with the following activities:

- Compare information to identify and investigate items that appear unusual; and

> For example, we may consider the introduction of a new product or purchase of large volumes of new raw materials by an industrial manufacturer during the intervening period as unusual. However, the general decline in balances between November 30 and January 31 in a retail environment because of the seasonal effect of holidays may not be considered unusual.

- Perform additional audit procedures over the remaining period.

How do we design procedures over changes when the entity conducts complete physical counts at multiple locations on different dates other than at period end? [ISA | 7774.7234]

Entities may conduct complete physical counts sporadically throughout the last couple of months of the year, and we may attend some number of those as part of a multiple location substantive sampling approach.

What's ultimately important is that the entity adjusts its subledger for each of the complete physical count results such that the effect of those results carries forward to period-end. What matters is that we can 'rollforward/rollback' the subledger as of the date of each count to the subledger that reconciles to period end inventory.

We apply any of the same approaches as described in question 'Over what population do we perform our procedures when there are multiple locations?' in this activity.

1.4.5 Perform procedures for a complete physical count at a date other than period end taking a controls approach [ISA | 7775]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs a complete physical count at date other than period end THEN perform procedures when taking a controls approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we attend the test count as a process control activity, then we design a separate substantive response in accordance with 'Design and perform substantive procedures for each risk of material misstatement'.

Execute the Audit

What procedures do we perform when attending the inventory count? [ISA | 7775.7197]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test count using a controls approach
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7775.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count other than at period end? [ISA | 7775.8392]

If the entity has a periodic inventory system, then we cannot rely on process control activities or outputs from that system to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. However, if the count is performed sufficiently close to the period end we may be able to rely on this count, if we determine that the risk of material misstatement in movements of inventory in the remaining period is remote.

> For example: The inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse is shut. Therefore, we confirm there have been no movements via cut-off testing or the entity's external website indicates that they are shut down during this period.

The following table illustrates the factors we think about to determine nature and extent of procedures to perform when the risk is more than remote:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary

The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

After thinking about these factors, we may:

- Attend management's inventory count other than at period end and perform procedures over changes in inventory; or
- Request that the entity perform a full inventory count at period end and attend that count and perform relevant procedures.

What documentation may the inventory count observer obtain? [ISA | 7775.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7775.9732]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.5.1 Test relevant process control activities [ISA | 7776]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the Audit

What process control activities do we test? [ISA | 7776.6927]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities over a complete physical inventory count at a date other than period end? [ISA | 7776.7268]

The following table illustrates the relevant control considerations when evaluating the design of process controls activities over a complete physical inventory count at a date other than period end:

Control Considerations	Matters to think about
Inventory movements are recorded correctly	• Shipping of goods • Receiving goods • Inventory adjustments made throughout the period

	• Inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses
Physical count is designed and performed appropriately	• The design of count instructions • The application of the count instructions • Test counts • Recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items are counted	• All inventory items/locations, etc. are in fact counted according to the entity's counting policies
Count results are appropriately monitored across locations, if applicable	• Monitoring overall count results (e.g. count exception rates) to determine if further counts are required (depending on count outcomes)

Do we identify a separate process control activity for every control consideration? [ISA | 7776.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

If the entity performs complete physical counts on a periodic basis (monthly/quarterly), how do we define the process control activity frequency? [ISA | 7776.6930]

Entities may count more frequently to meet operational or regulatory objectives, such as timelier identification of causes of shrinkage or required reporting of hazardous chemical levels to a regulatory agency. In these cases, it may be reasonable to assess the final complete physical count as an annual process control activity. This concept would not be applicable to account balances other than inventory.

In some circumstances, there may be more specific financial reporting objectives, such as when there are regular significant count adjustments that may affect costing standards. In these cases, we think about whether to characterize the process control activity with a higher frequency (e.g. monthly or quarterly).

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7776.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts

are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7776.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7776.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7776.6934]

Yes, when we test an entity's homogeneous process control activities over its physical counts that are performed over a population of locations.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation

and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7776.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and
(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7776.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7776.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7776.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7776.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7776.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7776.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What automated control activities we may test? [ISA | 7776.9733]

The automated control activities we may test include but are not limited to:

- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items were counted
- The reporting of count results.

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7776.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
  - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

    In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
  - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.
- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7776.6944]

Fact Pattern

The entity is a textiles manufacturer and has 10 factories. Each factory has its own warehouse to store its inventories. Complete physical counts are performed at each location on one day.

Analysis

The engagement team determines the following:

The number of locations that we obtain audit evidence for	The engagement team has assessed that the inventory count process control activities are homogeneous, and that RAWTC is base. The engagement team selects 3 locations (of the total 10) and obtain audit evidence on the operating effectiveness of the inventory count process control activities (see 'Determine the number of locations to obtain evidence from'). Of the 3 selected locations, the engagement team selects 2 locations for attendance at management's count. These 2 locations will be subject to observation and

	reperformance and the other 1 will be subject to inquiry and inspection.
The control sample sizes that the engagement team test, to obtain sufficient appropriate audit evidence of the operating effectiveness of process control activities related to the entity's inventory count control	As the inventory count process control activity is a recurring manual control with a base RAWTC, the controls sample size is 25 in accordance with 'Determine the control sample size'. The engagement team allocates the sample size of 25 over the 2 locations (taking into consideration a minimum of 5 occurrences per location). Location 1 was allocated a sample size of 10 and Location 2 was allocated a sample size of 15 based on the relative size of these locations. The engagement team attends the complete physical counts performed at the 2 locations and observes and re-performs management's test counts for a sample of 10 and 15 at location 1 and 2 respectively. The engagement team perform inquiries and inspection on a variety of documentary evidence of the execution of the complete physical counts of the 1 remaining location (i.e. 1 out of the 3), evaluating whether the inventory count process control activities were implemented as designed and operating effectively, consistent with what was observed and re-performed when attending the 2 locations.

How do we respond to the use of scanners in an inventory count? [ISA | 7776.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).
- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.

- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

1.4.5.2 Evaluate management's instructions and procedures [ISA | 7859]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7859.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);

- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7859.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7859.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7859.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7859.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7859.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7859.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7859.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.5.3 Observe the performance of management's count procedures [ISA | 7860]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the audit

What do we do when we observe the performance of management's count procedures? [ISA | 7860.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7860.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7860.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7860.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7860.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7860.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

1.4.5.4 Inspect the inventory [ISA | 7861]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7861.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7861.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.5.5 Perform test counts using a controls approach [ISA | 7884]

What do we do?

Perform test counts using a controls approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the audit

How do we perform test counts? [ISA | 7884.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7884.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when attending an inventory count for a controls approach? [ISA | 7884.6947]

When we are taking a controls approach we determine the number of test counts to perform in accordance with 'Design a control sample'.

Each individual count is a separate process control activity instance, such that counts are a recurring control when determining the number of test counts to perform for the control sample size and our ability to accept deviations.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7884.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we determine the number of locations to obtain evidence from when the inventory count process control activity is homogeneous? [ISA | 7884.6948]

If the homogenous process control activity operates in multiple locations, we determine the locations to obtain evidence from in accordance with 'Determine the number of locations to obtain evidence from'.

How do we determine the number of items to test at each location when inventory is held at multiple locations and the process control activity is homogeneous? [ISA | 7884.6985]

We determine the number of items to test at each location in accordance with 'Allocate the control sample size'.

How do we consider risk related to the completeness of inventory? [ISA | 7884.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7884.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7884.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7884.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What do we do if our count results differ from management's at a complete count? [ISA | 7884.6986]

If we are performing a test of operating effectiveness and we identify a difference between our count and management's, we treat this as a control deviation, provided the process control activities surrounding the count have been completed.

> For example, if management's initial count differs from the system amount and the quantity counted by the auditor, and the difference is above an error rate that would be subject to the research and recount process control activity, we allow that recount to occur before informing management of the deviation. While the deviation in the initial count process control activity still

requires our assessment, the recount control may identify the error and act as a compensating control that effectively mitigates the exception.

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

If we identify control deviations, we perform procedures in accordance with 'Perform relevant procedures when control deviations are identified'. We may be able to tolerate control deviations in accordance with 'Determine the effect of control deviations'.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7884.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7884.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7884.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

Examples

How do we determine if a control deviation exists? [ISA | 7884.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

1.4.5.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7862]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7862.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

> For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7862.6988]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no control deviation. If management's investigation identifies that an

adjustment is necessary to the inventory records, then this is an audit misstatement and a control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.5.7 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7777]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

Can we use our attendance at the count at a date other than at period end to support an assessment of control reliance at the period end? [ISA | 7777.7206]

It depends. When we take a controls approach to our attendance at the inventory count at a date other than at period end, we test process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory. If we determine there are no PRPs over inventory movements then we can support control reliance at period end, without testing process control activities over inventory movements. Otherwise, we test the operating effectiveness of process control activities over inventory movements.

If our attendance at the count is close to the period end, and inventory movements are sufficiently low in the period between the count and the period end, then we may not have PRPs over inventory movements.

> For example, the inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse are shut. Therefore, there are no PRPs over inventory movements and we assess control risk as control reliance as at period end.

If we determine that PRPs over inventory movements exist and process control activity testing is necessary, it may be more efficient and effective to perform this testing throughout the period, so that any issues are identified earlier, and we can plan our response appropriately.

What are examples of process control activities over inventory movements? [ISA | 7777.7207]

Examples of process control activities over inventory movements include:

- Process control activities over shipping of goods (e.g. three-way-match for sales)
- Process control activities over receiving goods (e.g. three-way-match for purchases)
- Process control activities over inventory adjustments made throughout the period
- Automated process control activities over the perpetual inventory system, such as control activities that systematically update quantities upon effective execution of the three-way matches
- Process control activities over estimating inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses.

Over what population do we perform our procedures when there are multiple locations? [ISA | 7777.7218]

The following approaches may be appropriate:

- Testing the total roll-forward activity for all locations that management counted from the dates of management's counts through period end.
- Testing the roll-forward activity for a sample of locations that management counted from the dates of management's counts through period end, i.e. applying multiple location sampling approach to the roll-forward activity similarly as we would apply such approach to the inventory balances (see activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant').
- Selecting a single date as of or prior to the earliest count performed by management, if counts are performed at different dates, and testing all inventory activity, including any adjustments made as a result of any differences of any count, for all locations from that date through period end.

How do we design procedures over changes when the entity conducts complete physical counts at multiple locations on different dates other than at period end? [ISA | 7777.7234]

Entities may conduct complete physical counts sporadically throughout the last couple of months of the year, and we may attend some number of those as part of a multiple location substantive sampling approach.

What's ultimately important is that the entity adjusts its subledger for each of the complete physical count results such that the effect of those results carries forward to period-end. What matters is that we can 'rollforward/rollback' the subledger as of the date of each count to the subledger that reconciles to period end inventory.

We apply any of the same approaches as described in question 'Over what population do we perform our procedures when there are multiple locations?' in this activity.

1.4.6 Perform procedures for a complete physical count at a date other than period end taking a dual-purpose approach [ISA | 7778]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs a complete physical count at date other than period end THEN perform procedures when taking a dual-purpose approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we attend the test count taking a dual-purpose approach then we obtain both controls and substantive evidence in response to the RMM. For additional considerations for dual-purpose tests see 'Consider performing a dual-purpose test'.

Execute the Audit

What procedures do we perform when attending the inventory count? [ISA | 7778.7284]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts using a dual-purpose approach
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7778.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What if the entity has a periodic inventory system and performs a complete physical count other than at period end? [ISA | 7778.8392]

If the entity has a periodic inventory system, then we cannot rely on process control activities or outputs from that system to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. However, if the count is performed sufficiently close to the period end we may be able to rely on this count, if we determine that the risk of material misstatement in movements of inventory in the remaining period is remote.

For example: The inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse is shut. Therefore, we confirm there have been no movements via cut-off testing or the entity's external website indicates that they are shut down during this period.

The following table illustrates the factors we think about to determine nature and extent of procedures to perform when the risk is more than remote:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.

balance (and/or the transactions in the balance)		
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

After thinking about these factors, we may:

- Attend management's inventory count other than at period end and perform procedures over changes in inventory; or
- Request that the entity perform a full inventory count at period end and attend that count and perform relevant procedures.

What documentation may the inventory count observer obtain? [ISA | 7778.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7778.9732]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.6.1 Test relevant process control activities [ISA | 7779]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the Audit

What process control activities do we test? [ISA | 7779.6927]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities over a complete physical inventory count at a date other than period end? [ISA | 7779.7268]

The following table illustrates the relevant control considerations when evaluating the design of process controls activities over a complete physical inventory count at a date other than period end:

Control Considerations	Matters to think about
Inventory movements are recorded correctly	• Shipping of goods • Receiving goods • Inventory adjustments made throughout the period • Inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses
Physical count is designed and performed appropriately	• The design of count instructions • The application of the count instructions • Test counts • Recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items are counted	• All inventory items/locations, etc. are in fact counted according to the entity's counting policies
Count results are appropriately monitored across locations, if applicable	• Monitoring overall count results (e.g. count exception rates) to determine if further counts are required (depending on count outcomes)

Do we identify a separate process control activity for every control consideration? [ISA | 7779.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

If the entity performs complete physical counts on a periodic basis (monthly/quarterly), how do we define the process control activity frequency? [ISA | 7779.6930]

Entities may count more frequently to meet operational or regulatory objectives, such as timelier identification of causes of shrinkage or required reporting of hazardous chemical levels to a regulatory agency. In these cases, it may be reasonable to assess the final complete physical count as an annual process control activity. This concept would not be applicable to account balances other than inventory.

In some circumstances, there may be more specific financial reporting objectives, such as when there are regular significant count adjustments that may affect costing standards. In these cases, we think about whether to characterize the process control activity with a higher frequency (e.g. monthly or quarterly).

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7779.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7779.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7779.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of homogeneous process control activities? [ISA | 7779.6934]

Yes, when we test an entity's homogeneous process control activities over its physical counts that are performed over a population of locations.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7779.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and
(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary

evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7779.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7779.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7779.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7779.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7779.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be

designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7779.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What automated control activities we may test? [ISA | 7779.9733]

The automated control activities we may test include but are not limited to:

- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items were counted
- The reporting of count results.

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7779.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
    - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

      In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
    - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.
- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7779.7318]

Fact Pattern

The entity a textiles manufacturer and has 10 factories. Each factory has its own warehouse to store its inventories. Complete physical counts are performed at each location on one day.

Analysis

The engagement team determines the following:

The number of locations that we obtain audit evidence for	The engagement team has assessed that the inventory control activities and populations are homogeneous, and that RAWTC is base. The engagement team selects 3 locations (of the total 10) and obtain audit evidence on the operating effectiveness of the inventory count process control activities in accordance with 'Determine the number of locations to obtain evidence from'. Of the 3 selected locations, the engagement team selects 2 locations for attendance at management's count. These 2 locations will be subject to observation and reperformance and the other 1 will be subject to inquiry and inspection.
The control sample sizes that the engagement team test, to obtain sufficient appropriate audit evidence of the operating effectiveness of process control activities related to the entity's inventory count control	As the inventory count process control activity is a recurring manual control with a base RAWTC, the controls sample size is 25 in accordance with 'Determine the control sample size'. The engagement team allocates the sample size of 25 over the 2 locations (taking into consideration a minimum of 5 occurrences per location). Location 1 was allocated a sample size of 10 and Location 2 was allocated a sample size of 15 based on the relative size of the locations. The engagement team attends the complete physical counts performed at the 2 locations and observes and re-performs management's test counts for a sample of 10 and 15 at location 1 and 2 respectively. The engagement team perform inquiries and inspection on a variety of documentary evidence of the execution of the complete physical counts

	of the 1 remaining location (i.e. 1 out of the 3), evaluating whether the inventory count process control activities were implemented as designed and operating effectively, consistent with what was observed and re-performed when attending the 2 locations.
The substantive sample size	The substantive sample size will be allocated between the 2 locations where attendance is planned. It is NOT appropriate to allocate a portion of the substantive sample to the location not attending as inspection of documentary evidence is not sufficient appropriate audit evidence from a substantive perspective. If the substantive sample is greater than the process control activity sample, the additional sample size is allocated to the locations attended. For example, if the substantive sample size is 60, it would not be appropriate to allocate 10 to location 1, 15 to location 2 and 35 items to location 3. Rather, the sample size of 60 is allocated to location 1 and 2: • Location 1 would have 10 management test counts subject to re-performance and 25 substantive test counts (i.e.15 additional independent test counts) • Location 2 would have 15 management test counts subject to re-performance and 35 substantive test counts (i.e. an additional 20 independent test counts). The engagement team may choose to apply both our substantive testing and process control activities testing to the larger sample size if they wish. In this case, the engagement team allocates the dual-purpose sample size over the 2 locations.

How do we respond to the use of scanners in an inventory count? [ISA | 7779.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).
- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.
- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

1.4.6.2 Evaluate management's instructions and procedures [ISA | 7863]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7863.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;

- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7863.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7863.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7863.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the

physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7863.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7863.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What do we evaluate about inventory movements during the count? [ISA | 7863.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7863.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.6.3 Observe the performance of management's count procedures [ISA | 7864]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the audit

What do we do when we observe the performance of management's count procedures? [ISA | 7864.6887]

When observing the performance of management's count procedures, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7864.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7864.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?

- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7864.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

What if we identify potential issues during our observation? [ISA | 7864.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7864.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

1.4.6.4 Inspect the inventory [ISA | 7865]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7865.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7865.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.6.5 Perform test counts using a dual-purpose approach [ISA | 7866]

What do we do?

Perform test counts using a dual-purpose approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the audit

How do we perform test counts? [ISA | 7866.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7866.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform for a dual-purpose approach? [ISA | 7866.7347]

When we perform a dual-purpose test, we determine the sample size for the process control activity test (see activity 'Perform test counts using a controls approach') and substantive test (see activity 'Perform test counts using a substantive approach') separately. Each individual count is a separate process control activity instance, such that the counts are a recurring control when determining the number of test counts to perform for the control sample size and considering if we can accept deviations.

> For example, if our sample size determined for process control activity testing is 25 items, and our substantive testing sample size is 100 items, then we only apply our control testing procedures and substantive to 25 items and only the substantive procedures to the remaining 75 samples.

However, we may choose to apply both our substantive testing and process control activities testing to the larger sample size if we wish. This may be appropriate for an inventory count where we perform the same procedure for both purposes.

For additional considerations when determining sample sizes see the chapter on Audit Sampling (ISA 530).

What do we think about when determining the sample unit? [ISA | 7866.6911]

In accordance with 'Perform substantive procedures over sample items' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7866.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we consider risk related to the completeness of inventory? [ISA | 7866.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of the count? [ISA | 7866.6889]

Procedures may include the following:

- Testing management's process control activities over completeness of the inventory count (for example, a tag control).
- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's count records (the count sheet).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations has been counted.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7866.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7866.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

Can our floor to sheet test counts apply to our substantive sample for our test counts? [ISA | 7866.6917]

It depends.

If we determine our sample size using the KPMG sampling plan (KSP), we may allocate a portion of our sample between 'sheet-to-floor' selections and 'floor-to-sheet' selections.

If we determine our sample size using MUS, we do not allocate the sample. This is because all MUS samples were selected from the inventory records as monetary units. In this case, our 'floor-to-sheet' samples are selected in addition to the 'sheet-to-floor' samples.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7866.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7866.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What do we do if our count results differ from management's at a complete count? [ISA | 7866.6986]

If we are performing a test of operating effectiveness and we identify a difference between our count and management's, we treat this as a control deviation, provided the process control activities surrounding the count have been completed.

> For example, if management's initial count differs from the system amount and the quantity counted by the auditor, and the difference is above an error rate that would be subject to the research and recount process control activity, we allow that recount to occur before informing management of the deviation. While the deviation in the initial count process control activity still requires our assessment, the recount control may identify the error and act as a compensating control that effectively mitigates the exception.

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

If we identify control deviations, we perform procedures in accordance with 'Perform relevant procedures when control deviations are identified'. We may be able to tolerate control deviations in accordance with 'Determine the effect of control deviations'.

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7866.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7866.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

How do we test inventory movements during the count for proper inclusion or exclusion within inventory? [ISA | 7866.6900]

Based on our assessment of whether movements could cause the count results to be incorrect, we perform procedures designed to test inventory movements during the count. These procedures may include:

- testing that items "received" before the count date are included in the inventory sub-ledger on the count date, and items "received" after the count date are excluded;
- testing that items "shipped" before the count date are excluded from the inventory sub-ledger on the count date, and items "shipped" after the count date are included; and
- validating that those items were shipped and received on the date of management's records by tracing or vouching them to original source documentation.

We also think about whether there are instances where inventory movement occurred between the time the inventory was received and the time counting commenced, which could lead to differences.

Examples

How do we determine if a control deviation exists? [ISA | 7866.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

1.4.6.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7867]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7867.6957]

We obtain copies of management's completed physical inventory count records to perform subsequent procedures and, when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- for a perpetual system, obtain evidence regarding whether differences between the count records and the system were appropriately investigated;

For example, supplier owned consignment inventory was not identified appropriately and has been inappropriately counted and recorded in the records, creating an error.

- reconcile the post-count adjusted sub-ledger to the general ledger;
- if there is a difference between the count results and management's post-count adjusted sub-ledger, investigate the reason for such difference.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger? [ISA | 7867.6988]

If management's subsequent investigation has determined inventory records (i.e. the post-count adjusted sub-ledger) are correct and an adjustment is not needed, then we obtain evidence that this is appropriate and that there is no control deviation. If management's investigation identifies that an adjustment is necessary to the inventory records, then this is an audit misstatement and a control deviation.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.6.7 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7780]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

What procedures may we perform to obtain audit evidence about whether changes in inventory between the count date and the period end are properly recorded? [ISA | 7780.7214]

Based on our assessment of the persuasiveness of the evidence necessary we may perform one or more to the following:

- inspecting purchases of inventory during the intervening period to and from perpetual records;

- inspecting sales of inventory during the intervening period to and from perpetual records;
- inspecting inventory sales and purchases for proper cut-off at period end;
- inspecting the reconciliation of the final adjusted inventory records at the count date to the general ledger at period end, including testing reconciling items;
- performing independent test counts at period end (as accurate counts at the period end provide evidence that changes are appropriately recorded);
- performing substantive analytical procedures (SAPs) to evaluate sales, purchases, gross margin percentages, inventory turnover and/or days sales in inventory; or
- other procedures as appropriate.

In addition to the substantive procedures performed, we may also test process controls activities over inventory movements.

We determine the persuasiveness of the evidence necessary by thinking about the following factors:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.

balance (and/or the transactions in the balance)		
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

We think about whether it is possible to gain sufficient appropriate audit evidence over the intervening period without process controls activities testing over inventory movements (see question 'What are examples of process controls activities over inventory movements?'). The more persuasive the evidence needs to be, the less likely we can obtain sufficient appropriate audit evidence from substantive testing alone and process controls activities testing will be necessary.

Over what population do we perform our procedures? [ISA | 7780.8468]

We test the movements in the total inventory balance in the intervening period. We may use audit sampling, specific items, 100% testing or a substantive analytical procedure (SAP) only or in combination with tests of process control activities over inventory movements.

Over what population do we perform our procedures when there are multiple locations? [ISA | 7780.7218]

The following approaches may be appropriate:

- Testing the total roll-forward activity for all locations that management counted from the dates of management's counts through period end.
- Testing the roll-forward activity for a sample of locations that management counted from the dates of management's counts through period end, i.e. applying multiple location sampling approach to the roll-forward activity similarly as we would apply such approach to the inventory balances (see activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant').
- Selecting a single date as of or prior to the earliest count performed by management, if counts are performed at different dates, and testing all inventory activity, including any adjustments made as a result of any differences of any count, for all locations from that date through period end.

Can we use our attendance at the count at a date other than at period end to support an assessment of control reliance at the period end? [ISA | 7780.7206]

It depends. When we take a controls approach to our attendance at the inventory count at a date other than at period end, we test process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory. If we determine there are no PRPs over inventory movements then we can support control reliance at period end, without testing process control activities over inventory movements. Otherwise, we test the operating effectiveness of process control activities over inventory movements.

If our attendance at the count is close to the period end, and inventory movements are sufficiently low in the period between the count and the period end, then we may not have PRPs over inventory movements.

For example, the inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse are shut. Therefore, there are no PRPs over inventory movements and we assess control risk as control reliance as at period end.

If we determine that PRPs over inventory movements exist and process control activity testing is necessary, it may be more efficient and effective to perform this testing throughout the period, so that any issues are identified earlier, and we can plan our response appropriately.

What are examples of process control activities over inventory movements? [ISA | 7780.7207]

Examples of process control activities over inventory movements include:

- Process control activities over shipping of goods (e.g. three-way-match for sales)
- Process control activities over receiving goods (e.g. three-way-match for purchases)
- Process control activities over inventory adjustments made throughout the period
- Automated process control activities over the perpetual inventory system, such as control activities that systematically update quantities upon effective execution of the three-way matches
- Process control activities over estimating inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses.

What else do we do when the count is performed at a date other than at period end? [ISA | 7780.7219]

When we perform substantive procedures as at an interim date, we perform procedures in accordance with the following activities:

- Compare information to identify and investigate items that appear unusual; and

For example, we may consider the introduction of a new product or purchase of large volumes of new raw materials by an industrial manufacturer during the intervening period as unusual. However, the general decline in balances between November 30 and January 31 in a retail environment because of the seasonal effect of holidays may not be considered unusual.

- Perform additional audit procedures over the remaining period.

How do we design procedures over changes when the entity conducts complete physical counts at multiple locations on different dates other than at period end? [ISA | 7780.7234]

Entities may conduct complete physical counts sporadically throughout the last couple of months of the year, and we may attend some number of those as part of a multiple location substantive sampling approach.

What's ultimately important is that the entity adjusts its subledger for each of the complete physical count results such that the effect of those results carries forward to period-end. What matters is that we can 'rollforward/rollback' the subledger as of the date of each count to the subledger that reconciles to period end inventory.

We apply any of the same approaches as described in question 'Over what population do we perform our procedures when there are multiple locations?' in this activity.

1.4.7 Not Integrated Audit | Perform procedures when taking an independent count approach [ISA | 7868]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs either cycle counts or a complete count at a date other than at period end THEN perform procedures when taking an independent count approach

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

Execute the audit

What relevant procedures do we perform when taking an independent count approach? [ISA | 7868.8362]

We perform the following procedures when taking an independent count approach:

- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test count using the independent count approach

When management's complete physical count is performed over multiple days, do we attend every day? [ISA | 7868.6904]

It depends. We determine the extent of our attendance that will enable us to observe enough of the count to be able to perform all of our procedures during the count, including performing test counts, observing system updates and gathering information relevant to procedures performed after the count, and to obtain evidence that throughout the period of the count it was performed consistently.

It is not appropriate to only attend at the end of the count to gather information and then perform test counts after management has already completed their count.

What documentation may the inventory count observer obtain? [ISA | 7868.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7868.9755]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- The perpetual sub-ledger records
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement.

1.4.7.1 Not Integrated Audit | Evaluate management's instructions and procedures [ISA | 7869]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7869.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;

- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7869.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7869.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7869.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7869.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7869.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What else do we evaluate when the entity performs cycle counts? [ISA | 7869.7244]

We evaluate the entity's cycle count program, including the following:

Consideration	Why do we evaluate this?
Whether all items are counted sufficiently frequently	A perpetual inventory system is designed to be an accurate reflection of inventory on hand at any point in time. Management's cycle count is a detective process control activity over the completeness and accuracy of book records. In order to be sufficiently precise, it needs to operate with sufficient frequency to identify and correct differences between actual inventory and records before they become large enough to affect the management's decision making. We evaluate whether it performed frequently enough to produce results substantially the same as those that would be obtained by a count of all items each year.
If and what cycle count software is used	Depending on the level of automation used by management, it may be necessary to test automated control activities over the inventory count.
The process surrounding how items are selected to be counted	If the process relies on automated production of reports such as count sheets, it may be necessary to test automated control activities over, or perform direct testing of, these reports.
The process surrounding the generation of count selections (e.g. count sheets) (i.e. documents detailing the locations and items to be counted)	During a cycle count, only a portion of the entity's inventory is counted at a particular time. Therefore, the count sheets not only provide a means for the entity to document its counts, but also serve as the scope of the inventory being counted at that particular point in time. The count sheets provide evidence that the counts performed had the appropriate coverage of inventory as designed under the cycle count procedures.

How management monitors that locations or items are counted as planned	We understand how management monitors the application of the count program to ensure the count program has operated as planned.
The processes that are in place for monitoring the results of the program	We understand the level of variances between the count results and the inventory in the perpetual system to determine whether they are low enough for us to be able to rely on the cycle count process control activity or further counts or a complete physical count will be necessary.

How do we evaluate whether all items are counted sufficiently frequently? [ISA | 7869.7245]

We think about the following factors when evaluating whether all items are counted sufficiently frequently:

Factors	Additional Guidance
The value of the individual items in inventory	As the value of individual items in inventory increases, the planned frequency of management's counts would be expected to increase.
Volume of activity	As inventory turnover increases, the planned frequency of management's counts would be expected to increase.
Nature of inventory	As goods become more susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.
Physical Security of warehouse	As physical security decreases at the warehouse it makes the inventory more susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.

What if items are counted less than once a year? [ISA | 7869.7246]

If the entity's cycle count program does not include a count of all items each year, we think about whether the procedures or methods are sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year.

Is it appropriate for a cycle count program to be designed to count inventory items by their physical storage location (e.g. bins, bays, shelves, rows) as opposed to by SKU? [ISA | 7869.7249]

Yes. An appropriate set of units may include inventory storage locations (e.g. bins, bays, or shelves within a warehouse) or individual inventory SKUs. When evaluating management's cycle count procedures, we identify the **'set of units'** used by management to design, perform and monitor cycle count progress in line with their planned cycle count program.

The auditing standards do not specify that the entity's cycle count procedures include a count of each inventory item or that inventory 'item' is defined as the entity's SKU categorization.

Cycle count techniques are regularly performed counts of a subset of inventory items throughout the period to monitor the effectiveness of control activities over inventory movement and the accuracy of the entity's perpetual inventory system on any given date. Cycle counts are not designed to count all items that are held in inventory at period-end, regardless of how those inventory items are categorized or the counting selection method (e.g. by storage location, SKU). As long as the cycle counts are consistently verifying the accuracy of the perpetual records, control activities over accuracy of the perpetual inventory system are working and, therefore, the perpetual inventory records are reliable at any given point in time.

Therefore, the set of units used by management for cycle counts is typically a function of the nature of the entity's inventory and how management categorizes and organizes its inventory. Cycle count programs with a set of units based on storage location, SKU, or other categorizations may be designed effectively to meet the objective of a cycle count.

How do we identify the set of units? [ISA | 7869.7251]

We identify the set of units used by management by considering how the entity tracks its inventory cycle counts (e.g. by storage location, SKU).

How do we assess whether the use of the set of units is appropriate? [ISA | 7869.7253]

We consider the following:

- Whether management applies its cycle count procedures over the set of units in a systematic manner without bias.
- Whether the count process control activities are operating over the entire set of units the process control activity is designed to cover.

> For example, if the controls are designed to cycle count all storage locations (e.g. bins, bays or shelves) within a facility, that all storage locations were in fact counted. If the controls are designed to cycle count all SKUs, based on an A, B, C categorization, the counts are executed consistently with that design and all SKUs are counted.

What else do we think about when management uses storage location as its set of units? [ISA | 7869.7256]

We also think about the following when management uses storage location (e.g. bins, bays and shelves) as its set of units:

- Storage location-based cycle counts help to eliminate selection bias (i.e. it avoids selection of only high dollar value items) and addresses the risk of completeness (i.e. identifies inventory that is found in a location but is not reflected in the perpetual records).
- The entity's inventory system may track quantity on a storage location-by- storage location basis; therefore, management could determine that validating the accuracy of inventory storage location is key in order for the perpetual inventory records to be accurate.
- The nature of the entity's inventory and layout of its facilities makes it logistically efficient to conduct counts by storage location.
- Whether inventory moves between storage locations within the facility, and if so, how frequently movements occur and how those movements are addressed in the cycle count procedures.
- Whether there have been any changes to the geographic layout of the facility during the year, and if so, how those changes affect the inventory records and how they are addressed in the cycle count procedures.
- Whether there are any identified fraud risks or fraud risk factors to be considered, such as the risk of company personnel moving inventory between storage locations to circumvent the identification of missing inventory during cycle counts.

What do we evaluate about inventory movements during the count? [ISA | 7869.9815]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count.

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7869.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.7.2 Not Integrated Audit | Observe the performance of management's count procedures [ISA | 7870]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the audit

What do we do when we observe the performance of management's count procedures? [ISA | 7870.7377]

When observing the performance of management's count procedures, including inventory movements, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary;
- inquire about whether the same procedures were followed throughout the period, if applicable; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7870.9729]

We determine whether the understanding provided by the engagement team of the inventory movements in the facility during the count is correct. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7870.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?

- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How many locations do we observe the performance of management's count procedures? [ISA | 7870.8377]

If the locations do not have shared characteristics, we perform an observation at each location at which we intend to perform an independent count to obtain evidence that management's instructions are adequately designed and implemented.

If the locations have shared characteristics, we use judgement to determine how many locations to perform an observation.

How many cycle counts do we observe the performance of management's count procedures? [ISA | 7870.8354]

We observe at least one cycle count.

What if we identify potential issues during our observation? [ISA | 7870.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

Not Integrated Audit | What evidence may indicate that the perpetual system is not reliable? [ISA | 7870.8356]

We inspect the records of management's counts and procedures relating to the physical inventory on which the period-end inventory is based to identify whether management's count records indicate a level of inaccuracy in inventory records that could give rise to a material misstatement (differences between management's count results and the pre-count records).

1.4.7.3 Not Integrated Audit | Inspect the inventory

[ISA | 7871]

What do we do?

Inspect the inventory to assess its condition as part of our independent inventory count

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the audit

Why do we inspect the inventory? [ISA | 7871.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7871.8378]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.7.4 Not Integrated Audit | Perform test counts using an independent count approach [ISA | 7872]

What do we do?

Perform test counts using an independent count approach, including obtaining evidence over completeness of inventory records

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the audit

How do we perform test counts for an independent count approach? [ISA | 7872.8363]

We:

- compare our test count results to inventory records and determine the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc.;

- count individual items within any open containers; and
- ask entity personnel to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

What if the entity has work-in-progress (WIP)? [ISA | 7872.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when performing an independent count? [ISA | 7872.8365]

To determine the number of counts we perform the activities detailed below:

How we determine the number of counts to perform	Relevant activity for additional considerations
Audit sampling	Chapter on audit sampling (AS 2315, ISA 530, AU-C 530).
Specific items	'Perform relevant procedures when we use specific item testing'.
Entire population	'Determine the appropriate means of selecting items'.
Multiple locations (for audit sampling)	See activity 'Determine the substantive sampling approach for multiple locations, seeking assistance if relevant'.
Non homogeneous locations	If some locations are non-homogeneous, then we treat them as separate populations and draw conclusions about each non-homogeneous location separately. It may be necessary to use a sub-population performance materiality (SPM) (see activity 'Determine SPM if applicable').

Remember that we assess control risk as no control reliance, when assessing combined assessed risk (CAR).

What inventory balance do we base our substantive sample on? [ISA | 7872.8366]

It depends on whether we are using KSP or MUS.

Sampling technique	Guidance

KPMG Sampling Plan (KSP)	We can calculate the sample size based on the total book value of the population to be tested. When the entity has a perpetual inventory system in place, we use it to determine the book value of inventory at the start of the count and calculate the sample size. If we are unable to get this at the start of the count, we estimate the book value of the population When the entity has a periodic inventory system, we estimate the book value of the population.
Monetary Unit Sampling (MUS)	MUS uses a detailed list and cannot simply calculate a general sample size. For this reason, we may choose to use an electronic list of inventory from the perpetual inventory system a few days before the count date to import it into our sampling tool. The tool then uses this list to select the items for testing during the count. Where we are concerned that inventory may increase or change between the date of the file we use and the count date, we think about if it is appropriate to use the file. If the entity uses a periodic system, then we cannot use MUS.

As we are comparing our independent count to management's inventory records, there is an increased chance that we identify small differences rather than comparing to management's results when attending the count. As a result, we think about setting an expected misstatement above 0 when determining our sample size (see question 'How do we determine the expected misstatement?).

What do we think about when determining the sample unit? [ISA | 7872.6911]

In accordance with 'Perform substantive procedures over sample items' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

Do we exclude excess, obsolete or damaged inventory from our test counts? [ISA | 7872.6894]

It depends. When such inventory is fully written down such that its net book value is zero and we have audit evidence that this is appropriate, we may determine it is appropriate to exclude it from exclude it from our test counts.

However, when inventory is only partially written down, particularly if the write-down is calculated based on the total quantity on hand, or if we have not obtained audit evidence that a full write-down is appropriate and so a reversal of some or all of the write-down is a possibility, then it may be appropriate to include these inventory items within our test counts.

How do we consider risk related to the completeness of inventory? [ISA | 7872.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

How do we obtain evidence over the completeness of inventory records? [ISA | 7872.8368]

Procedures may include the following:

- Performing floor to sheet counts (tracing items selected from the physical inventory (the floor) to management's inventory records on which we based our count).
- Inspecting the inventory perpetual list for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and determining whether or not there is any inventory in a selection of those locations.
- Inspecting whether any inventory which is stored outside of the normal inventory locations is included in inventory records on which we based our count.

Other audit procedures performed after the count may also provide evidence over completeness:

- performing substantive analytical procedures to evaluate the gross margin percentages;
- evaluating inventory turnover and/or days sales in inventory;
- testing inventory sales/purchases for proper cut-off at the inventory count date and at period end; and/or
- testing the accuracy of the inventory reconciliation to the general ledger at period end, including tests of reconciling items.

What are 'floor-to-sheet' counts? [ISA | 7872.6890]

A 'floor-to-sheet' count is when we select from the 'floor' of the inventory location (or the bins, shelves, stacks, vats, or other locations where the entity holds inventory), and we trace to the 'sheet', or the inventory records.

This is differentiated from the rest of our test counts, when we select from the 'sheet' or the inventory records and we count the item on the 'floor'.

For example, while on the 'floor', we select frozen food product EFG from location 246 as our 'floor' selection. We then count the number of pieces within location 246 without first looking at count sheets or book records and agree our count to management's count sheets.

'Floor-to-sheet' counts test the completeness of the inventory quantities in the entity's inventory sub-ledger, because an error due to an inventory understatement may be discovered when we find an item that's not on the inventory records. Testing from the floor also provides some evidence over existence.

How do we perform 'floor-to-sheet' counts? [ISA | 7872.6891]

We select a number of inventory items from the floor of the inventory location and trace the quantity we count to the 'sheet', or inventory records.

The organization of the inventory count sheet can impact how we conduct our 'floor-to-sheet' counts.

For example, if items are located in multiple storage locations throughout the warehouse and the count sheets are only organized by item number, we select an item from the floor and identify all of that item in the warehouse, regardless of location, to perform the 'floor-to-sheet' count. However, if the count sheets are organized by items by location, we do not count every location.

Can our floor to sheet test counts apply to our substantive sample for our test counts? [ISA | 7872.6917]

It depends.

If we determine our sample size using the KPMG sampling plan (KSP), we may allocate a portion of our sample between 'sheet-to-floor' selections and 'floor-to-sheet' selections.

If we determine our sample size using MUS, we do not allocate the sample. This is because all MUS samples were selected from the inventory records as monetary units. In this case, our 'floor-to-sheet' samples are selected in addition to the 'sheet-to-floor' samples.

Not Integrated Audit | May we use an acceptable variance when comparing our test counts to the inventory records? [ISA | 7872.8370]

Yes. There are circumstances when our counting method naturally contains some imprecision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to inventory records and differences within the acceptable variance do not indicate a control deviation or misstatement.

See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7872.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from inventory records? [ISA | 7872.8373]

If we compare our test count results to inventory records and we identify a difference, then we record the difference as a misstatement. We obtain an understanding about the nature and cause

of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

What else do we think about if our count results differ from inventory records? [ISA | 7872.8374]

Management cannot use the results of our count to alter their inventory records as this would constitute us preparing management's financial statements. If differences are identified, management considers whether they need to investigate and ultimately quantify and record their own correction of any misstatement - which may or may not include management performing a complete physical count.

What procedures do we perform to determine whether the entity's final inventory records accurately reflect count results? [ISA | 7872.8375]

Although we're not reperforming management's counts, the performance of our independent counts of inventory held at period end still provides evidence that final inventory records accurately reflect count results (otherwise our results would not reconcile to the period end financial records).

Are we expected to perform procedures over inventory in-transit (inventory that is en-route to or from third parties)? [ISA | 7872.6898]

If there is a risk related to inventory in-transit as part of the RMM over quantity and condition of inventory we respond to that risk by performing procedures over inventory in transit.

External source documents (external invoices, bills of lading, vendor statements, etc.) may provide sufficient and appropriate evidence as to the existence and accuracy of inventory while it is in transit (assuming significant variances between amounts reported by the supplier and amounts actually counted at the receiving dock are not common). Also, it may be impracticable to observe inventory while it is in transit.

Possible situations where we may determine it is appropriate to inspect the inventory in- transit subsequently received include unusual volumes, highly specialized or high dollar items.

What if there are intra-entity/group transfers (i.e. shipments between warehouses or from warehouses to stores)? [ISA | 7872.6899]

If there is a risk of material misstatement (RMM) related to inventory transfers in-transit between multiple locations (e.g. intra-entity/group transfers), we respond to that risk by performing procedures over inventory intra-entity/group transfers.

If the audit evidence is from an internal source (i.e. information produced by the entity, not external source documents), we evaluate whether it is sufficiently reliable for our audit purposes, which may include agreeing documentation to subsequent delivery or inspecting inventory in transit. We perform procedures to validate that inventory is only recorded once (i.e. taken out at transferor and put in books in transferee).

1.4.8 Perform procedures for cycle counts when taking a controls approach [ISA | 7785]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs cycle counts THEN perform procedures when taking a controls approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we attend the test count as a process control activity, then we design a separate substantive response in accordance with 'Design and perform substantive procedures for each risk of material misstatement'.

Execute the Audit

What relevant procedures do we perform when attending the count? [ISA | 7785.7215]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect Inventory
- Perform test count using a controls approach
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

Can the entity perform a cycle count if it has a periodic inventory system? [ISA | 7785.8396]

No. It is not possible for an entity or us to rely on cycle counts because the entity does not have effective processes and process control activities over inventory receipts and shipments that enable effective cycle count process control activities. Furthermore, we are unable to evaluate whether management can reasonably provide us with accurate data that is substantially the same as if a complete physical count were to occur.

What documentation may the inventory count observer obtain? [ISA | 7785.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7785.9747]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- The perpetual sub-ledger records
- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.8.1 Test relevant process control activities [ISA | 7786]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the Audit

What process control activities do we test for cycle counts? [ISA | 7786.7348]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities for cycle counts? [ISA | 7786.7349]

The following table illustrates the relevant control considerations when evaluating the design of cycle count process control activities:

Control Considerations	Matters to think about
Inventory movements are recorded correctly	• Shipping of goods • Receiving goods • Inventory adjustments made throughout the period • Inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses
Physical count is designed	• The design of count instructions • The application of the count instructions • Test counts

and performed appropriately	• Recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items to be counted within the cycle period were ultimately counted	• All inventory items/locations, etc. are in fact counted in the cycle period, according to the entity's counting policies (e.g. A category items are counted every 30 days, B category items every 60 days, etc.)
Count results are appropriately monitored across all counts	• Monitoring overall cycle count results (e.g. count exception rates) to determine if further counts or complete physical counts are required (depending on count outcomes)

Do we identify a separate process control activity for every control consideration? [ISA | 7786.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

Why do we test process control activities over all control considerations when attending cycle counts? [ISA | 7786.7351]

When an entity uses cycle counts, we satisfy ourselves that management's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by complete physical count of each item of inventory. To do so, we test the entity's process control activities that address the control objectives identified for cycle counts.

Process control activities over cycle counts are designed to determine inventory quantities (in practice, they are used to confirm accuracy of quantities reflected in a perpetual system) to prevent more than minor adjustments between the inventory records and physical cycle counts and thus produce the same results as a complete physical count. If more than a few minor adjustments are made to adjust inventory quantities as a result of cycle counts, this may indicate that cycle counting may not be appropriate and that a complete physical count at or near period end is warranted.

What are cycle count process control activities that we may test? [ISA | 7786.7352]

- Management's validation of inventory movements including, shipping, receiving, and transfers and any related safeguards.
- Management's verification of appropriate automated process control activities supporting the perpetual system.
- Policies for executing the counts including the frequency of counts and who is responsible for the counts.
- Management's verification that all inventory items/locations eligible to be counted are subject to count and result in substantially the same result as an annual count.

- Management's verification that each item that should be counted, is counted, including the use of count sheets.
- Management's identification of any obsolete, damaged, or lost (shrink) inventory.
- Management's identification and resolution of any differences identified during the count, including performing recounts.
- Management's recording of adjustments resulting from count procedures.
- Management's monitoring of accuracy of counts to periodically re-evaluate whether the cycle count program remains appropriate.

How do we determine the frequency of a cycle count process control activity(ies)? [ISA | 7786.7356]

It depends.

A cycle count process control activity(ies) may operate on a periodic basis (e.g. daily, weekly) and cover many individual set of units, and therefore involves elements of both a periodic control and a manual recurring control. It's reasonable to determine that the process control activity operates over individual set of units (e.g. SKU level), and that the counts simply occur over time such that each item is counted X times per period pursuant to management's policy. In this case, we treat each individual count of a unit (e.g. SKU) as a separate process control activity instance, such that the count is a recurring control when determining the number of test counts to perform and our ability to accept control deviations.

> For example, when multiple SKUs are counted over the year, this is considered a manual recurring control for the purposes of determining control sample sizes and our ability to accept control deviations (provided that there are more than 366 SKUs counted).

Even though the test count process control activity operates a manual recurring basis, the number of days from which we to obtain evidence from is determined separately in accordance with 'How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities?'. If the process control activity is performed over multiple locations, we determine the number of locations to obtain evidence from in accordance with 'Determine the number of locations to obtain evidence from'.

We may identify separate cycle count process control activities that occur once each time the cycle count is performed, on an ad-hoc basis or independent of the physical cycle count and are not considered as occurring over each individual unit counted. We therefore may consider certain process control activities operating as part of the cycle count as being periodic based on the frequency of occurrence in accordance with 'How do we determine the frequency of a control?' and we determine the control sample size in accordance with 'Determine the control sample size'.

Once we have determined the frequency of cycle count process control activity(ies), we determine whether we can get evidence of the operating effectiveness through performance of test counts or whether we plan additional procedures to obtain this evidence.

> For example, performance of test counts may also give us evidence around accuracy of the counting, accuracy of recording inventory count quantities, the appropriate implementation and following of count instructions. However, there may be other cycle count process control activities that operate at a different frequency e.g. the control that ensures all inventory is counted in the

period may operate quarterly and we would test this separately using the controls sample size table to determine the relevant sample size.

Can we perform our procedures on one day? [ISA | 7786.7358]

No, because the process control activity happens over time, it would be inappropriate to attend all our counts on a single day, even if spread over multiple locations. Instead, we gather evidence of the process control activity's operation over at least two cycle counts such that we achieve a meaningful distribution of the sample to gain evidence that the process control activity operates consistently over time across the entire population of inventory.

How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities? [ISA | 7786.7359]

We determine how many cycle counts to attend and select a representative sample from the period in which the process control activity operates. It would not be appropriate to only attend one cycle count in the period.

We also think about the following factors when determining the number of cycle counts to obtain evidence from:

Factors	Guidance
Risk associated with the control (RAWTC)	The higher the assessed RAWTC, the more cycle counts we obtain evidence from
Frequency of count	If more items counted per day, but fewer days, we may observe fewer cycle counts.
Other process control activities addressing the same RMM	Process control activities over shipping and receiving, the 3-way match for purchases and sales and the recording of inventory movements, when tested and determined to be designed, implemented and operating effectively, reduce the likelihood that the perpetual inventory records are inaccurate.
Historical count accuracy (vs. records)	When count accuracy is high, it validates the quality and precision of the related process control activities.
Nature of inventory	Low dollar/large quantity and neatly stacked provide lower risk. When inventory turns quickly, related process control activities have more recent influence on quantities on hand.

Homogeneity of control activities	The number of the entity's locations where the homogeneous control activity operates that will be subject to testing (e.g. it is not necessary to test each location multiple times when the total number of locations tested achieves our objective of observing a sufficient number of points in time). For example, if we determined that we intended to gather evidence from 15 locations to test management's assertion of homogeneity for process control activity testing purposes and determined that it would be necessary to observe counts on 10 different days. If we attend the 15 locations on 15 different days, this meets both objectives.

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7786.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7786.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the

entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7786.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts? [ISA | 7786.7363]

Yes. When we test an entity's process control activities over its physical counts that are performed on a cycle over the course of the year.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7786.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and

(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are

consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7786.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7786.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7786.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7786.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7786.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7786.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What cycle count automated control activities we may test? [ISA | 7786.9749]

The automated control activities we may test include but are not limited to:

- Configuration of how items are selected
- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items subject to the cycle counts were counted at the proper frequency
- The reporting of cycle count results (e.g. periodic summary reports reviewed centrally).

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7786.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
    - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

      In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
    - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.

- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7786.7373]

Fact pattern

The entity performs weekly cycle counts and the engagement team determines that they will obtain audit evidence for 5 cycle counts throughout the period. The engagement team assess the process control activity has a base RAWTC and, using the control sample size table, they perform 25 test counts in total (deemed a manual recurring control).

Analysis

The engagement team design their audit response to include a combination of techniques as follows:

After considering RAWTC, the engagement team determines it is appropriate to attend 3 cycle counts to perform observation and reperformance. During their attendance, they perform test counts of 25 items (approximately 8-9 items at each instance), to reperform management's counts as part of testing management's cycle count. The engagement team also test any periodic process control activities (controls performed once each time a count is performed) relevant to the count such as process control activities over selection of items for counting or process control activities over monitoring count results.

The engagement team performs inquiries and gather and inspect a variety of documentary evidence of the execution of weekly cycle counts for the remaining 2 cycle counts, evaluating whether the count process control activities are designed, implemented and operating effectively, consistent with what was observed in the performance of the procedures above.

The engagement team also performs inquires of the control operator(s) regarding how the count was performed, e.g. inquiring over how they controlled inventory movements during the count and how they deal with variances between the counted items and count sheets.

How do we respond to the use of scanners in an inventory count? [ISA | 7786.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).

- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.
- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

What type of process control activity do we test over the selection of items for counting? [ISA | 7786.7375]

Fact Pattern

Assume Company ABC uses a cycle count program with the following fact pattern:

- there are 26 pre-defined locations where inventory is stored and subject to cycle counting;
- the company conducts cycle counts on a weekly basis where one location is fully counted during each count;
- each location will be counted twice during the year;
- to track the counts, the warehouse supervisor maintains the stack of count sheets from each weekly count and tracks the progress of the counts within a separate control log, and
- at the end of the year, the corporate controller reviews the supervisor's control log, along with the count sheets from the cycle counts to determine whether all of the 26 locations were counted twice during the year.

Analysis

In such a case, the engagement team identify the controller's review of the cycle count log and count sheets as the process control activity to determine whether the cycle count program is complete. The engagement team test the design and implementation as well as the operating effectiveness of the process control activity in conjunction with their assessment of the company's cycle count program.

How do we determine the number of test counts to perform? [ISA | 7786.7299]

Fact Pattern

Period end: 31 December

Six entities perform cycle counts according to the following scenarios:

Backgroun	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6

Nature of inventory	Automotive tires	Big box retail	Raw materials for silicone water manufacturing	Spare parts1	HVAC equipment	Electronic Equipment
# of locations	2 large distribution centers, with approximately equal amounts of inventory	200 retail locations, with approximately equal amounts of inventory	1	1	40 regional branches	10 (8 manufacturing & warehouse facilities of approximately equal size, 2 locations are less than PM)
Materiality of inventory	50x PM	100x PM	10x PM	3x PM	20x PM	100x PM
Initial assessment of homogeneity	Yes	Yes	N/A - 1 location	N/A - 1 location	Yes	No
Historical count accuracy	99%	93%, with related shrink reserve consistently accurate	99%	97%	98%	98%
Other process control activities (3-way	Effective	Effective	Effective	N/A - only count process control activity	Effective	Effective

matches, cut-off)				deemed necessary based on risk		
RAWTC assessment	Base	Base	Elevated	Base	Base	Base
Frequency that items are counted	ABC System SKU category A, 60% counted monthly SKU category B, 30% counted quarterly SKU category C, 10% counted annually	Each store counted once per year, with a wall to wall physical count performed per store	All locations (bins/ bays/ aisles) within the warehouse are counted at least 1x per year tracked by warehouse aisle and bay. Certain locations with higher movement are counted more frequently.	All bins counted twice per year based on systematic spreadsheet tracker	ABC system SKU category A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually	ABC system SKU category A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually
Timing and extent of management's counts	50 SKUs counted daily	Stores are counted evenly throughout the year, all items counted	30 bins counted daily	No prescribed frequency. Counts occur 1-2x per week with ~ 10 bins	20 SKUs counted daily	50 SKUs counted daily

				counted each time		
Frequency to determine the control sample size for test counts	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring at each location

Analysis

Using the above scenarios, the engagement team may plan the following approaches.

Approach	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
# of locations from which we obtain evidence (see 'Determine the number of locations to obtain evidence from')	2	25 (between 100 (20) and 1000+ (30) locations)	1	1	10	8 (as none are homogeneous, we have to treat as 8 separate process control activities)
# of days attended per location[2] (see question 'How do we	5	1	7	2	1	5

determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities?')						
# of test counts reperformed each attendance	5	5	5	12-13	5	5
Total # of test counts per location[2]	25	5 (in accordance with 'Allocate the control sample size')	35	25	5 (in accordance with 'Allocate the control sample size')	25
Total # of test counts performed	50	125	35	25	50	200 (25 per location as process control activities are non-homogeneous)
Notes on approach	Observe minimum of 5 days	25 locations deemed	Observe minimum of 5 days	Only 2 observations deemed	10 locations deemed	Since not homogeneous, each

	at each location to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.	necessary to test assertion of homogeneity for ICFR; 1 observation at each location deemed appropriate to attain a total of 25 observations. Although complete physical counts are performed at each store, it is treated as a cycle count for the aggregate inventory balance with each store's count treated as a cycle count for the overall balance.	at single location to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.	necessary as account is only 3x PM and low transaction volume of inventory.	necessary to test assertion of homogeneity for ICFR. 10 total observations deemed appropriate based on risk assessment/ materiality of inventory.	location is an independent population. With balance of approx.10x PM per location attended, a minimum of 5 days at each location deemed appropriate to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.

[1] Spare parts may not be a part of core operations and may not be viewed as true "inventory". This example highlights how an engagement team might tailor our procedures to reflect this assessment.

[2] This assumes that the engagement team are reperforming/observing management's count at every attendance from which they are obtaining evidence. See question 'Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts?' for additional considerations.

The above table is for test counts only. When we test other process control activities as part of our inventory count, the control sample size depends on the frequency of operation of those process control activities.

> For example, management performs a cycle count daily over multiple SKUs. Whilst the frequency of test counts equates to a manual recurring control, the control that ensures all inventory is counted in the period may operate quarterly. The RAWTC for both controls is Base. We would apply the manual recurring control sample size to the test counts (25) and apply quarterly control sample size to the other control (2).

1.4.8.2 Evaluate management's instructions and procedures [ISA | 7787]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7787.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;
- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;

- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7787.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7787.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7787.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7787.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7787.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What else do we evaluate when the entity performs cycle counts? [ISA | 7787.7244]

We evaluate the entity's cycle count program, including the following:

Consideration	Why do we evaluate this?
Whether all items are counted sufficiently frequently	A perpetual inventory system is designed to be an accurate reflection of inventory on hand at any point in time. Management's cycle count is a detective process control activity over the completeness and accuracy of book records. In order to be sufficiently precise, it needs to operate with sufficient frequency to identify and correct differences between actual inventory and records before they become large enough to affect the management's decision making. We evaluate whether it performed frequently enough to produce results substantially the same as those that would be obtained by a count of all items each year.
If and what cycle count software is used	Depending on the level of automation used by management, it may be necessary to test automated control activities over the inventory count.
The process surrounding how items are selected to be counted	If the process relies on automated production of reports such as count sheets, it may be necessary to test automated control activities over, or perform direct testing of, these reports.
The process surrounding the generation of count selections (e.g. count sheets) (i.e.	During a cycle count, only a portion of the entity's inventory is counted at a particular time. Therefore, the count sheets not only

documents detailing the locations and items to be counted)	provide a means for the entity to document its counts, but also serve as the scope of the inventory being counted at that particular point in time. The count sheets provide evidence that the counts performed had the appropriate coverage of inventory as designed under the cycle count procedures.
How management monitors that locations or items are counted as planned	We understand how management monitors the application of the count program to ensure the count program has operated as planned.
The processes that are in place for monitoring the results of the program	We understand the level of variances between the count results and the inventory in the perpetual system to determine whether they are low enough for us to be able to rely on the cycle count process control activity or further counts or a complete physical count will be necessary.

How do we evaluate whether all items are counted sufficiently frequently? [ISA | 7787.7245]

We think about the following factors when evaluating whether all items are counted sufficiently frequently:

Factors	Additional Guidance
The value of the individual items in inventory	As the value of individual items in inventory increases, the planned frequency of management's counts would be expected to increase.
Volume of activity	As inventory turnover increases, the planned frequency of management's counts would be expected to increase.
Nature of inventory	As goods become more susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.
Physical Security of warehouse	As physical security decreases at the warehouse it makes the inventory more

	susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.

What if items are counted less than once a year? [ISA | 7787.7246]

If the entity's cycle count program does not include a count of all items each year, we think about whether the procedures or methods are sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year.

Is it appropriate for a cycle count program to be designed to count inventory items by their physical storage location (e.g. bins, bays, shelves, rows) as opposed to by SKU? [ISA | 7787.7249]

Yes. An appropriate set of units may include inventory storage locations (e.g. bins, bays, or shelves within a warehouse) or individual inventory SKUs. When evaluating management's cycle count procedures, we identify the **'set of units'** used by management to design, perform and monitor cycle count progress in line with their planned cycle count program.

The auditing standards do not specify that the entity's cycle count procedures include a count of each inventory item or that inventory 'item' is defined as the entity's SKU categorization.

Cycle count techniques are regularly performed counts of a subset of inventory items throughout the period to monitor the effectiveness of control activities over inventory movement and the accuracy of the entity's perpetual inventory system on any given date. Cycle counts are not designed to count all items that are held in inventory at period-end, regardless of how those inventory items are categorized or the counting selection method (e.g. by storage location, SKU). As long as the cycle counts are consistently verifying the accuracy of the perpetual records, control activities over accuracy of the perpetual inventory system are working and, therefore, the perpetual inventory records are reliable at any given point in time.

Therefore, the set of units used by management for cycle counts is typically a function of the nature of the entity's inventory and how management categorizes and organizes its inventory. Cycle count programs with a set of units based on storage location, SKU, or other categorizations may be designed effectively to meet the objective of a cycle count.

How do we identify the set of units? [ISA | 7787.7251]

We identify the set of units used by management by considering how the entity tracks its inventory cycle counts (e.g. by storage location, SKU).

How do we assess whether the use of the set of units is appropriate? [ISA | 7787.7253]

We consider the following:

- Whether management applies its cycle count procedures over the set of units in a systematic manner without bias.
- Whether the count process control activities are operating over the entire set of units the process control activity is designed to cover.

For example, if the controls are designed to cycle count all storage locations (e.g. bins, bays or shelves) within a facility, that all storage locations were in fact counted. If the controls are designed to

cycle count all SKUs, based on an A, B, C categorization, the counts are executed consistently with that design and all SKUs are counted.

What else do we think about when management uses storage location as its set of units? [ISA | 7787.7256]

We also think about the following when management uses storage location (e.g. bins, bays and shelves) as its set of units:

- Storage location-based cycle counts help to eliminate selection bias (i.e. it avoids selection of only high dollar value items) and addresses the risk of completeness (i.e. identifies inventory that is found in a location but is not reflected in the perpetual records).
- The entity's inventory system may track quantity on a storage location-by- storage location basis; therefore, management could determine that validating the accuracy of inventory storage location is key in order for the perpetual inventory records to be accurate.
- The nature of the entity's inventory and layout of its facilities makes it logistically efficient to conduct counts by storage location.
- Whether inventory moves between storage locations within the facility, and if so, how frequently movements occur and how those movements are addressed in the cycle count procedures.
- Whether there have been any changes to the geographic layout of the facility during the year, and if so, how those changes affect the inventory records and how they are addressed in the cycle count procedures.
- Whether there are any identified fraud risks or fraud risk factors to be considered, such as the risk of company personnel moving inventory between storage locations to circumvent the identification of missing inventory during cycle counts.

What do we evaluate about inventory movements during the count? [ISA | 7787.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?
- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7787.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.8.3 Observe the performance of management's count procedures [ISA | 7788]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the Audit

What do we do when we observe the performance of management's count procedures? [ISA | 7788.7377]

When observing the performance of management's count procedures, including inventory movements, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary;
- inquire about whether the same procedures were followed throughout the period, if applicable; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7788.9743]

We determine whether the understanding provided by the engagement team of the entity's controls over inventory movements in the facility during the count is correct and implemented as designed. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7788.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7788.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7788.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

What if we identify potential issues during our observation? [ISA | 7788.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

1.4.8.4 Inspect the inventory [ISA | 7873]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7873.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7873.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.8.5 Perform test counts using a controls approach [ISA | 7789]

What do we do?

Perform test counts using a controls approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the Audit

How do we perform test counts? [ISA | 7789.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7789.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform when attending an inventory count for a cycle count? [ISA | 7789.7289]

When we are taking a controls approach we determine the number of test counts to perform in accordance with 'Design a control sample'.

Each individual count is a separate process control activity instance, such that counts are a recurring control when determining the number of test counts to perform for the control sample size and our ability to accept deviations.

We allocate the sample size over the number of cycle counts we attend, ensuring we perform at least 5 test counts at each attendance.

For example, the entity performs cycle counts at one location and we determine to reperform test counts at 6 counts during the period. We assess RAWTC as base. Per the control sample size table for a manual recurring control, the sample size would be 25. As this results in us reperforming 4 counts per visit, we increase our sample size to 30.

How do we determine the number of locations to obtain evidence from when the inventory count process control activity is homogeneous? [ISA | 7789.6948]

If the homogenous process control activity operates in multiple locations, we determine the locations to obtain evidence from in accordance with 'Determine the number of locations to obtain evidence from'.

How do we determine the number of items to test at each location when inventory is held at multiple locations and the process control activity is homogeneous? [ISA | 7789.6985]

We determine the number of items to test at each location in accordance with 'Allocate the control sample size'.

How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities? [ISA | 7789.7359]

We determine how many cycle counts to attend and select a representative sample from the period in which the process control activity operates. It would not be appropriate to only attend one cycle count in the period.

We also think about the following factors when determining the number of cycle counts to obtain evidence from:

Factors	Guidance
Risk associated with the control (RAWTC)	The higher the assessed RAWTC, the more cycle counts we obtain evidence from
Frequency of count	If more items counted per day, but fewer days, we may observe fewer cycle counts.
Other process control activities addressing the same RMM	Process control activities over shipping and receiving, the 3-way match for purchases and sales and the recording of inventory movements, when tested and determined to be designed, implemented and operating effectively, reduce the likelihood that the perpetual inventory records are inaccurate.
Historical count accuracy (vs. records)	When count accuracy is high, it validates the quality and precision of the related process control activities.
Nature of inventory	Low dollar/large quantity and neatly stacked provide lower risk. When inventory turns quickly, related process control activities have more recent influence on quantities on hand.
Homogeneity of control activities	The number of the entity's locations where the homogeneous control activity operates that will be subject to testing (e.g. it is not necessary to test each location multiple times when the total number of locations tested achieves our objective of observing a sufficient number of points in time).

	For example, if we determined that we intended to gather evidence from 15 locations to test management's assertion of homogeneity for process control activity testing purposes and determined that it would be necessary to observe counts on 10 different days. If we attend the 15 locations on 15 different days, this meets both objectives.

How do we consider risk related to the completeness of inventory? [ISA | 7789.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or

(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

What evidence do we obtain over the completeness of the cycle count? [ISA | 7789.7294]

We obtain evidence that all inventory items/locations, etc. are in fact counted, according to the entity's counting policies.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7789.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7789.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from management's when taking a controls approach to attendance at the cycle count? [ISA | 7789.7297]

If we identify a difference between our count and management's, we treat this as a control deviation, provided the process control activities surrounding the count have been completed.

> For example, if management's initial count differs from the system amount and the quantity counted by the auditor, and the difference is above an error rate that would be subject to the research and recount process control activity, we allow that recount to occur before informing management of the deviation. While the deviation in the initial count process control activity still requires our assessment, the recount process control activity may identify the error and act as a compensating control that effectively mitigates the exception.

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

If we identify control deviations, we perform procedures in accordance with 'Perform relevant procedures when control deviations are identified'. We may be able to tolerate control deviations in accordance with 'Determine the effect of control deviations'.

The identification of differences during the cycle count indicate that the controls approach may be inappropriate.

Examples

How do we determine if a control deviation exists? [ISA | 7789.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

How do we determine the number of test counts to perform? [ISA | 7789.7299]

Fact Pattern

Period end: 31 December

Six entities perform cycle counts according to the following scenarios:

Backgroun	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Nature of inventory	Automotive tires	Big box retail	Raw materials for silicone water manufacturing	Spare parts1	HVAC equipment	Electronic Equipment
# of locations	2 large distribution centers, with approximately equal	200 retail locations, with approximately	1	1	40 regional branches	10 (8 manufacturing & warehouse facilities

	equal amounts of inventory	amounts of inventory				of approximately equal size, 2 locations are less than PM)
Materiality of inventory	50x PM	100x PM	10x PM	3x PM	20x PM	100x PM
Initial assessment of homogeneity	Yes	Yes	N/A - 1 location	N/A - 1 location	Yes	No
Historical count accuracy	99%	93%, with related shrink reserve consistently accurate	99%	97%	98%	98%
Other process control activities (3-way matches, cut-off)	Effective	Effective	Effective	N/A - only count process control activity deemed necessary based on risk	Effective	Effective
RAWTC assessment	Base	Base	Elevated	Base	Base	Base
Frequency that items are counted	ABC System SKU category	Each store counted once per year, with	All locations (bins/ bays/ aisles)	All bins counted twice per year based on	ABC system SKU category	ABC system SKU category

	A, 60% counted monthly SKU category B, 30% counted quarterly SKU category C, 10% counted annually	a wall to wall physical count performed per store	within the warehouse are counted at least 1x per year tracked by warehouse aisle and bay. Certain locations with higher movement are counted more frequently.	systematic spreadsheet tracker	A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually	A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually
Timing and extent of management's counts	50 SKUs counted daily	Stores are counted evenly throughout the year, all items counted	30 bins counted daily	No prescribed frequency. Counts occur 1-2x per week with ~ 10 bins counted each time	20 SKUs counted daily	50 SKUs counted daily
Frequency to determine the control sample size for test counts	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring at each location

Analysis

Using the above scenarios, the engagement team may plan the following approaches.

Approach	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
# of locations from which we obtain evidence (see 'Determine the number of locations to obtain evidence from')	2	25 (between 100 (20) and 1000+ (30) locations)	1	1	10	8 (as none are homogeneous, we have to treat as 8 separate process control activities)
# of days attended per location[2] (see question 'How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process	5	1	7	2	1	5

control activities?')						
# of test counts reperformed each attendance	5	5	5	12-13	5	5
Total # of test counts per location[2]	25	5 (in accordance with 'Allocate the control sample size')	35	25	5 (in accordance with 'Allocate the control sample size')	25
Total # of test counts performed	50	125	35	25	50	200 (25 per location as process control activities are non-homogeneous)
Notes on approach	Observe minimum of 5 days at each location to gain meaningful evidence over several points in time to conclude process control activity is	25 locations deemed necessary to test assertion of homogeneity for ICFR; 1 observation at each location deemed appropriate to attain	Observe minimum of 5 days at single location to gain meaningful evidence over several points in time to conclude process control activity is	Only 2 observations deemed necessary as account is only 3x PM and low transaction volume of inventory.	10 locations deemed necessary to test assertion of homogeneity for ICFR. 10 total observations deemed appropriate based on risk	Since not homogeneous, each location is an independent population. With balance of approx.10x PM per location attended, a

	operating consistently.	a total of 25 observations. Although complete physical counts are performed at each store, it is treated as a cycle count for the aggregate inventory balance with each store's count treated as a cycle count for the overall balance.	operating consistently.		assessment/ materiality of inventory.	minimum of 5 days at each location deemed appropriate to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.

[1] Spare parts may not be a part of core operations and may not be viewed as true "inventory". This example highlights how an engagement team might tailor our procedures to reflect this assessment.

[2] This assumes that the engagement team are reperforming/observing management's count at every attendance from which they are obtaining evidence. See question 'Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts?' for additional considerations.

The above table is for test counts only. When we test other process control activities as part of our inventory count, the control sample size depends on the frequency of operation of those process control activities.

For example, management performs a cycle count daily over multiple SKUs. Whilst the frequency of test counts equates to a manual recurring control, the control that ensures all inventory is counted in the period may operate quarterly. The RAWTC for both controls is Base. We would

apply the manual recurring control sample size to the test counts (25) and apply quarterly control sample size to the other control (2).

1.4.8.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7790]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the Audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7790.7353]

After completing the test counts and when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- obtain evidence regarding whether differences between the count records and the system were properly investigated; and
- evaluate whether the level of adjustments calls into the question the appropriateness of determining inventory quantity and condition through cycle counts.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger at cycle counts? [ISA | 7790.7354]

If there is a difference between the count sheets and management's post-count adjusted sub-ledger, we investigate the reason for such difference. We examine whether count differences are appropriately tracked by the entity and included in its monitoring of cycle counts results.

We obtain and evaluate management's summaries of cycle count information and recorded inventory adjustments. We evaluate count variances, if any, to determine if they fall within the established minimum accuracy percentages (i.e. entity's established acceptable threshold) and evaluate the reasonableness of the variances in terms of the total value. We consider whether there is an indication that an undetected misstatement exists as at the period-end.

If our subsequent investigation determines that the post-count adjusted sub-ledger is incorrect, then this is a control deviation.

When the adjustments from book to physical are trivial, it supports the assessment that cycle counts produce results substantially the same as those which would be obtained by a complete physical count.

If more than trivial adjustments are made to adjust inventory quantities as a result of the cycle counts, this challenges the effectiveness of the related process control activities and undermines the assessment that the same results are obtained from the perpetual inventory system as those by annual physical count. In such cases, we reassess control risk, and determine whether it is necessary for management to perform a complete physical count at or near period end that we would then attend. If the entity has remediated the cycle count process control activities, we may re-test the cycle counts subsequent to remediation of identified deficiencies.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.8.7 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7791]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

Can we use our attendance at the count at a date other than at period end to support an assessment of control reliance at the period end? [ISA | 7791.7206]

It depends. When we take a controls approach to our attendance at the inventory count at a date other than at period end, we test process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory. If we determine there are no PRPs over inventory movements then we can support control reliance at period end, without testing process control activities over inventory movements. Otherwise, we test the operating effectiveness of process control activities over inventory movements.

If our attendance at the count is close to the period end, and inventory movements are sufficiently low in the period between the count and the period end, then we may not have PRPs over inventory movements.

> For example, the inventory count is performed on 15 December with a period end of 31 December. In the remaining days between the count and period end, the factory and warehouse are shut. Therefore, there are no PRPs over inventory movements and we assess control risk as control reliance as at period end.

If we determine that PRPs over inventory movements exist and process control activity testing is necessary, it may be more efficient and effective to perform this testing throughout the period, so that any issues are identified earlier, and we can plan our response appropriately.

What are examples of process control activities over inventory movements? [ISA | 7791.7207]

Examples of process control activities over inventory movements include:

- Process control activities over shipping of goods (e.g. three-way-match for sales)
- Process control activities over receiving goods (e.g. three-way-match for purchases)
- Process control activities over inventory adjustments made throughout the period
- Automated process control activities over the perpetual inventory system, such as control activities that systematically update quantities upon effective execution of the three-way matches
- Process control activities over estimating inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses.

1.4.9 Perform procedures for cycle counts when taking a dual-purpose approach [ISA | 7792]

What do we do?

IF we are responding to a risk of material misstatement over quantity and condition and the entity performs cycle counts THEN perform procedures when taking a dual-purpose approach to performing test counts

Why do we do this?

If we are responding to a risk of material misstatement (RMM) over quantities and condition of inventory we are required by the auditing standards to attend management's inventory count and perform certain procedures in order to obtain sufficient appropriate audit evidence.

When we attend the test count taking a dual-purpose approach then we obtain both controls and substantive evidence in response to the RMM. For additional considerations for dual-purpose tests see 'Consider performing a dual-purpose test'.

Execute the Audit

What relevant procedures do we perform when attending the count? [ISA | 7792.7355]

We perform the following procedures when attending the count:

- Test relevant process control activities
- Evaluate management's instructions and procedures
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test count using a dual-purpose approach
- Determine whether entity's final inventory records accurately reflect count results
- Perform procedures over changes when count is performed at a date other than the period end

Can the entity perform a cycle count if it has a periodic inventory system? [ISA | 7792.8403]

No. It is not possible for an entity or us to rely on cycle counts because the entity does not have effective processes and process control activities over inventory receipts and shipments that enable effective cycle count process control activities. Furthermore, we are unable to evaluate whether management can reasonably provide us with accurate data that is substantially the same as if a complete physical count were to occur.

What documentation may the inventory count observer obtain? [ISA | 7792.9734]

We obtain relevant documentation around the count as directed by the engagement team. Such documentation may include:

- Count instructions used by warehouse personnel
- Perpetual inventory sub-ledger before and after the count
- Count sheets
- List of adjustments recorded.

What documentation may the inventory count observer prepare? [ISA | 7792.9747]

We prepare documentation as directed by the engagement team and report results in a timely manner. Such documentation may include:

- The perpetual sub-ledger records
- Results of the evaluation of design and implementation of process control activities
- Results of tests of operating effectiveness of process control activities.
- A list of all items we counted, and the quantities agreed by entity personnel
- For discrepancies between our count and management's count:
  - The nature and cause.
  - How they were resolved.
  - Whether they constitute a misstatement and/or deviation/deficiency.

1.4.9.1 Test relevant process control activities [ISA | 7793]

What do we do?

Test the design, implementation and operating effectiveness of relevant process control activity(ies)

Why do we do this?

If we consider the entity's process control activities to be effectively designed and implemented, and operating effectively, this may be considered in determining the nature, timing and extent of substantive procedures that we perform.

Execute the Audit

What process control activities do we test for cycle counts? [ISA | 7793.7348]

We test the process control activity(ies) over the process risk points (PRPs) identified in the process related to the risk of material misstatement over quantity and condition of inventory.

If there are relevant control activities over automated counting techniques, we also test the automated control activities.

How do we evaluate the design of process control activities for cycle counts? [ISA | 7793.7349]

The following table illustrates the relevant control considerations when evaluating the design of cycle count process control activities:

Control Considerations	Matters to think about
Inventory movements are recorded correctly	• Shipping of goods • Receiving goods • Inventory adjustments made throughout the period • Inventory losses due to shrink, loss or damage that estimate losses until counting can be performed to determine actual losses
Physical count is designed and performed appropriately	• The design of count instructions • The application of the count instructions • Test counts • Recounts, if applicable
Count results are recorded accurately	• Recording of inventory count quantities (e.g. scanners or manual keying) • Investigation of outliers and adjustments resulting from the counts within the perpetual system
All items to be counted within the cycle period were ultimately counted	• All inventory items/locations, etc. are in fact counted in the cycle period, according to the entity's counting policies (e.g. A category items are counted every 30 days, B category items every 60 days, etc.)
Count results are appropriately	• Monitoring overall cycle count results (e.g. count exception rates) to determine if further counts or complete physical counts are required (depending on count outcomes)

monitored across all counts	

Do we identify a separate process control activity for every control consideration? [ISA | 7793.6929]

Not necessarily. Depending on the facts and circumstances of the entity's process, we may identify one process control activity that addresses multiple considerations.

Why do we test process control activities over all control considerations when attending cycle counts? [ISA | 7793.7351]

When an entity uses cycle counts, we satisfy ourselves that management's procedures or methods are sufficiently reliable to produce results substantially the same as those which would be obtained by complete physical count of each item of inventory. To do so, we test the entity's process control activities that address the control objectives identified for cycle counts.

Process control activities over cycle counts are designed to determine inventory quantities (in practice, they are used to confirm accuracy of quantities reflected in a perpetual system) to prevent more than minor adjustments between the inventory records and physical cycle counts and thus produce the same results as a complete physical count. If more than a few minor adjustments are made to adjust inventory quantities as a result of cycle counts, this may indicate that cycle counting may not be appropriate and that a complete physical count at or near period end is warranted.

What are cycle count process control activities that we may test? [ISA | 7793.7352]

- Management's validation of inventory movements including, shipping, receiving, and transfers and any related safeguards.
- Management's verification of appropriate automated process control activities supporting the perpetual system.
- Policies for executing the counts including the frequency of counts and who is responsible for the counts.
- Management's verification that all inventory items/locations eligible to be counted are subject to count and result in substantially the same result as an annual count.
- Management's verification that each item that should be counted, is counted, including the use of count sheets.
- Management's identification of any obsolete, damaged, or lost (shrink) inventory.
- Management's identification and resolution of any differences identified during the count, including performing recounts.
- Management's recording of adjustments resulting from count procedures.
- Management's monitoring of accuracy of counts to periodically re-evaluate whether the cycle count program remains appropriate.

How do we determine the frequency of a cycle count process control activity(ies)? [ISA | 7793.7356]

It depends.

A cycle count process control activity(ies) may operate on a periodic basis (e.g. daily, weekly) and cover many individual set of units, and therefore involves elements of both a periodic control and a manual recurring control. It's reasonable to determine that the process control activity operates over individual set of units (e.g. SKU level), and that the counts simply occur over time such that each item is counted X times per period pursuant to management's policy. In this case, we treat each individual

count of a unit (e.g. SKU) as a separate process control activity instance, such that the count is a recurring control when determining the number of test counts to perform and our ability to accept control deviations.

> For example, when multiple SKUs are counted over the year, this is considered a manual recurring control for the purposes of determining control sample sizes and our ability to accept control deviations (provided that there are more than 366 SKUs counted).

Even though the test count process control activity operates a manual recurring basis, the number of days from which we to obtain evidence from is determined separately in accordance with 'How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities?'. If the process control activity is performed over multiple locations, we determine the number of locations to obtain evidence from in accordance with 'Determine the number of locations to obtain evidence from'.

We may identify separate cycle count process control activities that occur once each time the cycle count is performed, on an ad-hoc basis or independent of the physical cycle count and are not considered as occurring over each individual unit counted. We therefore may consider certain process control activities operating as part of the cycle count as being periodic based on the frequency of occurrence in accordance with 'How do we determine the frequency of a control?' and we determine the control sample size in accordance with 'Determine the control sample size'.

Once we have determined the frequency of cycle count process control activity(ies), we determine whether we can get evidence of the operating effectiveness through performance of test counts or whether we plan additional procedures to obtain this evidence.

> For example, performance of test counts may also give us evidence around accuracy of the counting, accuracy of recording inventory count quantities, the appropriate implementation and following of count instructions. However, there may be other cycle count process control activities that operate at a different frequency e.g. the control that ensures all inventory is counted in the period may operate quarterly and we would test this separately using the controls sample size table to determine the relevant sample size.

Can we perform our procedures on one day? [ISA | 7793.7358]

No, because the process control activity happens over time, it would be inappropriate to attend all our counts on a single day, even if spread over multiple locations. Instead, we gather evidence of the process control activity's operation over at least two cycle counts such that we achieve a meaningful distribution of the sample to gain evidence that the process control activity operates consistently over time across the entire population of inventory.

How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities? [ISA | 7793.7359]

We determine how many cycle counts to attend and select a representative sample from the period in which the process control activity operates. It would not be appropriate to only attend one cycle count in the period.

We also think about the following factors when determining the number of cycle counts to obtain evidence from:

Factors	Guidance
Risk associated with the control (RAWTC)	The higher the assessed RAWTC, the more cycle counts we obtain evidence from
Frequency of count	If more items counted per day, but fewer days, we may observe fewer cycle counts.
Other process control activities addressing the same RMM	Process control activities over shipping and receiving, the 3-way match for purchases and sales and the recording of inventory movements, when tested and determined to be designed, implemented and operating effectively, reduce the likelihood that the perpetual inventory records are inaccurate.
Historical count accuracy (vs. records)	When count accuracy is high, it validates the quality and precision of the related process control activities.
Nature of inventory	Low dollar/large quantity and neatly stacked provide lower risk. When inventory turns quickly, related process control activities have more recent influence on quantities on hand.
Homogeneity of control activities	The number of the entity's locations where the homogeneous control activity operates that will be subject to testing (e.g. it is not necessary to test each location multiple times when the total number of locations tested achieves our objective of observing a sufficient number of points in time). For example, if we determined that we intended to gather evidence from 15 locations to test management's assertion of homogeneity for process control activity testing purposes and determined that it would be necessary to observe counts on 10 different days. If we attend the 15 locations on 15 different days, this meets both objectives.

How do we determine whether control activities for inventory across locations are homogeneous? [ISA | 7793.6931]

To assess homogeneity of control activities across locations, we perform procedures in accordance with 'Assess homogeneity of control activities'.

When performing these procedures in accordance with 'Assess homogeneity of control activities', we think about whether count accuracies are consistent among locations. When the results of counts are inconsistent between locations this may be contradictory evidence to our assessment of the homogeneity of control activities.

What are examples of when an inventory count process control activity qualifies as homogeneous? [ISA | 7793.6932]

Examples of when inventory count process control activities could be considered homogeneous on their own:

- Each location does a periodic complete physical count and they follow the same program dictating the procedures to be executed and protocols for re- counting and updating the perpetual.
- The entity uses a separate inventory counting application (or module within the primary ERP) to direct periodic cycle counts. All locations/components are using the same instance of this application and therefore subject to the same control activities.
- A less sophisticated spreadsheet-based program is followed at each location, where each location is divided into static sections and entity personnel systematically cycle through and count each section, logging the results in a standard spreadsheet template to identify all locations have been counted.

In these scenarios the control activities followed by the locations is based on the same policies, practices and procedures established and monitored at the centralized level. This is how the entity demonstrates that the control activities are in fact homogeneous, and not just similar under a broad-based policy.

For instance, simply having a policy that all locations perform cycle counts such that all inventory is counted at least once during the year would generally not be sufficient to assert homogeneity because the control activities to implement the policy are not the same. We would expect to see greater consistency over such matters as: how inventory is divided into 'ABC' subsets and the frequencies of the cycle counts, use of blind counts, when second counts take place, and acceptable thresholds for count accuracy before a complete physical count is required. We would also expect monitoring activities to be in place to assess whether the control activities are, in fact, operating in a homogeneous manner.

Under what circumstances can we tolerate deviations when testing inventory count process control activities? [ISA | 7793.6933]

We can tolerate deviations when we meet the criteria outlined in question 'When can we accept a deviation and conclude that a control is operating effectively?'.

Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts? [ISA | 7793.7363]

Yes. When we test an entity's process control activities over its physical counts that are performed on a cycle over the course of the year.

Based on the entity-specific facts and circumstances, the results of our risk assessment, and considering inventory process control activities are routine in nature and do not involve judgment or complexity, the use of inquiry and inspection for a portion of the tests in combination with observation and reperformance on the other portion may be used to test the operating effectiveness of an entity's process control activities related to inventory counting procedures.

This approach cannot be extended to substantive audit procedures or when performing test counts.

How do we design an audit approach that uses inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7793.6935]

When designing an audit approach to test an entity's process control activities over its physical counts we determine:

(i) how many individual inventory items (SKUs, storage locations within the warehouse, etc.) will be tested through reperformance of management's counts, which is driven by control sample sizes for manual recurring controls or whatever the sample size is for substantive purposes when performing a dual-purpose test; and

(ii) how many cycle counts we will test to evaluate whether the process control activity is operating consistently over time and across the entire population of inventory, consistent with the design of the process control activity.

It is expected that observation and reperformance will be used for testing counts of individual inventory items ((i) above), either using the control sample sizes or the sample size dictated for a dual-purpose test.

Inquiry and inspection to obtain evidence of the operating effectiveness of count process control activities is limited to testing that the process control activities surrounding the physical counts are consistently operating effectively and as designed over time or across the company's locations (ii) above). Additionally, inquiry and inspection can be used only if there is sufficient documentary evidence available so that we can conclude on the operating effectiveness of the process control activity.

What documentary evidence do we obtain? [ISA | 7793.6936]

When performing inquiry and inspection procedures, we obtain evidence (e.g. count instructions, count sheets, control tags, evidence supporting research and resolution of outliers, such as results of re-counts, reports quantifying necessary adjustments to perpetual records identified, authorization of adjustments recorded, final inventory records after recognition of necessary adjustments) that the entity generated through execution of its process control activities. We obtain the same documents necessary to test each attribute of the process control activity, consistent with what would have been used had we attended to observe and reperform the process control activity. We do not simply obtain a document that 'signs-off' that the count process control activities were performed.

We determine if the results of our inquiries and inspection of the documented evidence is sufficient to conclude that the process control activity is operating effectively and achieves the entity's control objectives.

Who do we inquire of? [ISA | 7793.6937]

We perform inquiries of the individuals responsible for executing the count process control activities to corroborate that the process control activities are operating consistently as designed. The design of those process control activities were tested when we attended the count and observed and reperformed the count.

What portion of our audit evidence is inquiry and inspection vs. observation and reperformance when testing the operating effectiveness of count process control activities? [ISA | 7793.6938]

The portion of audit evidence gathered through inquiry and inspection as compared to observation and reperformance is based on judgment and the degree of risk associated with the process control activity. However, we observe and reperform sufficient instances to be satisfied we are gathering sufficient first-hand evidence of the design and operating effectiveness of the count process control activities. For that reason, it would not be appropriate to observe only one instance of a cycle count or location or even a small portion of the instances.

Can we use inquiry and inspection for a portion of our sample when performing a substantive test over counts? [ISA | 7793.6939]

No. The use of observation and reperformance for a portion of the tests and inquiry and inspection for the remainder is appropriate for testing the operating effectiveness of count process control activities but is not appropriate for obtaining substantive audit evidence. This is primarily because our substantive procedures validate the quantity and condition of the inventory through physical inspection of the asset and may not rely on management's process control activities. Therefore, appropriate substantive evidence is obtained while performing test counts.

How does the degree of automation affect management's process control activities over inventory and our testing? [ISA | 7793.6940]

Even in a fully automated warehouse, we do not accept management asserting that there would be no errors.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse. However, the control activities are still to be designed to address the sources of potential misstatement where inventory quantities may not match the perpetual records. As with any control activity, we assess the design of the control activity relative to risk and conclude whether the control activity was adequate.

What do we do when management uses automated counting? [ISA | 7793.6941]

We understand what information is captured, how that information is transmitted (e.g. via system interface) to the entity's inventory tracking system and what automated control activities are relevant.

In some cases, the type of automation of inventory management and inventory counting may mean that we cannot evaluate management's instructions and procedures over the count without testing the control activities over these automated procedures as part of our audit.

What cycle count automated control activities we may test? [ISA | 7793.9749]

The automated control activities we may test include but are not limited to:

- Configuration of how items are selected
- Configuration of how count information is captured (e.g. scanners) and transmitted (e.g. via system interface) to the entity's inventory tracking systems
- Control activity that all items subject to the cycle counts were counted at the proper frequency
- The reporting of cycle count results (e.g. periodic summary reports reviewed centrally).

When we can't get sufficient appropriate audit evidence without testing control activities over automated procedures, what else do we think about? [ISA | 7793.6943]

We think about the following:

- If the automated warehouse continues to permit some level of human interaction, the inventory may be subject to a suite of counting process control activities similar to that of a non-automated environment.
- If there is absolutely no human interaction with the inventory in a purely automated warehouse, we think about:
  - Whether it is possible for us to perform test counts over the inventory using the robotic system, whereby the system is ordered to pick and pull inventory from its location in the warehouse and stage it in an area so that it can be subject to manual count and then returned to its location.

    In this situation, it is appropriate for us to select our test counts and determine whether the robot actually went to the location it was instructed to go to and didn't pull inventory from another location.
  - When inventory quantities can only be counted when they are both entering the warehouse upon receipt and exiting the warehouse when staged for shipment to the customer, the counting approach is skewed to focus on inventory that is moving. It is still necessary for the entity to address the risk associated with any products that experience little to no movement during the year that may not be subject to these count automated process control activities.
- Whether there are process control activities in place to mitigate risks that the physical condition of goods may be impaired, such as periodic observations of the condition of the inventory through windows or video surveillance.

Examples

How do we determine the portion of our sample between inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities? [ISA | 7793.7407]

Fact pattern

The entity performs weekly cycle counts and, the engagement team determines that they will obtain audit evidence for 5 cycle counts throughout the period. The engagement team assess the process control activity has a base RAWTC and, using the control sample size table, they perform 25 test counts in total (deemed a manual recurring control). The engagement team also determines that the substantive sample size is 150 individual inventory items.

Analysis

The engagement team design their audit response to include a combination of techniques as follows:

- After considering RAWTC, the engagement team determines it is appropriate to attend 3 cycle counts to perform observation and reperformance. During their attendance, they perform test counts of 25 items (approximately 8-9 items at each instance), to reperform management's counts as part of testing management's cycle count and a substantive test.
- The remaining 125 items for the substantive sample are counted on the 3 days.
- The engagement team may choose to apply both substantive testing and process control activities testing to the larger sample size if they wish. In this case, the engagement team allocates the dual-purpose sample size over the 3 days which they attend.
- The engagement team also test any periodic process control activities (controls performed once each time a count is performed) relevant to the count such as process control activities over selection of items for counting or process control activities over monitoring count results.
- The engagement team performs inquiries and gather and inspect a variety of documentary evidence of the execution of weekly cycle counts for the remaining 2 cycle counts, evaluating whether the count process control activities are designed, implemented and operating effectively, consistent with what was observed in the performance of the procedures above.
- The engagement team also performs inquires of the control operator(s) regarding how the count was performed e.g. inquiring over how they controlled inventory movements during the count and how they deal with variances between the counted items and count sheets.

How do we respond to the use of scanners in an inventory count? [ISA | 7793.6945]

Fact Pattern

As a part of the engagement team's attendance at the annual physical count, the engagement team observe that management use scanners to input the counted quantities. The data uploaded into the scanner is then interfaced with the perpetual inventory system.

Scenario

After they inquire of management, the engagement team determines that the use of the scanners is a key part to the count process and there is little manual intervention in the automated flow of data into the perpetual system. In such case, the engagement team determine the process flow to consist of the following steps below.

- The scan guns serve as a front-end data input to the warehouse management system (WMS).
- The WMS is the system of record for the inventory in the distribution center and is updated as inventory enters and leaves the facility.
- The scan gun interacts with the WMS in a 'real-time' manner.
- In terms of inventory counts, the scan gun tells the employee where to go and what item to count. It gives no other information. The WMS stores the number of items it expects to have in the distribution center.
- The employee enters the count result into the scan gun and the WMS reconciles the count received to the number of items it has recorded.
- If there is a match, the scan gun sends the employee to the next location. If there is not a match, the scan gun will ask the employee to count again. If there continues to be a difference, WMS will mark the exception for review and the scan gun sends the employee to the next location.

Analysis

The engagement team incorporate their understanding of this automated counting, including the data flow within the audit documentation surrounding our inventory counts. After identifying the relevant PRPs, the engagement team identifies the automated process control activities to address the PRPs and performs testing.

What type of process control activity do we test over the selection of items for counting? [ISA | 7793.7375]

Fact Pattern

Assume Company ABC uses a cycle count program with the following fact pattern:

- there are 26 pre-defined locations where inventory is stored and subject to cycle counting;
- the company conducts cycle counts on a weekly basis where one location is fully counted during each count;
- each location will be counted twice during the year;
- to track the counts, the warehouse supervisor maintains the stack of count sheets from each weekly count and tracks the progress of the counts within a separate control log, and
- at the end of the year, the corporate controller reviews the supervisor's control log, along with the count sheets from the cycle counts to determine whether all of the 26 locations were counted twice during the year.

Analysis

In such a case, the engagement team identify the controller's review of the cycle count log and count sheets as the process control activity to determine whether the cycle count program is complete. The engagement team test the design and implementation as well as the operating effectiveness of the process control activity in conjunction with their assessment of the company's cycle count program.

1.4.9.2 Evaluate management's instructions and procedures [ISA | 7874]

What do we do?

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting

Why do we do this?

We evaluate management's instructions and procedures as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

How do we evaluate management's instructions and procedures? [ISA | 7874.6951]

We think about the following when evaluating management's count instructions and procedures:

- whether all categories of inventory (e.g. WIP, packaging materials, etc.) are covered;
- whether the instructions have been updated appropriately;
- whether the instructions have been issued in a timely manner;

- who is responsible for performing the counts;
- whether automation is used (for example, scanners);
- whether measurement techniques to be applied are described in detail (e.g. scale, gauges, meters);
- whether the instructions have been discussed with personnel responsible for the inventory count to check for understanding and any potential difficulties to manage;
- whether there were any areas requiring special attention in relation to inventory counts performed in previous periods;
- if not all inventory is counted at the count date, whether the scope of the inventory subject to the count is specified (e.g. certain locations or types of inventory within a warehouse);
- if specific circumstances exist which may impact how the count is performed, whether these are dealt with in management's instructions (e.g. the entity engages in "bill and hold" transactions);
- the procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile;
- the procedures over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off;
- the procedures that are in place for reflecting the results of the count into the inventory system/ general ledger and recording inventory adjustments;
- if there is a perpetual system, the procedures to monitor the magnitude of adjustments detected;
- how differences are investigated and resolved;
- the procedures for the collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures;
- the procedures to accurately identify the stage of completion of work in progress;
- whether slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment are identified; and
- whether the counts are 'blind counts' or the counters provided with quantity information reflected in the inventory records.

We also think about whether any aspect of our evaluation gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What are 'bill and hold transactions'? [ISA | 7874.6974]

'Bill and hold transactions' are arrangements between the customer and the entity where the customer has been billed or has paid for inventory that has not yet been delivered. Therefore, the inventory is still stored with the entity.

What if the entity has 'bill and hold transactions'? [ISA | 7874.6975]

We understand how management identifies the 'bill and hold' inventory, whether it is included or excluded from counts and how it is excluded from the final inventory subledger account balance, if appropriate.

If the entity uses third party counters, are they considered management's specialists? [ISA | 7874.6954]

When third party counters are an extension of management to provide additional operational capacity to perform a basic task (counting inventory), they are not considered management's specialists. However, if management engages a third party to provide the expertise required to perform the

physical count (for example, chemical products or precious metals) then we evaluate these as management's specialists and perform procedures in accordance with 'Perform specific procedures when using the work of a management's specialist'.

What do we provide observers of the inventory count with? [ISA | 7874.9728]

We provide observers of the inventory count with a copy of the entity's instructions that the engagement team inspected.

What if no instructions have been issued? [ISA | 7874.6956]

If no instructions have been issued, we inquire of management and other entity personnel, as appropriate, to gain an understanding of the inventory procedures.

We also think about whether the lack of instructions gives rise to a design deficiency in the entity's process control activities (if applicable) and resolve any concerns we have on the adequacy of the entity's procedures prior to the inventory count.

What else do we evaluate when the entity performs cycle counts? [ISA | 7874.7244]

We evaluate the entity's cycle count program, including the following:

Consideration	Why do we evaluate this?
Whether all items are counted sufficiently frequently	A perpetual inventory system is designed to be an accurate reflection of inventory on hand at any point in time. Management's cycle count is a detective process control activity over the completeness and accuracy of book records. In order to be sufficiently precise, it needs to operate with sufficient frequency to identify and correct differences between actual inventory and records before they become large enough to affect the management's decision making. We evaluate whether it performed frequently enough to produce results substantially the same as those that would be obtained by a count of all items each year.
If and what cycle count software is used	Depending on the level of automation used by management, it may be necessary to test automated control activities over the inventory count.
The process surrounding how items are selected to be counted	If the process relies on automated production of reports such as count sheets, it may be necessary to test automated control activities

	over, or perform direct testing of, these reports.
The process surrounding the generation of count selections (e.g. count sheets) (i.e. documents detailing the locations and items to be counted)	During a cycle count, only a portion of the entity's inventory is counted at a particular time. Therefore, the count sheets not only provide a means for the entity to document its counts, but also serve as the scope of the inventory being counted at that particular point in time. The count sheets provide evidence that the counts performed had the appropriate coverage of inventory as designed under the cycle count procedures.
How management monitors that locations or items are counted as planned	We understand how management monitors the application of the count program to ensure the count program has operated as planned.
The processes that are in place for monitoring the results of the program	We understand the level of variances between the count results and the inventory in the perpetual system to determine whether they are low enough for us to be able to rely on the cycle count process control activity or further counts or a complete physical count will be necessary.

How do we evaluate whether all items are counted sufficiently frequently? [ISA | 7874.7245]

We think about the following factors when evaluating whether all items are counted sufficiently frequently:

Factors	Additional Guidance
The value of the individual items in inventory	As the value of individual items in inventory increases, the planned frequency of management's counts would be expected to increase.
Volume of activity	As inventory turnover increases, the planned frequency of management's counts would be expected to increase.

Nature of inventory	As goods become more susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.
Physical Security of warehouse	As physical security decreases at the warehouse it makes the inventory more susceptible to loss, theft or damage, the planned frequency of management's counts would be expected to increase.

What if items are counted less than once a year? [ISA | 7874.7246]

If the entity's cycle count program does not include a count of all items each year, we think about whether the procedures or methods are sufficiently reliable to produce results substantially the same as those that would be obtained by a count of all items each year.

Is it appropriate for a cycle count program to be designed to count inventory items by their physical storage location (e.g. bins, bays, shelves, rows) as opposed to by SKU? [ISA | 7874.7249]

Yes. An appropriate set of units may include inventory storage locations (e.g. bins, bays, or shelves within a warehouse) or individual inventory SKUs. When evaluating management's cycle count procedures, we identify the **'set of units'** used by management to design, perform and monitor cycle count progress in line with their planned cycle count program.

The auditing standards do not specify that the entity's cycle count procedures include a count of each inventory item or that inventory 'item' is defined as the entity's SKU categorization.

Cycle count techniques are regularly performed counts of a subset of inventory items throughout the period to monitor the effectiveness of control activities over inventory movement and the accuracy of the entity's perpetual inventory system on any given date. Cycle counts are not designed to count all items that are held in inventory at period-end, regardless of how those inventory items are categorized or the counting selection method (e.g. by storage location, SKU). As long as the cycle counts are consistently verifying the accuracy of the perpetual records, control activities over accuracy of the perpetual inventory system are working and, therefore, the perpetual inventory records are reliable at any given point in time.

Therefore, the set of units used by management for cycle counts is typically a function of the nature of the entity's inventory and how management categorizes and organizes its inventory. Cycle count programs with a set of units based on storage location, SKU, or other categorizations may be designed effectively to meet the objective of a cycle count.

How do we identify the set of units? [ISA | 7874.7251]

We identify the set of units used by management by considering how the entity tracks its inventory cycle counts (e.g. by storage location, SKU).

How do we assess whether the use of the set of units is appropriate? [ISA | 7874.7253]

We consider the following:

- Whether management applies its cycle count procedures over the set of units in a systematic manner without bias.
- Whether the count process control activities are operating over the entire set of units the process control activity is designed to cover.

For example, if the controls are designed to cycle count all storage locations (e.g. bins, bays or shelves) within a facility, that all storage locations were in fact counted. If the controls are designed to cycle count all SKUs, based on an A, B, C categorization, the counts are executed consistently with that design and all SKUs are counted.

What else do we think about when management uses storage location as its set of units? [ISA | 7874.7256]

We also think about the following when management uses storage location (e.g. bins, bays and shelves) as its set of units:

- Storage location-based cycle counts help to eliminate selection bias (i.e. it avoids selection of only high dollar value items) and addresses the risk of completeness (i.e. identifies inventory that is found in a location but is not reflected in the perpetual records).
- The entity's inventory system may track quantity on a storage location-by- storage location basis; therefore, management could determine that validating the accuracy of inventory storage location is key in order for the perpetual inventory records to be accurate.
- The nature of the entity's inventory and layout of its facilities makes it logistically efficient to conduct counts by storage location.
- Whether inventory moves between storage locations within the facility, and if so, how frequently movements occur and how those movements are addressed in the cycle count procedures.
- Whether there have been any changes to the geographic layout of the facility during the year, and if so, how those changes affect the inventory records and how they are addressed in the cycle count procedures.
- Whether there are any identified fraud risks or fraud risk factors to be considered, such as the risk of company personnel moving inventory between storage locations to circumvent the identification of missing inventory during cycle counts.

What do we evaluate about inventory movements during the count? [ISA | 7874.6961]

We make inquiries about how inventory movements (in and out of the entity's facilities and in-transit items), if any, will be controlled during the count and determine the nature of audit procedures we will perform to assess whether appropriate cut-off was achieved (this may involve an automated process control activity).

At a minimum, we expect management to have a process in place where they track the inventory movements during the count to determine whether the inventory is properly subject to the count. When inventory movements are ongoing, it is common for entities to separate the inventory moved from those that are subject to the count. Other times, an entity will stop all movements in its inventory for a period to allow for the completion of the count.

Questions we might ask in performing our evaluation include:

- What is the date and time of the inventory records that will be compared to the quantities on-hand?

- Is management moving inventory during the time of the count, and if so, how are those tracked and adjusted in the count?
- Is management shipping and receiving inventory during the count, and if so, how are those segregated, tracked, or adjusted?
- How are in-transit inventory items treated?

What if we identify potential issues with the entity's count procedures or instructions? [ISA | 7874.6962]

An appropriately senior team member discusses potential issues in the inventory count procedures or instructions with management in advance of the count. This allows us to attempt to resolve them, or to clearly communicate the potential impacts on our audit and/or audit report if they are not resolved.

1.4.9.3 Observe the performance of management's count procedures [ISA | 7875]

What do we do?

Observe the performance of management's count procedures, including inventory movements

Why do we do this?

We observe the performance of management's count procedures, to assist us in obtaining audit evidence that management's instructions are adequately designed and implemented.

Execute the Audit

What do we do when we observe the performance of management's count procedures? [ISA | 7875.7377]

When observing the performance of management's count procedures, including inventory movements, we:

- gain an understanding of where and how the inventory is stored at the location, which may involve a tour of the facility. If appropriate, request a layout of the location and arrange to visit the different areas within the facility (if any) with the person in charge;
- inquire and observe as to whether the counters have used and followed management's count instructions and procedures, including the procedures over inventory movements;
- obtain documentary evidence of movements during the count for subsequent follow up, as necessary;
- inquire about whether the same procedures were followed throughout the period, if applicable; and
- observe the entity's process for investigating and recording count differences, if applicable.

How do we determine whether the counters have followed management's procedures over inventory movements? [ISA | 7875.9743]

We determine whether the understanding provided by the engagement team of the entity's controls over inventory movements in the facility during the count is correct and implemented as designed. We examine whether:

- the facility was closed for the inventory count, and
- there were any movements from one part of the facility to another.

We also determine whether any movements (receipts or shipping of inventory) are in accordance with the entity's instructions and guidelines (as communicated by the engagement team) and documented by the entity.

How do we determine whether the inventory count is being performed in accordance with the entity's instructions and guidelines? [ISA | 7875.9742]

We think about the following:

- Are the inventory instructions understood by the inventory count teams?
- Are counts of individual items that are being performed the ones that are supposed to be counted and are they consistent with the count policy?
- Where required, are counts performed "blind"?
- How are the count results accumulated and recorded?
- How are the perpetual inventory records updated?
- Has the counting been subject to review (double checking on counting) by a person other than the person who counted in the first place?
- Do the people counting the inventory and the people monitoring the counters have the appropriate level of objectivity, knowledge and experience to be able to undertake the count in a diligent manner?

How do we observe the entity's process for investigating and recording count differences? [ISA | 7875.9730]

We inspect the 'adjusted sub-ledger' to determine whether it was updated to reflect the correct quantity. This may be performed through observing that all of the accurate counts are input into the system, screen shots, or other reports produced by the inventory system.

If we are unable to perform this procedure, we notify the engagement team and arrange to provide appropriate evidence such that they can evaluate whether adjustments were appropriately recorded.

How do we observe inventory counts when the entity has a highly automated warehouse? [ISA | 7875.6946]

Highly automated warehouses may use a combination of robotic and human involvement or be fully automated from the point the goods enter the warehouse until the point they are staged for shipment to a customer. In the latter case, it may not be possible for management or us to perform test counts of inventory quantities directly at the shelf/location where the inventory is stored because the automated warehouse is closed off from any human entry or interference.

Accordingly, management may reduce the extent or frequency of counts of physical goods to the extent the goods are held in an automated warehouse.

Regardless of the degree of automation, we expect management to assess the risk that unexpected variances may arise between what is on the shelves and what is recorded in the perpetual records. It's possible that this risk is reduced as automation increases but is unlikely that it becomes completely eliminated such that counting procedures are no longer relevant at some point in the process.

We expect management to still design process control activities to address the sources of potential misstatement where inventory quantities may not match the perpetual records.

What if we identify potential issues during our observation? [ISA | 7875.6886]

If we observe instances where inventory does not appear to be properly managed or the count process varies from management's instructions and procedures, we investigate further and respond appropriately.

In instances where the inventory does not appear properly managed or management's count differs from management's instructions and procedures, we determine the implications on our audit.

1.4.9.4 Inspect the inventory [ISA | 7876]

What do we do?

Inspect the inventory to assess its condition

Why do we do this?

We inspect the inventory as part of our process of obtaining audit evidence regarding the quantities and condition of inventory.

Execute the Audit

Why do we inspect the inventory? [ISA | 7876.6963]

We inspect the condition of the inventory in general and for those items selected during test counts to ascertain its existence and to identify potentially obsolete, discontinued, slow-moving, over-stocked, expired or damaged items.

We also observe how the entity controls the safeguarding of the condition of the inventories from weather, theft and other losses.

What if we identify issues with the condition of the inventory? [ISA | 7876.6969]

If we identify issues with the condition of the inventory, we:

- Determine if such inventory is clearly identified, excluded from the count or separately counted (so that they can be traced through to final books and records)
- Document all such items identified so that these can be followed up when performing the audit procedures regarding the valuation of inventories, if applicable
- Consider inclusion of these items in our test counts.

1.4.9.5 Perform test counts using the dual-purpose approach [ISA | 7794]

What do we do?

Perform test counts using the dual-purpose approach, including obtaining evidence over completeness of the count

Why do we do this?

We perform test counts to obtain audit evidence about the completeness and accuracy of management's inventory records.

Execute the Audit

How do we perform test counts? [ISA | 7794.6888]

We:

- compare our test count results to management's and obtain agreement from entity personnel as to the appropriate quantity when there is a difference;
- physically inspect items tested to determine their quantity and condition; and
- remain alert for indicators of fraud/fraud risk factors. For example, management justification for why items cannot be physically inspected is not consistent with our business understanding.

When we are using the work of others, such as internal audit, those observers are physically present to perform the testing procedures over the count.

As part of physically inspecting items, we may:

- ask entity personnel to open boxes to inspect contents to validate quantities and not relying on quantity per box on outside labels/packing slip, etc;
- count individual items within any open containers; and
- ask the client to pull down pallets from high or hard-to-reach locations to make sure all boxes and/or contents exist - i.e. no false bottoms.

In addition, we do not rely on entity or third-party counters test count results without reperforming them.

What if the entity has work-in-progress (WIP)? [ISA | 7794.6892]

If the entity has WIP where unfinished items are uniquely identifiable and therefore can be counted, we physically examine items to obtain evidence that supports the recorded stage of completion.

How do we determine the number of test counts to perform at a cycle count using the dual-purpose approach? [ISA | 7794.7416]

When we perform a dual-purpose test, we determine the sample sizes separately for substantive tests (test of details) using KPMG Sampling Plan (KSP) and tests of process control activities in accordance with the activity 'Perform test counts using a controls approach'). We then allocate these two samples to the cycle counts at which we are observing management's procedures throughout the period the process control activity operates, ensuring we perform at least 5 test counts at each attendance. Each individual count is a separate process control activity instance, such that the counts are a recurring control when determining the number of test counts to perform for the control sample size and our ability to accept deviations.

> For example, if our sample size determined for process control activity testing is 25 items, and our substantive testing sample size is 100 items, then we only apply our control testing procedures and substantive to 25 items and only the substantive procedures to the remaining 75 samples.

However, we may choose to apply both our substantive testing and process control activities testing to the larger sample size if we wish. This may be appropriate for an inventory count where we perform the same procedure for both purposes.

For additional considerations when determining sample sizes see the chapter on Audit Sampling (ISA 530).

What inventory balance do we base our substantive sample on when attending a cycle count using the dual-purpose approach? [ISA | 7794.7417]

We calculate the sample size based on the estimated total book value of the population.

We cannot use MUS to determine our sample size.

What do we think about when determining the sample unit? [ISA | 7794.6911]

In accordance with 'Perform substantive procedures over sample items' we count all of the items of each sampling unit.

> For example, if the inventory ledger records a single total for the quantity for an inventory SKU stored at multiple locations, then the sampling unit is likely to be the individual SKU for all locations.
>
> However, if the inventory ledger records separate quantities for an inventory SKU by individual locations, then the sampling unit could be the individual SKU for all locations, or the individual SKU for a single location.

When there is a perpetual system, we think about requesting inventory reports at disaggregated levels - it's easier for us to summarize, if necessary, than to break it down ourselves.

How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities? [ISA | 7794.7359]

We determine how many cycle counts to attend and select a representative sample from the period in which the process control activity operates. It would not be appropriate to only attend one cycle count in the period.

We also think about the following factors when determining the number of cycle counts to obtain evidence from:

Factors	Guidance
Risk associated with the control (RAWTC)	The higher the assessed RAWTC, the more cycle counts we obtain evidence from
Frequency of count	If more items counted per day, but fewer days, we may observe fewer cycle counts.
Other process control activities addressing the same RMM	Process control activities over shipping and receiving, the 3-way match for purchases and sales and the recording of inventory movements, when tested and determined

	to be designed, implemented and operating effectively, reduce the likelihood that the perpetual inventory records are inaccurate.
Historical count accuracy (vs. records)	When count accuracy is high, it validates the quality and precision of the related process control activities.
Nature of inventory	Low dollar/large quantity and neatly stacked provide lower risk. When inventory turns quickly, related process control activities have more recent influence on quantities on hand.
Homogeneity of locations	The number of the entity's homogeneous locations that will be subject to testing (e.g. it is not necessary to test each location multiple times when the total number of locations tested achieves our objective of observing a sufficient number of points in time). For example, if we determined that we intended to gather evidence from 15 locations to test management's assertion of homogeneity for process control activity testing purposes and determined that it would be necessary to observe counts on 10 different days. If we attend the 15 locations on 15 different days, this meets both objectives.

How do we consider risk related to the completeness of inventory? [ISA | 7794.6913]

Much of the completeness risk for inventory relates to cut-off, which is a separate RMM is addressed through procedures separate from physical counts themselves (e.g. inspecting documentation of sales, shipments and receipts near period-end). Cut-off is inherently limited to a brief interval near period-end or the count date.

A risk related to completeness of inventory occurs when inventory:

(1) comes into an entity's possession without being recorded, or
(2) is recorded as shipped without being shipped (unless there was a specific fraud risk assessed).

The degree of risk will be influenced, in part, by the nature of inventory and how it is received or shipped. For example, there may be more risk associated with natural resource extraction from entity-owned and operated sites than for boxed-goods purchased from third party suppliers.

What evidence do we obtain over the completeness of the cycle count? [ISA | 7794.7294]

We obtain evidence that all inventory items/locations, etc. are in fact counted, according to the entity's counting policies.

May we use an acceptable variance when comparing our test counts to management's count? [ISA | 7794.6895]

Yes. There are circumstances when our counting method naturally contains some imprecision, or our test is based on an estimate of the inventory quantity and management's process for determining quantities has greater precision. This is common when certain items may be reliably weighed or measured with certain precision thresholds as their weights or measurements are effectively estimates of the quantities on hand. In these circumstances, we can use an acceptable variance when comparing our test counts to management's count and differences within the acceptable variance do not indicate a control deviation or misstatement.

We are still mindful as to whether there appears to be any management bias based on the results of the test and whether the overall imprecision of the test is appropriate. See 'Establish an acceptable variance, if applicable' for further considerations.

What is an acceptable variance? [ISA | 7794.10946]

Acceptable variances provide for a range in which a difference between the book value and the audit value (i.e. actual value as determined in testing the sample) that is not considered a misstatement.

What if our count results differ from management's when taking dual purpose approach to attendance at the cycle count? [ISA | 7794.7427]

If we identify a difference between our count and management's count, we treat this difference as a control deviation, provided the process control activities surrounding the count have been completed. We evaluate any deviations in accordance with 'Perform relevant procedures when control deviations are identified'.

> For example, if the quantity counted by us differs from management's inventory records and the difference is above an error rate that would be subject to management's research and recount control, we wait before informing management of the deviation to allow their controls to operate (e.g. their research and recount control).

We obtain an understanding about the nature and cause of each difference and contact the engagement team to discuss whether a revised audit response is necessary.

We project misstatements identified during our cycle count observations to the entire inventory account population subject to cycle counting. If the total most likely misstatement is clearly trivial (i.e. below AMPT and qualitatively trivial), and the number of control deviations is acceptable (i.e. no indication of a control deficiency), it may be acceptable to still conclude that the perpetual inventory system gives results consistent with a complete count at period end. However, the identification of differences during the cycle count that extrapolate to an amount that is not trivial may indicate that the dual-purpose approach is not appropriate, and deficiencies need to be remediated so that the tests can be reperformed or a complete physical count at or near period end is warranted.

Examples

How do we determine if a control deviation exists? [ISA | 7794.6987]

Fact Pattern

The engagement team observes 50 pieces of frozen food product ABC in location 123 (the sampling unit) for one of our test counts. The engagement team then obtains management's count sheet/results for location 123, along with the perpetual inventory list, and identifies that their count differs.

Scenario 1

Perpetual system: 48 pieces

Management's count: 50 pieces

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 1

This is not a control deviation or a misstatement. Management has counted the correct quantity, identified the outlier and made the appropriate adjustment.

Scenario 2

Perpetual system: 48 pieces

Management's initial count: 52 pieces

Management's recount: 50 pieces (management recounted as a result of the initial count difference and its own process control activities and procedures)

The engagement team's count: 50 pieces (the correct count)

Management records a count adjustment to update the perpetual inventory system to 50 pieces.

Analysis 2

This is not a control deviation nor a misstatement. Management has counted the correct quantity (the company's process control activities resulted in the recount which resulted in the correct quantity), identified the outlier and made the appropriate adjustment.

Scenario 3

Perpetual system: 48 pieces

Management's count: 48 pieces

The engagement team's count: 50 pieces (the correct count)

Management recount: 50 pieces (recounted only when we drew management's attention to the count discrepancy)

Analysis 3

Management adjusts the perpetual inventory for the recount (the correct count).

Notwithstanding the ultimate correction, management's initial count was incorrect and only corrected as a result of the engagement team's procedures (not its own process control activities). This is considered a deviation for control testing purposes and a misstatement for substantive sampling purposes and we respond in accordance with 'Determine the effect of control deviations' and 'Perform relevant procedures for misstatements/errors', respectively.

How do we determine the number of test counts to perform? [ISA | 7794.7429]

Fact Pattern

Period end: 31 December

Six entities perform cycle counts according to the following scenarios:

Background	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Nature of inventory	Automotive tires	Big box retail	Raw materials for silicone water manufacturing	Spare parts[1]	HVAC equipment	Electronic Equipment
# of locations	2 large distribution centers, with approximately equal amounts of inventory	200 retail locations, with approximately equal amounts of inventory	1	1	40 regional branches	10 manufacturing & warehouse facilities of approximately equal size
Materiality of inventory	50x PM	100x PM	10x PM	3x PM	20x PM	100x PM
Initial assessment of homogeneity	Yes	Yes	N/A - 1 location	N/A - 1 location	Yes	No
Historical count accuracy	99%	93%, with related shrink reserve consistently accurate	99%	97%	98%	98%

Other process control activities (3-way matches, cut-off)	Effective	Effective	Effective	N/A - only count process control activity deemed necessary based on risk	Effective	Effective
RAWTC assessment	Base	Base	Elevated	Base	Base	Base
Frequency that items are counted	ABC System SKU category A, 60% counted monthly SKU category B, 30% counted quarterly SKU category C, 10% counted annually	Each store counted once per year, with a wall to wall physical count performed per store	All locations (bins/bays/ aisles) within the warehouse are counted at least 1x per year tracked by warehouse aisle and bay. Certain locations with higher movement are counted more frequently	All bins counted twice per year based on systematic spreadsheet tracker	ABC system SKU category A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually	ABC system SKU category A, 50% quarterly SKU category B, 25% semi-annually SKU category C, 25% annually
Timing and extent of management's counts	50 SKUs counted daily	Stores are counted evenly throughout the year, all items counted	30 bins counted daily	No prescribed frequency. Counts occur 1-2x per week with ~ 10 bins	20 SKUs counted daily	50 SKUs counted daily

				counted each time.		
Frequency to determine the control sample size for test counts	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring	Manual Recurring at each location

The engagement team determines that they will apply both their substantive testing and process control activities testing to the larger sample size.

Analysis

Using the above scenarios, the engagement team may plan the following approaches.

Approach	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
# of locations from which we obtain evidence (see 'Determine the number of locations to obtain evidence from' and 'Determine the substantive sampling approach for multiple locations,	2	25	1	1	10	8 (as none are homogeneous, we have to treat as 8 separate process control activities/ populations)

seeking assistance if relevant')						
# of days attended per location[2] (see question 'How do we determine how many cycle counts to obtain evidence from for manual recurring cycle count process control activities?')	5	1	5	2	1	5
# of test counts reperformed each attendance	10	8	30	25	7	6
Total # of test counts per location [2]	50	8	150	50	7	30
Total # of test	100	200	150	50	70	240 (30 per location

counts performed (higher of KSP and controls sample size)						assuming the size of the 8 locations are the same)
Notes on approach	Observe minimum of 5 days at each location to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.	25 locations deemed necessary to test assertion of homogeneity for ICFR; 1 observation at each location deemed appropriate to attain a total of 25 observations. Although complete physical counts are performed at each store, it is treated as a cycle count for the aggregate inventory	Observe minimum of 5 days at single location to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.	Only 2 observations deemed necessary as account is only 3x PM and low transaction volume of inventory.	10 locations deemed necessary to test assertion of homogeneity for ICFR. 10 total observations deemed appropriate based on risk assessment/ materiality of inventory.	Since not homogeneous, each location is an independent population. With balance of approx.10x PM per location attended, a minimum of 5 days at each location deemed appropriate to gain meaningful evidence over several points in time to conclude process control activity is operating consistently.

		balance with each store's count treated as a cycle count for the overall balance.				

[1] Spare parts may not be a part of core operations and may not be viewed as true "inventory". This example highlights how an engagement team might tailor our procedures to reflect this assessment.

[2] This assumes that the engagement team are reperforming/observing management's count at every attendance from which they are obtaining evidence. See question 'Can we use inquiry and inspection for a portion of our sample when testing the operating effectiveness of process control activities of cycle counts?' for additional considerations.

The above table is for test counts only. When we test other process control activities as part of our inventory count, the control sample size depends on the frequency of operation of those process control activities.

> For example, management performs a cycle count daily over multiple SKUs. Whilst the frequency of test counts equates to a manual recurring control, the control that ensures all inventory is counted in the period may operate quarterly. The RAWTC for both controls is Base. We would apply the manual recurring control sample size to the test counts (25) and apply quarterly control sample size to the other control (2).

1.4.9.6 Determine whether entity's final inventory records accurately reflect count results [ISA | 7877]

What do we do?

Perform audit procedures to determine whether entity's final inventory records accurately reflect count results

Why do we do this?

We perform procedures to assist us in obtaining audit evidence that the count results were accurately reflected within the sub-ledger. It helps us understand how management address risks surrounding the completeness and existence of inventory records and sub-ledger.

Execute the Audit

What procedures do we perform to determine whether the entity's final inventory records accurately reflect the actual inventory count results? [ISA | 7877.7353]

After completing the test counts and when the post-count adjusted sub-ledger is available, we (if not already performed by the observer):

- trace quantities between count records and the post-count adjusted sub-ledger to determine whether management has appropriately recorded the quantities on-hand;
- obtain evidence regarding whether differences between the count records and the system were properly investigated; and
- evaluate whether the level of adjustments calls into the question the appropriateness of determining inventory quantity and condition through cycle counts.

What if there are differences between the inventory count results and management's post-count adjusted sub-ledger at cycle counts? [ISA | 7877.7354]

If there is a difference between the count sheets and management's post-count adjusted sub-ledger, we investigate the reason for such difference. We examine whether count differences are appropriately tracked by the entity and included in its monitoring of cycle counts results.

We obtain and evaluate management's summaries of cycle count information and recorded inventory adjustments. We evaluate count variances, if any, to determine if they fall within the established minimum accuracy percentages (i.e. entity's established acceptable threshold) and evaluate the reasonableness of the variances in terms of the total value. We consider whether there is an indication that an undetected misstatement exists as at the period-end.

If our subsequent investigation determines that the post-count adjusted sub-ledger is incorrect, then this is a control deviation.

When the adjustments from book to physical are trivial, it supports the assessment that cycle counts produce results substantially the same as those which would be obtained by a complete physical count.

If more than trivial adjustments are made to adjust inventory quantities as a result of the cycle counts, this challenges the effectiveness of the related process control activities and undermines the assessment that the same results are obtained from the perpetual inventory system as those by annual physical count. In such cases, we reassess control risk, and determine whether it is necessary for management to perform a complete physical count at or near period end that we would then attend. If the entity has remediated the cycle count process control activities, we may re-test the cycle counts subsequent to remediation of identified deficiencies.

We evaluate any misstatements identified in accordance with activity 'Evaluate the nature, circumstances, effect and implications of misstatements' or 'Perform relevant procedures for misstatements/errors'.

1.4.9.7 Perform procedures over changes when count is performed at a date other than the period end [ISA | 7795]

What do we do?

IF the count is performed at a date other than the period end THEN perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded

Why do we do this?

When planning our audit procedures over the physical attendance of inventory, we determine whether the counts occur on the period-end date. If the date of the count differs from period end, we perform additional procedures to address whether the changes in the balance between the count date and the balance sheet date have been appropriately recorded. This is because our observations only give us evidence about the quantities and condition of the inventory on the day the count is actually performed.

Execute the Audit

When performing a dual-purpose test over cycle counts, is it necessary to perform procedures over changes in inventory between the count date and the date of the financial statements? [ISA | 7795.7414]

Not necessarily. When performing a dual-purpose test over inventory cycle counts, we reach our conclusions only after completing our tests of our determined sample, and thus conclude as of the date of the last cycle count tested. When the date of the last count is prior to period end, we reached a conclusion as of an interim period.

When we have designed our procedures to extend to close to the period end, in many cases, the risk of an undetected material misstatement (or control deficiency) associated with the remaining period between the date of our conclusion and period end may have been reduced to remote and an audit response may not be necessary.

When an audit response is necessary, we cover the remaining period by performing relevant procedures to provide a reasonable basis for extending the audit conclusions from the interim date to the period-end in accordance with the following activities:

- Compare information to identify and investigate items that appear unusual; and
- Perform additional audit procedures over the remaining period.

How do we determine the nature and extent of procedures to perform if the risk in the remaining period is other than remote? [ISA | 7795.7415]

If the risk is other than remote, additional procedures are designed to respond to the risk. In cases where the remaining period is short (close to period-end/near period-end) and the degree of risk is assessed at the low end of the continuum, the remaining period may be addressed through procedures such as cut-off testing, the search for unrecorded liabilities, etc. that provide sufficient and appropriate evidence over quantity and condition. To the extent the risk is higher along the continuum,

more persuasive audit evidence may be necessary, including testing activity during the rollforward period or performance of additional test counts as of the end of the period.

We determine the persuasiveness of the evidence necessary by thinking about the following factors:

Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment, other CERAMIC components, and other relevant control activities	We identify weaknesses in the control environment, other CERAMIC components, and/or other relevant control activities.	We conclude that the control environment, other CERAMIC components and other relevant control activities are effective.
Our assessment of inherent risk of error	We assess inherent risk as Elevated or Significant.	We assess inherent risk as Base.
Whether fraud risks exist and the nature of those risks	We identify and assess that a fraud risk exists.	We do not identify a fraud risk.
The length of the intervening period	The intervening period is longer.	The intervening period is shorter.
The nature of the significant account or disclosure and relevant assertions, including the predictability of the account balance (and/or the transactions in the balance)	Judgmental, less predictable, etc.	Routine, non-judgmental, more predictable, etc.
The extent of activity in inventory between the count date and period end	Higher level of activity.	Lower level of activity.

1.5 Perform procedures if we are unable to attend

[ISA | 7799]

What do we do?

IF we are unable to attend management's inventory count(s) due to unforeseen circumstances THEN perform relevant procedures

Why do we do this?

If we are unable to attend management's inventory count, we perform relevant procedures in order to obtain sufficient appropriate audit evidence over the quantities and condition of inventory.

Execute the Audit

What procedures do we perform if we are unable to attend management's inventory count due to unforeseen circumstances? [ISA | 7799.7434]

If we are unable to attend due to unforeseen circumstances, we:

- document why we are unable to attend management's inventory count(s) due to unforeseen circumstances;
- make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions/intervening period; and
- inspect the records of any of the entity's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based.

Over what period do we perform our procedures over intervening transactions? [ISA | 7799.7436]

The relevant period is the date we make or observe our own counts and the period end date.

> For example, we were unable to attend the entity's count on 15 December due to unforeseen circumstances and instead performed an independent count on 15 January. The period end was 31 December. Our procedures on intervening transaction are performed over the period between 31 December and 15 January (rollback).
>
> If we instead performed an independent count on 28 December. Our procedures would be performed over the period between 28 December - 31 December (rollforward).

Our rollback/forward procedures provide evidence that changes between date of management's count and the date of financial statements are properly recorded (otherwise our results would not reconcile to the financial records).

How do we observe a physical count on an alternative date? [ISA | 7799.9752]

If we were able to observe management's complete physical count on an alternative date, we document our observation and relevant procedures for the complete physical count in accordance with:

- activity 'Determine our approach to inventory count attendance for an RMM', if we are responding to an RMM over quantity and condition, or
- activity 'Perform procedures when attending the count if no RMM has been identified over quantities and condition and inventory is a material financial statement caption', if inventory is a

material financial statement caption and the risk over quantity and condition of inventory has not been assessed as an RMM.

How do we make a physical count on an alternative date (i.e. perform an independent count)? [ISA | 7799.9753]

If we are not able to observe management's inventory count on an alternative date, we perform an independent count as follows:

Circumstance	Considerations
When the following risk has been identified and assessed as a risk of material misstatement (RMM): • Quantity of inventory held by the entity is not completely and accurately recorded, the inventory does not exist, or the condition of inventory is not identified; and/or • Quantity of inventory held by third parties is not completely and accurately recorded, the inventory does not exist, or the condition of inventory is not identified.	We perform an independent count in accordance with activity 'Not Integrated Audit | Perform procedures when taking an independent count approach' and document our independent count and relevant procedures related to the following: • Engagement team risk assessment and planning procedures (other than planning the observation of managements count(s)); • Independent count audit procedures performed by the attendee; • Evaluation of independent count results.
When inventory is a material financial statement caption and the risk over quantity and condition of inventory has not been assessed as an RMM	We perform an independent count as noted above for when we are responding to the RMM; however, we keep in mind that the objective of these procedures differs from those that are responsive to the RMM. As a result, they may be less precise (see question 'What substantive procedures do we perform for a material non-significant accounts (MNSAs)?').

What are appropriate tests of intervening transactions? [ISA | 7799.7440]

We perform the following:

- Testing the roll-forward activity by:
  - Performing substantive analytical procedures to evaluate sales, gross margin percentages, inventory turnover and/or days sales in inventory; and/or
  - Vouching purchases and sales of inventory during the roll-forward period to and from perpetual records.
- Testing inventory sales and purchases for proper cut-off at period end.

- Testing the accuracy of the inventory reconciliation to general ledger at period end, including tests of reconciling items.

When we have to make or observe a physical count after the period end, what are appropriate tests of intervening transactions? [ISA | 7799.7441]

Appropriate tests of intervening transactions may include:

- **Sampling transactions**. It may be appropriate to perform roll-back procedures to the most recent balance sheet date.

There's no limit on how far back a sampling approach may be employed. However, if the period of intervening transactions extend beyond a year, we think about using other auditing techniques such as substantive analytical procedures described below.

- **Perform substantive analytical procedures**. We may perform substantive analytical procedures, such as trend or predictive analyses over purchases and sales volumes, gross margin and turnover ratio analyses, and data analysis of inventory quantities by location over the intervening period.

What are examples of unforeseen circumstances? [ISA | 7799.7442]

Examples of unforeseen circumstances include:

- Where we are appointed as auditors, after the inventory count has taken place
- Poor weather conditions, meaning we are unable to attend the site where the count is being performed
- Carve-out audits

What else do we think about for carve-outs or initial audits? [ISA | 7799.7444]

We also think about the following:

- Taking some credit for counts performed by the entity. While this may not an appropriate substitute when we have the capacity to be present, evidence of the entity's count procedures related to the balance sheet date may be appropriate in certain circumstances.

> For example, we may obtain an understanding of count procedures, and get records of their occurrence and tie them into the balances we are testing. The nature of the evidence (blind count sheets versus a signed final perpetual list), and who produced it (internal audit versus warehouse staff), affects its persuasiveness for our purposes.

- Taking some credit for procedures previously performed by us. In carve-out audits, when we have audited the predecessor entity at a higher level, we can isolate the specific procedures performed over the carved-out entity and use that evidence toward our conclusions. However, we only take credit for procedures specifically performed over the carve-out entity and do not transfer conclusions reached at a higher level over the organization.

> For example, if as part of the predecessor audit we attended 20 of 100 homogeneous locations, including 2 of 10 for the carved-out entity, we have sufficient evidence on the homogeneity of the 10 locations because of the homogeneity conclusion from the original test, we reassess the

substantive evidence gained on the 2 locations relative to the 10 locations as an independent population (typically with a different materiality). We may determine that the attendance at the 2 locations, and aggregate sample size, provided adequate evidence over the total population of 10 locations.

1.6 Perform alternative procedures if attendance is impracticable [ISA | 7801]

What do we do?

IF attendance at management's inventory count is impracticable THEN perform alternative procedures and perform procedures over the entity's final inventory records to determine whether they accurately reflect inventory count result to obtain sufficient appropriate audit evidence regarding the quantities and condition of inventory

Why do we do this?

If attendance is impracticable, we still obtain sufficient appropriate audit evidence regarding the quantities and condition of inventory.

Execute the audit

What does 'impracticable' mean? [ISA | 7801.6862]

Impracticable is not specifically defined but may be due to factors such as the nature and location of the inventory.

For example, the inventory is located in a war zone and there is a threat to safety in visiting the inventory location.

We expect these situations to be rare and the matter of general inconvenience is not sufficient to conclude that attendance is impracticable.

When we do not attend management's inventory count, we document why it is impracticable to do so and perform procedures in accordance with 'Perform alternative procedures if attendance is impracticable'.

Do we evaluate management's count results if it's impracticable to attend? [ISA | 7801.7382]

We inspect the records of any management's counts and procedures relating to the physical inventory on which the balance-sheet inventory is based to identify whether management's count records indicate a material level of inaccuracy in inventory records (differences between management's count results and the pre-count records), whether or not we attended the count.

What if we are unable to obtain sufficient and appropriate audit evidence over quantities and condition of inventories by performing alternative procedures? [ISA | 7801.7383]

We modify the audit opinion in accordance with the chapter on modifications to the opinion (AS 3105, ISA 705, AU-C 705).

Examples

How might we design alternative procedures to an inventory count that is impracticable to attend? [ISA | 7801.7385]

Fact Pattern:

The engagement team is performing an audit of an entity that maintains inventory in dangerous and remote locations (military bases in a war zone) that they believe pose a threat to the safety and security to the auditor(s). While management performs physical inventory counts, it is done so at the military base, and the results are communicated back to corporate headquarters. The location of the inventory may pose threats to the safety of the auditor(s). In such instances, it is not merely a matter of inconvenience, but a matter of safety.

Analysis:

The engagement team determines that attendance at the count is "impracticable" due to the fact that the safety and security of the auditor(s) is at risk.

While management still conducts its physical inventory counts, the engagement team designs alternative procedures to determine the quantities and condition of the inventory on hand. This could include:

- Requesting the client to provide photographic evidence of the quantities and condition of inventory. In such cases the engagement team incorporate elements of unpredictability into the procedure by sending the sampled selection on the day of the count and request that photographs include a random number or image selected by the auditor to determine whether the photographs are contemporaneous with the count date.
- Inspect documentation of the purchase and sale of select inventory items (i.e. by unique item serial number), to determine appropriateness of dates and quantities.

1.7 Obtain evidence at third party locations [ISA | 7800]

What do we do?

Obtain sufficient and appropriate audit evidence regarding the quantities and condition of that inventory held at third party locations

Why do we do this?

Performing procedures over inventory held at third parties (under the custody and control at a public warehouse or an outside custodian) provides evidence for:

- inventory quantities;
- condition; and
- evidence about other balance sheet and income statement accounts that capture inventory transactions.

Execute the Audit

When do we obtain sufficient and appropriate audit evidence regarding the quantities and condition of inventory held at third party locations? [ISA | 7800.7446]

We obtain sufficient and appropriate audit evidence, when the following risk has been identified and assessed as a risk of material misstatement (RMM):

- Quantity of inventory held by third parties is not completely and accurately recorded, the inventory does not exist, or the condition of inventory is not identified.

Or the inventory balance held at third party locations is material.

What is a public warehouse or an outside custodian? [ISA | 7800.7448]

A public warehouse is a third-party facility that stores inventory for many different businesses as opposed to a 'private warehouse', which are owned and operated by the entity whose inventory is stored there. The entity's employees do not operate controls over the movement of goods, as this is provided as part of a service contract.

Other outside custodians include other third parties that maintain custody and physical storage of inventory on an entity's behalf. Like a public warehouse, the location where the inventory is stored is not owned or leased by the entity and the individuals who operate controls over the movement of goods are not employees of the entity.

A public warehouse or an outside custodian may also serve as a service organization. See the chapter on service organizations (AS 2601, ISA 402, AU-C 402) for additional considerations to be applied.

Does an entity's use of a third party to perform the inventory count indicate that inventory is under the third party's custody and control? [ISA | 7800.7449]

No, if the entity engages a third party to perform the physical inventory count, its involvement does not indicate that the inventory is under the custody and control of a third party.

What relevant procedures do we perform when inventories are held at third party locations? [ISA | 7800.7450]

We perform the following procedures:

- Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity; and/or
- Perform inspection or other audit procedures appropriate in the circumstances.

How do we determine whether to request confirmation of the inventory and/or perform inspection or other audit procedures appropriate in the circumstances? [ISA | 7800.7457]

We think about the following factors in determining whether we send confirmations and/or perform inspection or other audit procedures:

- the assessed inherent risk of the RMM (if any);
- whether we intend to rely on process control activities, and whether controls at the third-party warehouse are important to assessing control risk;
- the materiality of inventory at the third-party warehouse;
- other RMMs that depend on data from the third-party warehouse, such as data inputs to inventory reserves and allowances.

Further, when information is obtained that raises doubt about the integrity and objectivity of the third party, we may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

Refer to activity 'Determine whether to perform external confirmation procedures' for additional considerations when determining whether to request confirmations.

How do we request confirmation of inventory? [ISA | 7800.7455]

We request confirmation of inventory in accordance with 'Design the confirmation request'.

Other than confirming inventory held at the third party, what are examples of other audit procedures we may perform? [ISA | 7800.7459]

Example additional procedures include:

- Attend or arrange for another auditor to attend the third party's physical counting of inventory, if practicable
  - In such circumstances, it might be appropriate for us to physically attend the count performed by the third party to determine the quantities that are maintained by the third party and the condition of that inventory. In this scenario, we plan to execute our audit procedures as though we are attending a physical inventory count for inventory managed by the entity.
- Obtain another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
  - Under these procedures, we obtain the SOC-1 report(s) associated with the third party responsible for the custody of management's inventory. We evaluate the internal controls performed by the service organization and perform activities in the chapter on service organizations (ISA 402, AU-C 402).
- Inspect documentation regarding inventory held by third parties, for example, warehouse receipts, subsequent sales and shipments to third parties
  - In such circumstances, we obtain evidence that the third party has the inventory within their custody without obtaining confirmation directly from the outside custodian. To perform this procedure, we may conduct detail testwork and obtain the associated receipt acknowledgements (for each sample item) from the custodian to the entity to demonstrate that the inventory had be received by the third party.
- Request confirmation from other parties when inventory has been pledged as collateral.

We evaluate whether the audit procedures or combination of procedures performed provide sufficient and appropriate audit evidence with respect to both quantities and condition of the inventory.

Can third party warehouses be treated as homogeneous? [ISA | 7800.7460]

Possibly, but it's a high bar.

Keep in mind that separate third-party warehouses may operate different systems in distinct IT environments, and they may have autonomy about the policies and procedures for processing and monitoring inventory quantities.

These conditions are difficult to overcome, even if the entity has a standard warehouse agreement with requirements to perform periodic counts, etc.

However, there may be circumstances in which the entity places more reliance on process control activities it has designed and implemented over the third party warehouse's operations, such as when the entity sends some of its own personnel to the warehouse full-time to perform or oversee counts (periodically or for a complete annual count), or directs the counting performed by the third party warehouse remotely, including selection of items to be counted and providing blind count sheets to be used for the counts.

In such scenarios, the process control activity is specific to what management does - directing or monitoring warehouse personnel or performing their own counts. When management implements and operates such process control activities across distinct third-party warehouses, these process control activities over the warehouses could be evaluated for homogeneity just like any process control activity operated by management. This assessment may lead to different third-party warehouses being assessed as homogeneous. Absent these entity-operated process control activities, it would be rare for third party warehouses to be deemed homogeneous with other third-party warehouses or the entity's own warehouses simply due to the basic operational differences.

The separate activities of the warehouse personnel would not constitute a process control activity unless management is identifying, testing and monitoring the process control activity as if it were management's own.

Litigation and Claims

International Standards on Auditing: ISA 501.09-12

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts. (Ref: Para. A20)

10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.(Ref: Para. A21-A25)

11. If:

(a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and

(b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,

the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised).

Written Representations

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

ISA Application and Other Explanatory Material: ISA 501.A17-A25

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. ISA 540[10] establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

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10 ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor's review of legal expense accounts.

Communication with the Entity's External Legal Counsel (Ref: Para. 10-11)

A21. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's

external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example, if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(a) A list of litigation and claims;

(b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

A25. In accordance with ISA 700 (Revised),[11] the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

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11 ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements,* paragraph 49

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Obtain audit evidence related to litigation, claims, and assessments [ISA | 4007]

What do we do?

Obtain sufficient appropriate audit evidence relevant to actual or potential litigation, claims, and assessments.

Why do we do this?

Given that litigation, claims, and assessment is an area that can impact most entities, we perform some specific procedures as part of our audit directed at these matters.

Execute the Audit

What are litigation, claims, and assessments? [ISA | 4007.1300]

Litigation, claims, and assessments are actual or potential legal actions, demands, fines, and/or proceedings involving the client related to alleged wrongful conduct. They may be brought by an individual, entity and/or regulatory or governmental body.

What types of procedures do we perform over the client's litigation, claims, and assessments? [ISA | 4007.1500]

We perform procedures to identify and obtain evidence of litigation, claims, and assessments, which helps us identify when actual or potential litigation, claims, or assessments exist that may give rise to a risk of material misstatement.

When we identify and assess RMMs relating to litigation, claims, and assessments or when audit procedures performed indicate that other material litigation or claims may exist, we may perform the following types of procedures:

- Inquire of the client's lawyer(s)
- Evaluate the lawyer's response to legal inquiries
- Evaluate any scope limitations

What evidence do we obtain related to litigation, claims, and assessments? [ISA | 4007.1600]

With respect to litigation, claims, and assessments, we obtain evidential matter relevant to the following factors:

- The existence of known or potential litigation, claims, and assessments due to the specific condition/situation
- The period in which the underlying cause for legal action occurred
- The degree of probability (i.e. likelihood) of an unfavorable outcome
- The estimated amount/range of potential loss

Over what period do we perform procedures pertaining to litigation, claims, and assessments?

Similar to other areas in our audit, we perform audit procedures to evaluate litigation, claims, and assessments for the entire period under audit, up to and including the date of our audit report.

When we learn of a legal matter, we obtain evidence about the period in which the underlying cause for the legal action occurred as well as the expected timing of resolution for the litigation, claim, or assessment. This helps us determine how the identified legal matter could impact the current period under audit.

Why do we determine the degree of probability (i.e. likelihood) of an unfavorable outcome with regards to litigation, claims, and assessments?

We understand the degree of probability of an unfavorable outcome to help us determine whether there is a risk of material misstatement. Accounting and disclosure for litigation, claims, and assessments is dependent on the probability (i.e. likelihood) of an unfavorable outcome. The accounting standards dictate whether the entity is required to reserve and/or disclose an amount

related to the identified litigation, claim, or assessment based on the probability of an unfavorable outcome.

How do we determine the degree of probability (i.e. likelihood) of an unfavorable outcome with regards to litigation, claims, and assessments?

In order to determine the degree of probability (i.e. likelihood) of an unfavorable outcome, we look to the guidance in the accounting standards relevant to our audit. The degree of probability is not usually a number (e.g. x%), but rather a general assessment (e.g. probable, reasonably possible). The accounting standards provide definitions and insight to the varying degrees of probability and impact on our audit procedures.

Why do we determine the potential amount or range of potential loss related to litigation, claims, and assessments?

We determine the potential amount or range of potential loss to assess the magnitude as part of assessing whether there is a risk of material misstatement. We understand the estimated amount or range in order to determine whether it could be material to the financial statements. Depending on the applicable financial reporting framework, the entity may also be required to disclose the potential amount or range of potential loss.

Will an RMM always arise related to litigation, claims, and assessments? [ISA | 4007.1700]

No. We first perform risk assessment procedures to determine whether there is a reasonable possibility that a RMM exists within the process.

As part of this assessment, we inquire about management's evaluation of identified actual or suspected litigation, claims, and assessments.

When we identify the following types of items, we may determine they do not give rise to an RMM:

- Matters unrelated to actual or potential litigation, claims or assessments, such as consulting services related to real estate or potential merger and acquisition transactions
- Matters in which the entity records indicate that management or the legal counsel has not devoted substantive attention to the matter
- Matters in which the entity's insurance coverage exceeds the amount of the actual or potential litigation, claim or assessment sought against the entity, or
- Matters that are clearly trivial to the financial statements

Do we identify an RMM at an individual litigation, claims, and assessments level or on a portfolio level? [ISA | 4007.13132]

It may be appropriate to determine the RMM at:

- the entire population of litigation, claims, and assessments; or
- disaggregate the RMMs:
- by different categories, for examples when there are different profiles; or
- at the individual litigation, claims, and assessments, for example to tailor our audit response for a specific matter.

Could an RMM exist even if no litigation, claims, and assessments are identified? [ISA | 4007.13134]

Yes. Even if no litigation, claims, and assessments are identified as a result of our risk assessment procedures, if we believe that the entity has not identified or does not have an understanding of the complete population of litigation, claims, and assessments, we may determine that an RMM exists.

1.1 Identify and obtain evidence of litigation, claims, and assessments [ISA | 4008]

What do we do?

Design and perform procedures to identify and obtain evidence of litigation, claims, and assessments which may give rise to a risk of material misstatement.

Why do we do this?

We design and perform procedures to identify potential risks of material misstatement (RMM) related to litigation, claims, and assessments. When we identify an RMM related to litigation, claims, and assessments, we perform further audit procedures to identify and obtain sufficient appropriate evidence.

Execute the Audit

How do we identify and obtain evidence of litigation, claims, and assessments? [ISA | 4008.1400]

In order to identify and obtain evidence of litigation, claims, and assessments we inquire of management and others within the entity including in-house counsel, where applicable, and perform the following risk assessment procedures:

- Understand management's policies and procedures
- Obtain management's description and evaluation of litigation

To corroborate our inquiries with management, we also perform the following procedures:

- Examine documents in the client's possession concerning litigation
- Obtain management representations regarding disclosure of claims
- Review meeting minutes to identify litigation, claims, and assessments

Additionally, we:

- Modify our audit procedures when management has not consulted with a lawyer; and
- Consider performing inquiries when the client has changed lawyers.

What is management's responsibility with regards to litigation, claims, and assessments? [ISA | 4008.13136]

Management is responsible for adopting policies and procedures to identify, evaluate, and account (including disclosure) for litigation, claims, and assessments as a basis for the preparation of financial statements, in accordance with the requirements of the applicable financial reporting framework.

1.1.1 Understand management's policies and procedures [ISA | 4009]

What do we do?

Obtain an understanding of management's policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments

Why do we do this?

Before performing detailed audit procedures over litigation, claims, and assessments, we inquire of management regarding their policies and procedures to identify, evaluate, and account for litigation, claims, and assessments. The inquiry is a risk assessment procedures that inform our identification and assessment of risks of material misstatement and allow us to design an audit response.

Execute the Audit

How do we obtain an understanding of management's policies and procedures with regards to identifying, evaluating and accounting for litigation, claims, and assessments? [ISA | 4009.1300]

We obtain an understanding of managements' policies and procedures with regards to litigation, claims, and assessments by performing inquiries of management.

Who do we inquire of to obtain an understanding of management's process over litigation, claims, and assessments? [ISA | 4009.1600]

We inquire of management's process over litigation, claims, and assessments with those individuals knowledgeable about the entity's process for identifying possible litigation, claims, and assessments, which could include management (i.e. CFO, CEO, Controller), those charged with governance, internal audit, and/or in-house legal counsel. We may also inquire of individuals knowledgeable about the processes for evaluating and accounting for, including disclosure of, litigation, claims, and assessments.

What do we do differently to understand management's policies and procedures when there is an RMM related to litigation, claims, and assessments? [ISA | 4009.13148]

If we determine that an RMM exists or if there is a reasonable possibility that one exists, we obtain an understanding of the entity's process over litigation, claims, and assessments (for example, by performing a walkthrough, if applicable). See activity 'Understand business processes ' for more information on walkthroughs and when we perform them.

What do we do if management does not have an established process to identify, evaluate and account for litigation, claims, and assessments? [ISA | 4009.1700]

If management does not have an established process to identify, evaluate and account for litigation, claims, and assessments, we think about the reasons why and factor that into our determination as to whether there is identifying and assessing RMMs related to litigation, claims, and assessments. The lack of an established process could be an indicator of a risk of material misstatement, since management may not be aware of all litigation, claims, or assessments without an established process. On the other hand, it could also reflect that the business operates in a non-litigious environment, or that strong preventative controls avoid litigation in the first place.

1.1.2 Obtain management's description and evaluation of litigation [ISA | 4010]

What do we do?

Obtain from management a description and evaluation of litigation, claims, and assessments which could have a material effect on, or require disclosure in, the current period financial statements and make specific inquiries of management and in-house counsel.

Why do we do this?

Once we understand the general policies and procedures management has in place related to litigation, claims, and assessments, we obtain management's description of specific pending or potential litigation, claims, and assessments, and management's evaluation of each item. We do this in order to corroborate management's evaluation with the other evidence we obtain and identify litigation, claims and assessments involving the entity that may give rise to a risk of material misstatement.

Execute the Audit

What do we obtain from management related to litigation, claims, and assessments? [ISA | 4010.1300]

We ask management to provide us a description (i.e. nature) and evaluation of the pending or potential litigation, claims, and assessments, including those defended by insurance companies. We also ask that management indicate which matters they have referred to legal counsel.

What does management's evaluation of litigation, claims, and assessments include?

Management's evaluation includes enough information to understand the matter and how they reached their conclusions. This may include information such as:

- Factors influencing the likelihood of loss
- Factors influencing the range of possible loss, the estimated loss, and the exposure to loss in excess of amounts accrued
- Management's materiality considerations
- Management's process for updating disclosures for new developments
- Significant assumptions (qualitative and quantitative) and why management did not consider other assumptions

What period is relevant as it relates to litigation, claims, and assessments?

We are concerned with litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is provided by management.

Do we always obtain management's description and evaluation of litigation, claims, and assessments in writing? [ISA | 4010.1400]

Not necessarily. Management could provide this analysis orally or in a written document. If written, we include it as part of the audit evidence we gather about litigation. If orally, we document management's remarks in a memorandum that is included in the work papers, including the member of management

and date of our inquiries. The lack of documentation by management could influence our risk assessment, including whether the entity has effective policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

What components of management's evaluation of litigation, claims, and assessments do we document and how do we use that evaluation?

Whether the documentation is prepared by management or by us, it clearly documents a description and evaluation of the litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is provided by management, including an identification of those matters referred to legal counsel.

What specific inquiries do we make of management and where relevant, others within the entity, including inside counsel, regarding litigation, claims, and assessments? [ISA | 4010.1500]

As part of the inquiries we make about litigation, claims, and assessment, we specifically inquire about the following and include the responses in our audit documentation.

- Is the entity involved in any litigation, claims or assessments, including those defended by insurance companies?
- What is management's assessment of any such litigation or claims?
- Which of the litigation, claims, and assessments may have a material effect on the financial statements and/or may require disclosure in the financial statements?

What other inquiries might we make about litigation, claims, and assessments? [ISA | 4010.13147]

We may choose to make additional inquiries about litigation, claims, and assessments, such as:

Objective	Inquiry
To understand commitments and contingencies that may lead to litigation or assessments	*Are there commitments and contingencies that may develop into litigation, claims, or assessments such as:* • *purchase commitments in excess of normal requirements or at prices in excess of those prevailing in the market* • *contractual obligations for material amounts outside the ordinary course of business* • *contracts that go into effect after period-end* • *agreements to purchase outstanding debt or equity* • *communications from regulatory agencies concerning non-compliance with laws or regulations* • *possible additional taxes* • *claims threatened, pending, or probable of assertion* • *items disposed of with recourse* • *non-compliance with debt agreements* • *items covered in legal counsel's responses* • *environmental contingencies* • *items covered in bank or other debt confirmations*

	• *sales commitments at prices below current selling prices or below cost to complete and deliver* • *pending mergers or acquisitions* • *pensions or other postretirement benefit obligations* • *sales subject to renegotiation or non-standard sales terms (e.g., delayed payment pending resale of the merchandise, return if not sold by-date, and bill-and-hold)* • *obligations under leases, and* • *guarantees or endorsements of the obligations of others.*
To understand the law firms engaged	*What law firms have been engaged to assist with pending litigation, claims, and assessments?* *What is the nature of the types of services provided by each law firm engaged?*

1.1.3 Examine documents in the client's possession concerning litigation [ISA | 4011]

What do we do?

Examine documents in the client's possession concerning litigation, claims, and assessments including correspondence with, and invoices from, external legal counsel.

Why do we do this?

In addition to inquiries, we obtain and inspect documents within the client's possession related to pending or potential litigation, claims, and assessments. This will help us become aware of items that may not have been discussed or are inconsistent with information obtained during inquiries with the client.

Execute the Audit

What types of documents do we examine? [ISA | 4011.1300]

We examine the following types of documents to help identify litigation, claims, and assessments that may give rise to a risk of material misstatement:

- Correspondence with external counsel
- Invoices from external counsel, and
- Legal expense general ledger accounts detail

What are other documents that can help us identify litigation, claims, and assessments? [ISA | 4011.13137]

Other documents that can help us identify litigation, claims, and assessments that may give rise to a risk of material misstatement include:

- Contracts of relevant types (customer and supplier contracts, financing agreements, leases, etc.)

- Correspondence from tax or other governmental agencies
- Information concerning guarantees from bank confirmations

What do we think about when examining these documents to identify litigation, claims, and assessments? [ISA | 4011.13139]

We think about whether there are any inconsistencies (i.e. disconfirming evidence) between the documents or information obtained through our inquiries. We also remain alert for any new information we had not identified through management inquiries that may give rise to a risk of material misstatement.

How do we address inconsistencies or new information arising from examining documents to identify litigation, claims, and assessments? [ISA | 4011.13140]

We inquire further with management to understand the nature of the inconsistency or newly identified information and why it was not addressed through our initial inquiries. We then determine whether the inconsistent or new information represents disconfirming evidence and reassess our risk assessment and, if appropriate, our planned audit procedures accordingly.

What else do we consider when litigation, claims, or assessments are defended by insurance companies? [ISA | 4011.1400]

When litigation, claims, or assessments are defended by insurance companies, we obtain additional audit evidence to corroborate whether the ultimate liability may exceed the insurance coverage and the entity's reserve, if any.

Do we examine documents related to all litigations, claims and assessments? [ISA | 4011.13141]

No. Given that we are focused on what may give rise to a risk of material misstatement, our procedures may focus on those matters that may give rise to a risk of material misstatement.

1.1.4 Obtain management representations regarding disclosure of claims [ISA | 4013]

What do we do?

Obtain management representations that all known actual or possible litigation, claims, and assessments whose effects should be considered when preparing the financial statements have been disclosed.

Why do we do this?

We request management to include a representation in the management representation letter about all known actual or possible litigation, claims, and assessments. The representation complements the other audit procedures performed over litigation, claims, and assessments. In particular, we often rely on management to disclose information about litigation, claims, and assessments to us that could be relevant to the audit.

We also ask that management provide assurance that it has disclosed all known or potential claims in accordance with the applicable financial reporting framework.

Execute the Audit

When do we obtain management representations regarding litigation, claims, and assessments? [ISA | 4013.1300]

We obtain management representations related to litigation, claims, and assessments for all audits of financial statements and for all reviews of interim financial information. We perform the activities in the chapters on management representation letters (AS 2805 , ISA 580 , AU-C 580) and interim reviews of financial information (AS 4105 , ISRE 2410 , AU-C 930), respectively.

What does management include in its written representations as it relates to litigation, claims, and assessments? [ISA | 4013.1400]

Management represents that all known actual or possible litigation, claims, and assessments whose effects should be considered by management when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework. This includes assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date we receive the information, including an identification of those matters referred to legal counsel.

1.1.5 Review meeting minutes to identify litigation, claims, and assessments [ISA | 4014]

What do we do?

Review meeting minutes of those charged with governance to identify litigation, claims, and assessments

Why do we do this?

Reviewing minutes of meetings of those charged with governance, stockholders, governing bodies, and relevant committees can assist us in identifying pending litigation, claims, and assessments. More significant litigation matters are frequently discussed in board meetings or other board committee meetings.

Execute the Audit

What types of meeting minutes do we obtain and review for mention of pending litigation, claims, or assessments? [ISA | 4014.1300]

We obtain the entity's meeting minutes to help identify potential or pending litigation, claims, or assessments. The types of meeting minutes we request include minutes of:

- Those charged with governance (e.g. Board of Directors)
- Appropriate committees (e.g. Audit Committee, Compensation Committee, etc.)
- Stockholders
- Governing bodies of governmental entities, where relevant

We may perform our review of the meeting minutes in conjunction with our review for other purposes, such as in our obtaining of the entity and its environment as part of risk assessment.

Do we review the minutes for all committees of the board of directors? [ISA | 4014.11564]

No. Our focus is on those committees of the board of directors that oversee and address matters that we believe could impact the financial statements or our audit approach.

What period is relevant as it relates to reviewing meeting minutes to identify litigation, claims, and assessments? [ISA | 4014.1400]

We are concerned with litigation, claims, and assessments that existed during the period being reported on and in the subsequent period up to the date of our auditor's report.

What are we looking for in when we review meeting minutes related to litigation, claims, and assessments? [ISA | 4014.1500]

When we read the meeting minutes, we are alert for items discussed that could provide insight into possible litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement.

Examples

- Specific transactions that may give rise to litigation, claims, and assessments, such as business combinations, asset sales, insurance disputes
- Reports from general counsel providing overview of litigation, claims, and assessments
- Investigations into legal or regulatory matters, including possible illegal acts

1.1.6 Modify audit procedures when management has not consulted with a lawyer [ISA | 4015]

What do we do?

IF management has not consulted with a lawyer regarding a potentially material litigation, claim or assessment THEN consider whether we have obtained sufficient, appropriate audit evidence, and, if necessary, discuss with the client the need to consult with legal counsel and, if they refuse, determine whether it is necessary to modify the audit report.

Why do we do this?

If management has not consulted with a lawyer, we determine whether this was appropriate, as it may be necessary to modify our audit procedures. If we determine that management did not consult with legal counsel during the period, but we believe consultation is necessary, we discuss this with management. We do this in order to determine if this indicates a scope limitation and what the effect is on the audit report.

Execute the Audit

What audit evidence may we obtain related to litigation, claims, and assessments when the client has not consulted with legal counsel during the period and we agree that consultation is not necessary? [ISA | 4015.1300]

When the client has not consulted with legal counsel during the period and we agree that consultation was not necessary, we obtain alternative sufficient, appropriate audit evidence to support our assessment of litigation, claims, and assessments. This may involve the inspection of internal client documentation. Types of internal documentation we might inspect are similar to those items that we already request and include:

- Legal expense accounts detail
- Legal correspondence
- Contracts
- Correspondence from tax or other regulatory agencies
- Information concerning guarantees from bank confirmations
- Meeting minutes

See activities 'Examine documents in the client's possession concerning litigation' and 'Review meeting minutes to identify litigation, claims, and assessments' for more information on these types of internal documentation.

Do we modify management representations in the management representation letter when management has not consulted with a lawyer? [ISA | 4015.1400]

Yes. Management representations will be modified from the standard letter when management has not consulted with a lawyer. Refer to the guidance in the chapter over management representation letters (AS 2805, ISA 580, AU-C 580).

How do we evaluate the sufficiency of audit evidence obtained pertaining to litigation, claims, and assessments? [ISA | 4015.1500]

As auditors, we are not responsible for independently concluding on the merits of a legal case. The auditing standards also do not require us to independently consult with our legal experts, but rather with legal experts with whom management has consulted.

If management has not consulted with legal counsel, we gather the internal documentation as our audit evidence and evaluate the sufficiency of that evidence to address the identified risk of material misstatement.

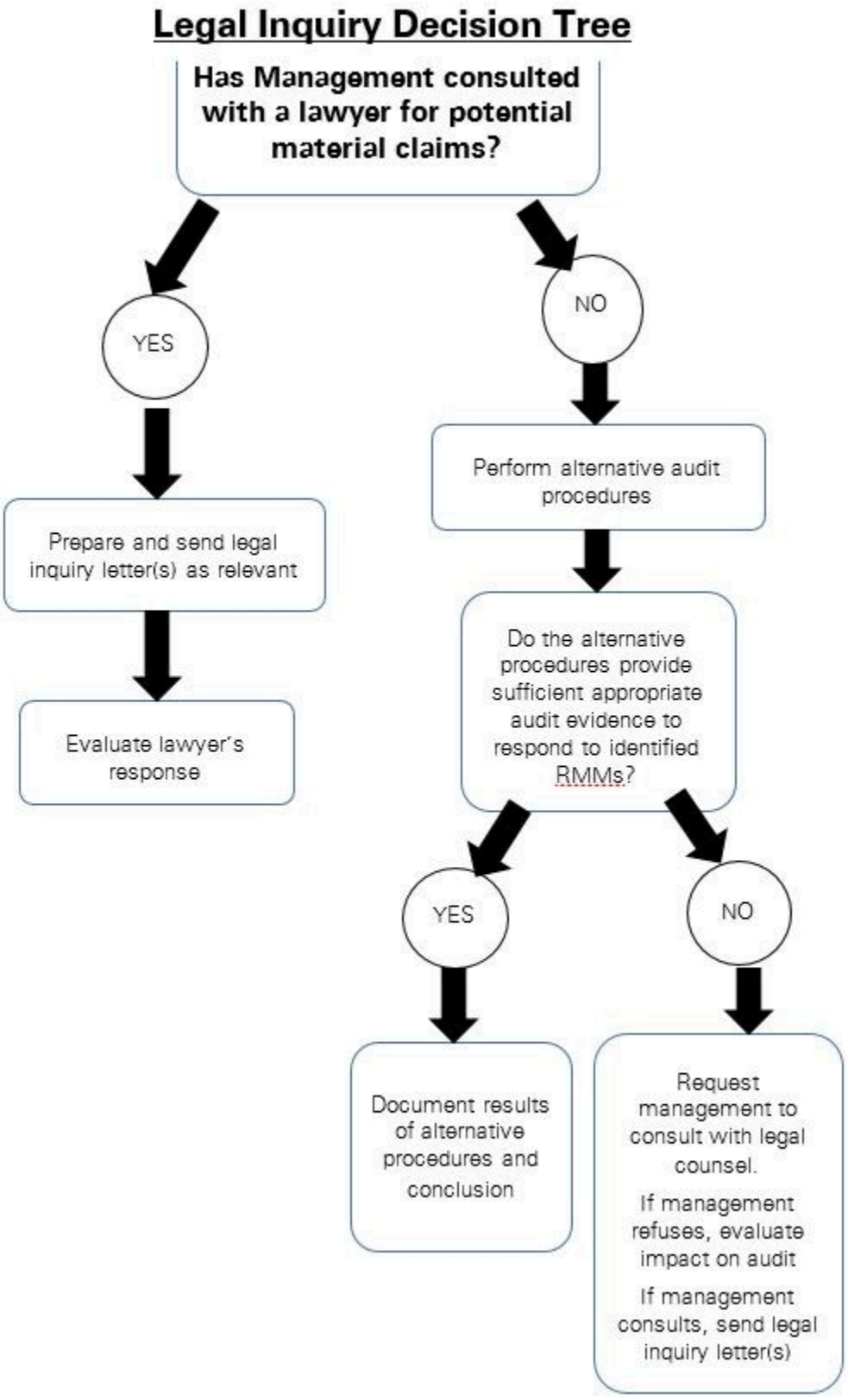
Our evaluation considers the relevance and reliability of evidence for this purpose; however, it is not the same as making a legal judgment, which involves legal skills that we do not possess. Rather, our evaluation is to determine whether a legal judgment (or opinion) is necessary in order to obtain sufficient appropriate audit evidence.

How do we respond when management has not consulted with a lawyer, but we believe they should have? [ISA | 4015.1600]

If we become aware of information indicating it is necessary for management to consult with a lawyer in order to evaluate its responsibility under the appropriate accounting standards to accrue or disclose loss contingencies, we request that the client consult with a lawyer, and obtain a letter following that consultation.

What if after discussing with management, we still think management should consult, and they refuse to do so?

Depending on the severity of the matter, we determine whether the refusal to consult with a lawyer indicates a scope limitation and determine the impact on the audit report in accordance with the applicable auditing standards.



1.1.7 Consider performing inquiries when the client has changed lawyers [ISA | 4016]

What do we do?

IF the client has changed lawyers, THEN consider performing inquiries of management to understand why the lawyer is no longer associated with the client

Why do we do this?

If the client disregards the legal advice offered from its external lawyer(s), the external lawyer may be required to resign from engagement with the entity due to his or her Code of Professional Responsibility. Given this, we consider whether to gain an understanding as to why the lawyer is no longer associated with the client to identify matters that may warrant additional procedures or follow ups.

Execute the Audit

What do we do when we are aware that the client has changed lawyers? [ISA | 4016.1300]

We consider whether to inquire of management or others within the entity to gain an understanding as to why the lawyer resigned and is no longer associated with the client. If the lawyer resigned due to the client disregarding legal advice, we gain an understanding of the nature of the disagreement.

How do we decide whether to inquire regarding the change in lawyers? [ISA | 4016.1400]

We exercise professional skepticism when making this evaluation.

More likely to inquire when ...	Less likely to inquire when ...
The litigation the previous lawyer was involved in is more significant to the financial statements	The nature of the change or resignation is known and is not related to a disagreement
There is a known disagreement that is more significant or the reason for the change or resignation is unknown	The legal matters served by the lawyer do not pose a risk of material misstatement
The litigation the previous lawyer was involved in has more attention from management, the board, investors, analysts, or outside stakeholders	

What do we do with the information learned from our inquiry of management or others about the change in lawyers? [ISA | 4016.1500]

We use the information learned from our inquiry with management or others within the entity to determine whether the responses warrant a revision to our risk assessment and audit procedures responding to any identified RMMs.

1.2 Inquire of the client's lawyer(s) [ISA | 4018]

What do we do?

Inquire of the client's lawyer(s) regarding pending and threatened litigation, claims, and assessments

Why do we do this?

When we identify a risk of material misstatement related to the recognition, measurement or disclosure of litigation, claims, and/or assessments, a valuable source of audit evidence can come from direct communication with the client's external (and in-house) legal counsel related to specific pending litigation, claims, and assessments.

Direct communication with the entity's lawyer(s) assists us in obtaining sufficient, appropriate audit evidence as to whether potentially material litigation, claims, and assessments are known and management's estimates of the financial implications, including costs, are reasonable. The response to the letter of audit inquiry usually provides us with such evidence.

Execute the Audit

How do we inquire of a client's lawyer regarding litigation, claims, and assessments? [ISA | 4018.1300]

For external counsel, we perform the following procedures:

- Identify the legal counsel to send inquiry letter(s) to
- Prepare and send the inquiry letter(s)

For internal counsel we may either perform direct inquiries or send an inquiry letter. If we send an inquiry letter, we perform the following procedures:

- Identify the legal counsel to send inquiry letter(s) to
- Prepare and send the inquiry letter(s)

1.2.1 Identify the legal counsel to send inquiry letter(s) to [ISA | 4020]

What do we do?

Identify to which of the client's legal counsel we will send audit inquiry letters or perform alternative procedures when there are regulatory restrictions prohibiting us from sending a letter

Why do we do this?

When we identify a risk of material misstatement related to the recognition, measurement or disclosure of litigation, claims, and assessments, a valuable source of audit evidence comes from

direct communication with the entity's legal counsel related to specific pending litigation, claims, and assessments. However, we perform procedures to identify the specific lawyers to whom we will send letters of inquiry because it may not always be necessary to send letters to all lawyers the client has consulted, depending on the nature and risk of material misstatement related to specific legal matters.

Execute the Audit

Which lawyer(s) do we send letters of audit inquiry to regarding identified litigation, claims, and assessments? [ISA | 4020.1300]

We send letters of audit inquiry to the lawyer(s) with whom management has consulted on legal matters that are, or could potentially be, material to the current year financial statements, either individually or in combination with other matters. These lawyer(s) may consist of in-house (internal) or external counsel that have devoted substantive attention to the litigation, claims, or assessments identified.

In addition, we frequently inquire of lawyer(s) that management normally involves to help address material litigation, claims, and assessments or correspondence or claims from regulatory agencies, if any (for example, SEC counsel).

How do we identify the lawyers with whom management has consulted on potentially material legal matters? [ISA | 4020.13170]

In order to identify the lawyers with whom management has consulted on potentially material legal matters, we use management's evaluation (see activity "Obtain management's description and evaluation of litigation ", as well as our examination of the client's internal documents, which may include:

- Legal expense accounts detail
- Legal correspondence
- Contracts
- Correspondence from tax or other regulatory agencies
- Information concerning guarantees from bank confirmations
- Meeting minutes

Significant legal expense, significant legal correspondence, and/or significant contractual or regulatory matters discussed with lawyers may indicate that we want to inquire of those lawyers even if they did not appear on management's assessment.

See activities 'Examine documents in the client's possession concerning litigation ' and 'Review meeting minutes to identify litigation, claims, and assessments ' for more information on these types of internal documentation.

What do we mean by 'substantive attention' in the context of a lawyer devoting time to an instance of litigation or a claim? [ISA | 4020.13171]

Lawyers that have devoted substantive attention to particular legal matter are those that have been authorized (by the client) to investigate the legal matter - i.e., lawyers engaged by the client for legal consultation (advice) or legal representation. In contrast, a lawyer with limited knowledge of the matter that provided preliminary or passing advice over incomplete or hypothetical information would likely not have devoted substantive attention.

Who is the in-house counsel? [ISA | 4020.13172]

We may refer to lawyers employed by the entity as "in-house counsel," as differentiated by external lawyers, or "external counsel".

How does the level of spend by the client on a particular lawyer influence our decision to inquire of them? [ISA | 4020.13173]

When management provides its description of litigation, claims, and assessments and those lawyers consulted, we may also find it beneficial to obtain a detail of legal spend (expense) by lawyer. Greater legal spend on a lawyer can be an indicator that the lawyer has spent more time on matters for the company, and increases the likelihood that we may inquire of the lawyer.

What if we determine not to send a letter of audit inquiry to the entity's external legal counsel? [ISA | 4020.13175]

We document the basis for any determination not to send a letter of audit inquiry to the entity's external legal counsel.

Is a legal counsel consulted by an entity considered to be a 'specialist'? [ISA | 4020.13174]

It depends. When the entity retains the services of a legal counsel, whether external or in-house, to assist in the determination of amounts or disclosures in the financial statements (for example, by providing an interpretation of a contractual provision to help management determine the appropriate accounting or disclosure) and we intend to use the legal counsel's work and conclusions as audit evidence, we consider the legal counsel a 'management's specialist' and follow the activities in the audit evidence chapter relating to using the work of a management's specialist (AS 1105 , ISA 500 , AU-C 500).

> For example, management engages a legal counsel specializing in environmental litigation to obtain an opinion on the likely outcome of an environmental litigation brought on to the entity by a local government. The engagement team has identified this matter to be one that gives rise to an RMM due to the high public profile of the case and the potential material penalties that the entity could incur. The engagement team uses the legal counsel's opinion as part of their audit evidence to assess the amount recorded in the entity's financial statements. In these circumstances, the engagement team identifies this legal counsel as a management's specialist and evaluates the relevance and reliability of the legal counsel's work and whether his/her findings support or contradict management's assertions related to the litigation.

On the other hand, if a management's legal counsel simply provides information to the audit engagement team pursuant to a letter of audit inquiry concerning litigation, claims and assessments, we do not consider the legal counsel acting in this capacity as a management's specialist and instead follow the activities in the AS 2505/ISA 501/AU-C 501 chapter relating to the evaluation of the legal counsel's response to the legal inquiries .

> For example, management asserts to the engagement team that there are no material pending litigation, claims, or assessments as of year-end. To confirm management's assertion, the engagement team determines to send audit inquiry letters to those lawyers for which the entity

incurred legal expenses during the year. These lawyers are not identified as management's specialist based solely on the fact that they provided responses to our audit inquiry letters.

What do we do if management has not consulted with a lawyer regarding litigation, claims or assessments that present an RMM? [ISA | 4020.1400]

If management has not consulted with a lawyer, we perform other audit procedures (see activity 'Modify audit procedures when management has not consulted with a lawyer ' for more information).

When do we send a letter of inquiry to the external counsel when management consulted with both in-house and external counsel on the same litigation, claims or assessments? [ISA | 4020.1500]

This depends on the scenario, as outlined below.

Who management consulted with	Who has primary responsibility	Send letter of inquiry to external counsel?
Both in-house and external counsel.	External counsel	Yes. We send to external counsel and do not rely on in-house counsel alone*
Both in-house and external counsel	In-house counsel BUT External counsel has devoted substantial overall participation on a matter that is of significance to the financial statements (e.g., the matter relates to a significant risk)	Generally yes. We consider sending a letter to external counsel to confirm that they have not formulated a substantive conclusion that differs in any material respect from inside counsel's evaluation.
Both in-house and external counsel	In-house counsel BUT External counsel has not devoted substantial overall participation	Generally no
** When we send a letter to external counsel, we likely have done so because more persuasive evidence was necessary. If external counsel do not respond, this could result in a scope limitation (see activity 'Evaluate impact if lawyer refuses to respond or management refuses to send the letter' for more information on what to do when we do not get a response from the lawyer).*		

What else do we include in a letter of inquiry to external counsel when in-house counsel has primary responsibility? [ISA | 4020.13176]

We ask external counsel to confirm that they do not have a substantive conclusion that differs from in-house counsel's conclusion. Example wording is available as shown.

> Please confirm that you have not formulated a substantive conclusion that differs in from the company's in-house counsel's evaluation.

What do we do when sending a letter of audit inquiry regarding litigation, claims or assessments is not appropriate due to regulatory restrictions? [ISA | 4020.1800]

It is the responsibility of the auditor to use his/her judgment in determining what alternative procedures to perform. Alternative procedures are adequate when they still provide sufficient, appropriate persuasive evidence in lieu of sending a legal letter.

Regulatory bodies in some countries do not allow lawyers to respond to auditors' inquiries. These situations are distinguished from a refusal to respond or an inability to form a conclusion (see activity 'Evaluate any scope limitations ' for more information on these scenarios). It is appropriate to perform alternative procedures when the client has consulted with a lawyer practicing outside of the United States that follows different practices or is subject to different regulations which preclude the lawyer from responding.

However, the inability of lawyers in some jurisdictions to respond to our legal letter does not relieve us of our responsibility to obtain sufficient, appropriate evidence regarding the recognition, measurement and disclosure of litigation, claims, and assessments in the financial statements.

Is it ever appropriate to perform alternative procedures when management has only consulted regarding litigation, claims, and assessments with US-based lawyers? [ISA | 4020.13180]

No. Alternative procedures are not appropriate if the client has consulted with lawyer(s) practicing within the United States. The American Bar Association has published a statement of policy (AS 2505C: Exhibit II https://alex.kpmg.com/AROWeb/document/lfc/US_PCAOB_BG_AS_2505/toc/US_PCAOB_BG_AS_2505?tocref=, AU-C 501 Exhibit A https://alex.kpmg.com/AROWeb/document/lfc/US_AICPA_PS_AU_C_500_0500/toc/US_AICPA_PS_AU_C_500_0501?tocref=US_AICPA_PS_AU_C_075&x=0) regarding a lawyer's response to an audit inquiry letter in which US lawyers are allowed to respond.

What types of alternative procedures can be performed when management has consulted regarding litigation, claims, and assessments with non-US based lawyers who cannot respond to auditors' inquiries? [ISA | 4020.13181]

Alternative procedures are designed to provide sufficient, appropriate *evidence* when obtaining a legal letter is not possible. They may include, but are not limited to, the following types of procedures.

- Further inquiries to discuss litigation, claims, and assessments with management or those charged with governance about the processes, procedures, and assumptions they implement, adopt, or make to confirm litigation, claims, and assessments are recognized and disclosed in accordance with the applicable financial reporting framework
- Where possible, make arrangements to discuss litigation, claims, and assessments with management and the entity's in-house legal counsel

- Further review of documents in management's possession concerning litigation, claims, and assessments, including the entity's board minutes and any available communications with external legal counsel

What do we do when we cannot send letters of audit inquiry to external counsel and there are indications that other material litigation and claims in addition to those identified by management may exist? [ISA | 4020.13182]

We consult with DPP.

1.2.2 Prepare and send the inquiry letter(s) [ISA | 4022]

What do we do?

Prepare and send the audit inquiry letter to the identified lawyer(s)

Why do we do this?

After identifying the lawyer(s) we will send inquiry letters to, we request management to prepare the letters. We obtain these letters from management and send them out.

As in other areas of the audit, not every client situation related to litigation, claims, and assessments is the same, and therefore, it may be appropriate to prepare a properly tailored letter of audit inquiry sent to the client's lawyer(s).

Execute the Audit

Who prepares the letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4022.1300]

Management prepares the letter using our template.

Who sends the letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4022.1400]

Once management has signed the letter of audit inquiry, we send the letter directly to the client's lawyer(s).

To whom is the lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments addressed? [ISA | 4022.1500]

The lawyer addresses his or her response directly to us, rather than management. We do not accept letters sent to management that are forwarded or provided to us by management.

What types of inquiry letters regarding litigation, claims, and assessments may we send to the client's external counsel? [ISA | 4022.1700]

We may send either a letter of general inquiry or a letter of specific inquiry.

When is it appropriate to send a letter of general inquiry regarding litigation, claims, and assessments rather than a letter of specific inquiry to the client's external legal counsel? [ISA | 4022.13191]

We may send a letter of general inquiry in any case, but typically only send when we think it likely that the external legal counsel will respond appropriately. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry (i.e. the professional

body to which the external legal counsel belongs prohibits response to such a letter), we will send a letter of specific inquiry.

What do we include in a general letter of inquiry to the client's external legal counsel regarding litigation, claims, and assessments? [ISA | 4022.13192]

A letter of general inquiry requests the entity's external legal counsel to inform the auditor of any litigation, claims, and assessments that the counsel is aware of, together with an assessment of the outcome of the litigation, claims, and assessments, and an estimate of the financial implications, including costs involved.

What do we include in a letter of specific inquiry to a client's lawyer(s) regarding litigation, claims, and assessments? [ISA | 4022.13193]

We use auditor judgment and knowledge about the regulatory framework in which the client operates to determine exactly what to include in the letter of specific inquiry. At a minimum the letter will include the following:

- A list of litigation, claims, and assessments
- Where available, management's assessment of the outcome of each of the identified litigation, claims, and assessments and its estimate of the financial implications, including costs involved
- A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect

As part of this letter, management authorizes the entity's legal counsel to discuss applicable matters with us relating to litigation, claims, and assessments.

When do we send the letter of audit inquiry regarding litigation, claims, and assessments to the entity's lawyer(s)? [ISA | 4022.1800]

We send the letter as close to the report date as is possible and practical in order to get the most accurate response as it relates to our audit period. As a leading practice, this typically means that we mail the letter(s) about four weeks prior to our expected report date in order to allow sufficient time for the lawyer to receive and respond to the inquiry. Ordinarily, we indicate a response date about two weeks prior to the expected date of the auditors' report in order to give sufficient time to follow up if no response is received by the requested date.

We follow member firm policies when they exist and consider expected response times when determining the appropriate time to make these requests.

When do we request the effective date of the lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments to be? [ISA | 4022.1900]

The latest date of the period covered by the lawyer's response (the "effective date") is as close to the date of the auditor's report as is practicable in the circumstances.

When do we assume the effective date of response to our letter of audit inquiry to be, when no date is specified in the lawyer's response? [ISA | 4022.2000]

If the response from the entity's lawyer does not specific an effective date, we may assume that the date of the response is the effective date.

When do we obtain updated legal letters regarding litigation, claims, and assessments? [ISA | 4022.2100]

Specifying the effective date of the lawyer's response to be as close to the date of the auditor's report as is possible and practical in the circumstances will in most instances eliminate the request for an updated response from the lawyer. However, the more important the lawyer's opinion is to the recognition, measurement, or disclosure of a legal matter in the financial statements, the closer the date of the legal letter to our auditor's report. We use auditor judgment to determine if the original response is close enough to the date of our report.

Can we use a discussion with the entity's lawyer(s) as a substitute for a legal inquiry letter regarding litigation, claims, and assessments? [ISA | 4022.2200]

No. Discussions are held to clarify or add to what was received in a response letter and may not be a substitute for written communications.

How do our procedures differ in sending a letter of audit inquiry when litigation, claims, or assessments are defended by insurance companies or other parties that indemnify the client? [ISA | 4022.1600]

Our procedures do not differ when legal matters are defended by insurance companies (or other parties that indemnify the client) as opposed to lawyers. We still send letters of audit inquiry to the insurance companies and/or the insurance companies' legal counsel and seek audit evidence as to whether the ultimate liability may exceed the insurance coverage and the entity's reserve, if any.

Examples

How might the client give consent to the lawyer(s) to discuss legal matters with us? [ISA | 4022.2300]

Fact pattern

The client may give consent to the lawyer(s) explicitly or implicitly through the legal inquiry letter. Management's signing of the letter indicates in and of itself their authorization of the lawyer to communicate with us. A statement may also be explicitly noted in the letter, if preferred. In this scenario, the engagement team have requested management to prepare a letter of audit inquiry to be sent to lawyer(s) with whom management has consulted during the period. In order to urge timely response, the engagement team also request management to authorize its lawyer(s) to communicate directly with them.

Analysis

The client includes the following wording in the audit inquiry letter to authorize the lawyer(s) to communicate with them:

This letter will serve as our consent for you to provide to our auditors all the information requested herein.

1.3 Evaluate lawyer's response to legal inquiries [ISA | 4023]

What do we do?

Evaluate the lawyer's response to our letter of audit inquiry using the procedures appropriate to the specific circumstance.

Why do we do this?

We may receive a response from the lawyer via letter alone or via letter and a discussion, if necessary as additional clarification. We evaluate each response individually to determine whether it provides sufficient appropriate audit evidence regarding the litigation, claim, or assessment.

Execute the Audit

How do we evaluate a lawyer's response to our audit inquiry regarding litigation, claims, and assessments? [ISA | 4023.1300]

When we send audit inquiry letters to the client's lawyer(s), we perform the following procedures:

- Evaluate the lawyer's response to each letter of inquiry
- Document follow up discussions with lawyer(s)
- Discuss with relevant parties when in-house and external counsel opinions differ

1.3.1 Evaluate lawyer's response to each letter of inquiry [ISA | 4024]

What do we do?

Evaluate the lawyer's response to each letter of audit inquiry sent

Why do we do this?

Each lawyer's response varies and is evaluated in the context of the audit. We read and review each response to determine if any follow-up is necessary for clarification.

Execute the Audit

What information do we focus on within the lawyer's response to a letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4024.1300]

The lawyer's response provides a legal assessment of the following matters, which may impact the recognition, measurement, or disclosure of the case in the financial statements:

- The nature of the legal matters involved
- The progress of the case to date
- The potential amounts involved (if the lawyer is able to estimate)
- The experience of the entity with similar matters and, perhaps other entities in similar cases

We also obtain an understanding of how management plans to respond to the litigation, claims, or assessments referred to by the lawyer.

How do we evaluate a lawyer's response on the likelihood of material loss resulting from litigation, claims, and assessments? [ISA | 4024.1400]

In evaluating likelihood of an unfavorable outcome, lawyers may or may not respond using the terminology from the relevant financial reporting framework, which may include terminology like "remote likelihood", "reasonable possibility", "more likely than not", and "probable chance", among others. Regardless, we look to the relevant accounting framework to understand the lawyer's response. The lawyer may also provide a range of potential outcomes, in which case we may seek to understand the lawyer(s)' assessed range of possible outcomes, including when there is or is not a most likely point within that range. We may get to this understanding by following up with the lawyer via additional letter or through discussion.

What if the lawyer does not use the words specifically defined in the accounting framework in his/her response to our letter of inquiry regarding litigation, claims, and assessments?

The lawyer is not required to use the specific words, and may use vocabulary other than that in the applicable accounting framework to indicate likelihood. We often may find other words sufficiently clear as long as the terms can be used to classify the outcome of the uncertainty into one of the defined probability (i.e. likelihood) classifications. We use auditor judgment to determine the meaning of the words used by the lawyer. The response may indicate significant uncertainties when the lawyer is not able to clearly support a conclusion on the likelihood of a material loss, in which case we evaluate how this impacts our audit report (see activity 'Evaluate impact when the lawyer cannot form a conclusion ' for more information on evaluating a lawyer's response in these situations).

US GAAP ONLY | What are responses that are indicative of a remote likelihood of material loss and how do we evaluate the response?

The following example responses are indicative of a remote likelihood of material loss . When there is remote likelihood of material loss, we may conclude that disclosure of the matter in the financial statements is not necessary.

Example wording in lawyer's response considered to provide sufficient clarity such that the likelihood of an unfavorable outcome resulting in a material loss is "remote"
We are of the opinion that this action will not result in any liability to the company.
It is our opinion that the possible liability to the company in this proceeding is nominal in amount.
We believe the company will be able to defend this action successfully.
We believe that the plaintiff's case against the company is "without merit", has "no merit", or has "little or no merit". [The phrase "no substantial merit" is not satisfactory to conclude on a remote probability].
Based on the facts known to us, after a full investigation, it is our opinion that no liability will be established against the company in these suits, although it may well incur substantial litigation expense in defending these suits.*

*Although, the opinion is that no liability will be established, we still consider the qualification related to legal expenses.
The ultimate liability, if any, is not material (with the materiality criteria defined in the letter).
The possible liability to the company is nominal in amount.
The entity "will prevail".
There is a "high probability the entity will prevail" in an action.
The plaintiff's chances of prevailing in an action against the entity "are remote".
The ultimate liability of the entity will not exceed a specified monetary amount [the amount being an amount that is immaterial]

US GAAP ONLY | What are responses that are indicative of a probable chance of material loss and how do we evaluate the response?

The following example responses are indicative of a probable chance of material loss. When there is a probable chance of material loss, we consider whether management has appropriately accrued and disclosed the loss contingency in the financial statements in accordance with the financial reporting framework. If management has not appropriately accrued and disclosed the loss contingency, we consider whether to modify the audit report.

Example wording in lawyer's response		Our Evaluation
An unfavorable outcome of the litigation, claims, and assessments is "probable" or "highly probable".	***Response is considered to provide sufficient clarity the likelihood of an unfavorable outcome is resulting in a material loss is "probable"***	*The ultimate liability of the entity will not exceed a specified monetary amount* [the amount being an amount that is material].
An unfavorable outcome of the litigation, claims, and assessments is "probable" or "highly probable".		

US GAAP ONLY | What are responses that are indicative of a reasonable possibility of material loss and how do we evaluate the response?

The following example responses are indicative of a reasonable possibility of material loss . When there is a reasonable possibility of material loss, we consider whether management has appropriately accrued and disclosed the loss contingency in the financial statements in accordance with the financial reporting framework. If management has not appropriately accrued and disclosed the loss contingency, we consider whether to modify the report in accordance with the auditing standards. We perform the activities in the chapter on departures from unqualified opinions (AS 3105 / ISA 705 / AU-C 705).

Example wording in lawyer's response	Our Evaluation
This action involves unique characteristics wherein authoritative legal precedents do not seem to exist. We believe that the plaintiff will have serious problems establishing the company's liability under the act; nevertheless, if the plaintiff is successful, the award may be substantial.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***
It is our opinion that the company will be able to assert meritorious defenses to this action.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***
We believe the action can be settled for less than the damages claimed.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***
We are unable to express an opinion as to the merits of the litigation at this time. The company believes there is absolutely no merit to the litigation.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***
In our opinion, the company has a substantial chance [reasonable opportunity] of prevailing in this action [i.e. the response does not indicate a "high probability" of prevailing].	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***
The response disclaims an opinion.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***

The responses expresses a weak or overly qualified opinion.	***Response is unclear as to the likelihood of an unfavorable outc ome and therefore could indicate a "reasonable possibility" of material loss.***
The response states that an outcome of an action is unpredictable.	***Response is unclear as to the likelihood of an unfavorable outcome and therefore could indicate a "reasonable possibility" of material loss.***

What if the lawyer's assessment is not clear or is incomplete in his or her response to our letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4024.13205]

If we do not understand the lawyer's response to our letter of audit inquiry or believe the response is incomplete, we follow up (see question 'What do we do when we are uncertain as to a lawyer's response? ' for more information). This is often most effective through a discussion via meeting or phone call, because it allows us to ask clarifying questions and receive follow-up responses. We document those conversations and the additional clarifications received.

If we are unable to obtain an evaluation of the likelihood and magnitude from the lawyer, we evaluate whether we have obtained sufficient, appropriate audit evidence without such evaluation.

How do we compare the lawyer's response with management's evaluation regarding litigation, claims, and assessments? [ISA | 4024.1800]

After we receive the lawyer's response, we build on the evidence obtained during risk assessment, similar to when we compared our initial evaluation to management's evaluation. The only difference is we now have the opinion of the lawyer(s) with whom we have inquired as additional audit evidence.

We consider similar factors as we do when auditing other accounting estimates (AS 2501 , ISA 540 , AU-C 540), including whether we agree with management's analysis and the assumptions that were included or excluded in the estimate and our evaluation of the consistency of management's estimate of the likelihood or amount or range of potential loss. Also similar to auditing other accounting estimates, we perform a retrospective review of results of prior period litigation, claims and assessments and subsequent changes in management's estimate of likelihood or amount or range of the loss.

How does our evaluation of the lawyer's response to a letter of audit inquiry regarding litigation, claims, and assessments impact our audit procedures? [ISA | 4024.1900]

We use all of this to aid in our evaluation, considering any disconfirming evidence or management bias and how this impacts our audit procedures. Ultimately, we will document our conclusion about whether the response warrants an accrual or disclosure of loss as compared to what management has recorded and/or disclosed.

How do we evaluate the sufficiency of audit evidence obtained pertaining to litigation, claims, and assessments? [ISA | 4024.1500]

As auditors, we are not responsible for independently concluding on the merits of a legal case. The auditing standards also do not require us to independently consult with our legal experts, but rather with legal experts with whom management has consulted.

If management has not consulted with legal counsel, we gather the internal documentation as our audit evidence and evaluate the sufficiency of that evidence to address the identified risk of material misstatement.

Our evaluation considers the relevance and reliability of evidence for this purpose; however, it is not the same as making a legal judgment, which involves legal skills that we do not possess. Rather, our evaluation is to determine whether a legal judgment (or opinion) is necessary in order to obtain sufficient appropriate audit evidence.

1.3.2 Document follow up discussions with lawyer(s) [ISA | 4025]

What do we do?

IF we hold follow up discussions in order to conclude our evaluation of the lawyer's response to our audit inquiry letter, THEN document conclusions reached.

Why do we do this?

A discussion cannot be used as substitute for sending a letter, however sometimes a lawyer's response to a letter of audit inquiry is not sufficiently clear to us. If the lawyer's response warrants follow up in order to obtain clarification, a discussion may be appropriate and deemed more efficient than a follow-up letter.

Execute the Audit

What do we do when a lawyer's response to our letter regarding litigation, claims, and assessments is unclear? [ISA | 4025.1300]

When we are uncertain as to the meaning of a lawyer's response to our letter of audit inquiry, we have two options. We may either send a follow up letter with clarifying points or hold a discussion with the lawyer (see question 'What do we do when we are uncertain as to a lawyer's response?' for more information). In some cases when we hold a discussion, it may take more than one discussion depending on the complexity of the matters requiring clarification.

When does a response indicate a discussion rather than follow-up letter might be useful regarding litigation, claims, and assessments?

We a discussion may be useful when our evaluation of how management has accounted for (including the disclosure of) litigation, claims, and assessments involves any the following situations:

- The client's lawyer has provided legal advice to the client concerning unsettled points of law.
- The response from the lawyer to our audit inquiry contains uncorroborated information based on our inquiries with management and inspection of other internal documentation.
- There is a disagreement between management and the external counsel.

- The lawyer's response and evaluation of litigation, claims, and assessments involves other complex judgments.
- We determine the matter discussed in the letter gives rise to a significant risk of material misstatement.

Although it is not necessary to hold a discussion in these scenarios, it may be more useful and efficient than a follow-up letter.

Who arranges the discussion if a lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments is not clear?

We arrange the discussion with the external counsel after receiving management's permission.

Who is present during the discussion if a lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments is not clear?

The discussion between the KPMG representative(s) and the external counsel will also ordinarily include management representative(s).

How do we document our conclusion when we obtain clarifying responses to a lawyer's written response regarding litigation, claims, and assessments via discussion? [ISA | 4025.1400]

We obtain the same audit evidence to support our conclusion as if we had received the response in writing when we receive it via a follow up discussion. As the discussion is not in writing, we include additional documentation to evidence the discussions and considerations obtained from the meeting.

Our documentation focuses on including the necessary information we obtained additionally from the discussion, which can include:

- The nature of the matters involved
- The progress of the case(s)
- The potential amounts involved (if the lawyer can estimate)
- The experience of the entity with similar matters and, perhaps other entities in similar cases
- Management's representations on how it plans to respond to the litigation, claim, or assessment
- Other audit evidence obtained throughout the audit to corroborate the discussion

Can we use a discussion with the entity's lawyer(s) as a substitute for a legal inquiry letter regarding litigation, claims, and assessments? [ISA | 4025.1500]

No. Discussions are held to clarify or add to what was received in a response letter and may not be a substitute for all written communications.

1.3.3 Discuss with relevant parties when in-house and external counsel opinions differ [ISA | 4026]

What do we do?

IF in-house and external legal counsel's evaluations of a possible outcome differ AND both have devoted substantive attention on the matter, THEN discuss with in-house and external legal counsel and determine any impact on our report.

Why do we do this?

When the client's in-house and external counsel are involved in litigation, claims, and assessments that are significant to the financial statements, and both have devoted substantive attention, we send letters of inquiry to both parties. We expect both parties to come to similar conclusions regarding the discussed litigation, claims, and assessments.

When the in-house and external counsel formulate different conclusions on the same litigation, claims, and assessments, we perform further audit procedures and hold discussions to address this disconfirming evidence.

Execute the Audit

How do we respond when the in-house and external counsel form different conclusions on the outcome of specific litigation, claims, or assessments? [ISA | 4026.1300]

We discuss the differences with all parties involved to better understand the differences and attempt to resolve. If differences of opinion cannot be resolved, we evaluate the impact on our audit report.

For more information on determining the impact on the audit report, see the activities in the chapter on departures from unqualified opinions (AS 3105) or modifications to the opinion (ISA 705 , AU-C 705).

1.4 Evaluate any scope limitations [ISA | 4027]

What do we do?

IF there are limitations on the scope of a lawyer's response THEN modify the audit report as appropriate.

Why do we do this?

Sometimes the letter of audit inquiry response, or lack thereof, from a lawyer, results in a limitation on the scope of the audit. In such circumstances, we assess the impact to our audit and consider whether a modification to the audit opinion is necessary as we currently do not have sufficient appropriate audit evidence to evaluate the risks of material misstatement (RMMs).

Execute the Audit

What circumstances might result in a scope limitation pertaining to a letter of audit inquiry with lawyer(s) regarding litigation, claims, and assessments? [ISA | 4027.1300]

A scope limitation may result when the lawyer refuses to respond to our letter of audit inquiry (other than when they are prohibited by law or regulation) or management refuses to allow us to send the letter of audit inquiry.

We evaluate the impact if the lawyer refuses to respond or management refuses to send the letter .

What do we do when the lawyer is unable to provide an evaluation of the likelihood of an unfavorable outcome or range of potential loss relating to litigation, claims or assessments or the response is unclear (even after follow-up through letter or discussion)? [ISA | 4027.1500]

When the lawyer is unable to provide an evaluation of the likelihood of an unfavorable outcome or range of potential loss, or the response is unclear (even after follow-up through letter or discussion), we evaluate the impact on the audit report (see activity 'Evaluate impact when the lawyer cannot form a conclusion ').

1.4.1 Evaluate the impact if letter of audit inquiry is unsent or receives no response [ISA | 4028]

What do we do?

IF the lawyer refuses to respond to, or management refuses to send, the letter of audit inquiry and the lawyer is permitted by law to respond, AND, no alternative procedures are adequate, THEN modify our audit opinion.

Why do we do this?

If we send a letter of audit inquiry to the client's in-house or external legal counsel, and the lawyer refuses to respond, we consider the effect this has on our audit opinion. The same is true when management does not allow us to send a letter of audit inquiry to its lawyer(s).

Since we typically do not possess the legal skills necessary to evaluate a client's pending or threatened litigation, claims, and assessments, with the corroborating evidence provided by the response to the letter of audit inquiry, there may be limited alternative procedures that can be performed in order to obtain sufficient appropriate audit evidence in lieu of a legal letter.

Execute the Audit

What do we do when management refuses to let us send a letter of audit inquiry to its lawyer(s) practicing in the US regarding litigation, claims, and assessments? [ISA | 4028.1300]

We use all possible avenues to resolve the matter with the entity to allow us to correspond with the lawyer. Communications with those charged with governance may be appropriate and helpful. When management refuses to let us send a letter to a lawyer practicing within the US, this results in a limitation on the scope of the audit causing us to modify our audit opinion.

What do we do when we are unable to send a letter of audit inquiry to lawyer(s) practicing outside of the US regarding litigation, claims, and assessments? [ISA | 4028.13151]

When we are unable to send a letter to a lawyer practicing outside of the US, we may perform alternative procedures. When we are unable to obtain sufficient appropriate audit evidence from alternative procedures, this results in a limitation on the scope of the audit and we modify our audit opinion.

What do we do when the client's lawyer(s) refuses to respond to our letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4028.1400]

When the lawyer refuses to respond to our letter of audit inquiry, we make management aware of the lawyer's refusal to respond and understand why that refusal is made. Management may be able to help us obtain a response from the lawyer, however, we exercise care and professional

skepticism in making sure that the client does not coerce the lawyer in responding in a way that is not an independent assessment of the merits of the case. The reason for the lawyer's refusal may indicate other issues that warrant audit attention

What do we do when a client's lawyer(s) practicing in the US continues to refuse to respond to our letter of audit inquiry regarding litigation, claims, and assessments?

When a lawyer practicing within the US continues to refuse to respond to our letter of audit inquiry, this results in a limitation on the scope of the audit causing us to modify our audit opinion in accordance with the applicable auditing standard.

What do we do when the client's lawyer(s) practicing outside of the US refuses to respond to our letter of audit inquiry regarding litigation, claims, and assessments?

When a lawyer practicing outside the US continues to refuse to respond to our letter of audit inquiry because they are prohibited by law or regulation, we may perform alternative procedures. When we are unable to obtain sufficient appropriate audit evidence from alternative procedures, this results in a limitation on the scope of the audit and we modify our audit opinion in accordance with the applicable auditing standard.

What do we do when the lawyer practices outside of the US and is subject to a regulatory restriction on responding to audit inquiry letters? [ISA | 4028.1600]

A lawyer's inability to respond due to law or regulation is distinguished from a refusal to respond. See question 'What do we do when sending a letter of audit inquiry is not appropriate due to regulatory restrictions? ' for more information on alternative procedures that may be performed in some cases and our evaluation of the sufficiency and appropriateness of evidence resulting from those procedures.

When does a limited response from a lawyer not result in a limitation on the scope of the audit? [ISA | 4028.13155]

It is appropriate for the lawyer to limit his or her response to only those matters he or she has given substantive attention. It is also appropriate for the lawyer to limit his or her response to only those matters considered material, either individually or in the aggregate. Limitations such as either of these scenarios do not result in a limitation on the scope of the audit.

What other circumstances may result in a scope limitation? [ISA | 4028.1900]

The response from the entity's lawyer may indicate a scope limitation when any of the following circumstances are met:

- The entity's lawyer does not provide evidence of a sufficient investigation of the facts.
- The entity's lawyer lacks knowledge of the facts and circumstances.
- The referenced case is very new and the lawyer disclaims an opinion when available information has not been considered.
- The issues or unclear areas are not resolved through a clarifying letter or discussion.

How do we evaluate the sufficiency of audit evidence obtained pertaining to litigation, claims, and assessments? [ISA | 4028.1500]

As auditors, we are not responsible for independently concluding on the merits of a legal case. The auditing standards also do not require us to independently consult with our legal experts, but rather with legal experts with whom management has consulted.

If management has not consulted with legal counsel, we gather the internal documentation as our audit evidence and evaluate the sufficiency of that evidence to address the identified risk of material misstatement.

Our evaluation considers the relevance and reliability of evidence for this purpose; however, it is not the same as making a legal judgment, which involves legal skills that we do not possess. Rather, our evaluation is to determine whether a legal judgment (or opinion) is necessary in order to obtain sufficient appropriate audit evidence.

Examples

How do we interpret lawyer responses to audit inquiry letters regarding litigation, claims, and assessments that may result in a scope limitation? [ISA | 4028.2100]

Fact pattern

The audit team sent out audit inquiry letters to the client's lawyer. The lawyer responded, but either has not performed a sufficient investigation of the litigation, claims, or assessments, or has qualified his or her opinion due to lack of knowledge. Below are examples of the types of scope limitation responses received by the audit team and how they evaluated the responses.

Wording in lawyer's response	Audit team evaluation
Although no real investigation of the facts has been made, based on a reading of the complaint, the entity should prevail.	Without further knowledge, an entity's legal counsel would not be in a position to give an opinion on an action if the entity's legal counsel had only read the complaint and made no investigation of the facts.
The evidence elicited from the discovery conducted thus far in the suit does not, in our view, indicate that the plaintiffs in either action will prevail on their claims.*	The entity's legal counsel is limiting the bases for the opinion; the opinion does not take into account the entity's legal counsel's own knowledge of the facts that may have been obtained otherwise. The entity's legal counsel may know of other facts, some of which may affect the eventual outcome of the action. Moreover, the wording does not clearly indicate that the entity will prevail.
It is our opinion, based upon the limited facts of which we are presently apprised, that the plaintiff's claims are without substantial merit. This opinion is based	The opinion is qualified based on limited knowledge.

solely upon the complaint, preliminary discussions with management of, and legal counsel for, the corporation, and a review of limited documentary materials. The opinion expressed in this letter is subject to amendments or qualification based upon additional facts that might be developed or upon amended pleadings.	

**Discovery in this context means making testimony before trial, obtaining answers to written interrogations, subpoenaing documents, and other information obtained through the legal process.*

Analysis

Based on the lawyer's responses the audit team concluded that there is a scope limitation and they modified the opinion in accordance with the applicable auditing standard.

For more information on determining the impact on the audit report see the activities in the chapters on departures from unqualified opinions (AS 3105) and modifications to the opinion (ISA 705 , AU-C 705).

1.4.2 Evaluate impact when the lawyer cannot form a conclusion [ISA | 4029]

What do we do?

IF the lawyer is unable to provide an evaluation of the likelihood of an unfavorable outcome or range of potential loss in writing or orally, THEN evaluate the impact on the audit report.

Why do we do this?

Due to the inherent uncertainty associated with legal matters, the client's lawyer may be unable to form an opinion or provides an unclear opinion as to the likelihood of an unfavorable outcome and the estimated potential amount or range associated with the litigation, claims, or assessments. In these situations we acknowledge this uncertainty, and consider the effect (if any) on our audit report in accordance with the applicable auditing standard or request clarification.

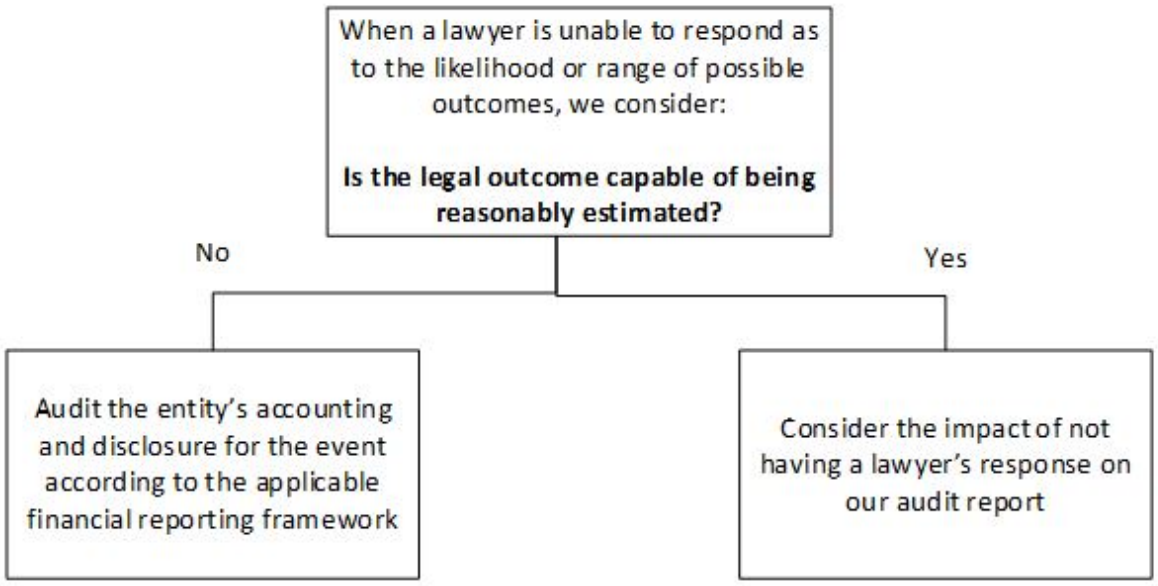
Execute the Audit

What might cause a lawyer to be unable to respond as to the likelihood of an unfavorable outcome or estimate the potential amount (or range) of loss of an instance of litigation, claim or assessment? [ISA | 4029.1300]

It is not always easy for a lawyer to put a dollar value or range estimate on the potential loss that could arise from pending litigation, claims or assessments. Historical experience of the entity (or comparable entities) in similar litigation may not be relevant or readily available. Further, even if an amount is estimable at the time, that amount of loss could significantly vary at different stages of the litigation period.

What do we do when a lawyer cannot come to a conclusion on an instance of litigation, claim or assessment? [ISA | 4029.1400]

When a lawyer cannot come to a conclusion concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount of estimated loss or range of loss, we first evaluate whether the matter can be reasonably estimated. We then respond by auditing the company's accounting and disclosure and/or evaluating the impact on our auditor's report.



What do we do when the estimate of a pending litigation, claim or assessment is not capable of reasonable estimation?

If the matter is not capable of reasonable estimation, we conclude that the financial statements are affected by the uncertainty of a future event that cannot be reasonably estimated. If the lawyer is able to come to a conclusion on likelihood, even without an estimated amount, disclosure may still be deemed necessary in accordance with the applicable financial reporting framework.

What do we do when the estimate of a pending litigation, claim or assessment is capable of reasonable estimation, but the lawyer does not provide an estimation to us? [ISA | 4029.13185]

While it is a rare situation in practice, when we believe the estimate is capable of reasonable estimation, and the lawyer has not provided its estimate of the likelihood or amount or range of potential loss, we determine whether this imposes a scope limitation on our audit. We then look to the relevant auditing standards to determine the impact on our audit report (see the activities in the chapter on modifications to the opinion (ISA 705 , AU-C 705) for more information on determining the impact on the report).

How do we evaluate the sufficiency of audit evidence obtained pertaining to litigation, claims, and assessments? [ISA | 4029.1500]

As auditors, we are not responsible for independently concluding on the merits of a legal case. The auditing standards also do not require us to independently consult with our legal experts, but rather with legal experts with whom management has consulted.

If management has not consulted with legal counsel, we gather the internal documentation as our audit evidence and evaluate the sufficiency of that evidence to address the identified risk of material misstatement.

Our evaluation considers the relevance and reliability of evidence for this purpose; however, it is not the same as making a legal judgment, which involves legal skills that we do not possess. Rather, our evaluation is to determine whether a legal judgment (or opinion) is necessary in order to obtain sufficient appropriate audit evidence.

What causes us to be uncertain as to a lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4029.1700]

We may be uncertain as to the meaning of the lawyer's response, when the lawyer does not use language that clearly states likelihood using the terminology in the applicable accounting framework or the lawyer does not use language that clearly states how material the loss could be (i.e. a specific dollar value or range is not identified).

What do we do when we are uncertain as to a lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments? [ISA | 4029.1800]

We may take one of two approaches (or use both in combination).

If additional inquiry is necessary due to inadequate response from the entity's lawyer(s) we may send a follow up letter with clarifying language. We introduce alternative, more specific wording related to each case such as the following [in italics]:

- The nature of the litigation, *including identification of:*
  - *The proceedings;*
  - *The claim(s) asserted*
  - *The amount of money or other damages sought (if no amounts are stated in preliminary case filings, the state as such);*
  - *Whether or not the potential damages are covered by insurance and, if so, to what extent (policy limits, deductibles, etc.);*
  - *The objectives sought by the plaintiff (if any) other than monetary or other damages (such as performance or discontinued performance of certain actions);*
- The progress of the case to date;
- How management is responding or intends to respond to the litigation; for example, to contest the case vigorously or seek out-of-court settlement; and
- An evaluation of the likelihood of an unfavorable outcome and an estimate of the amount or range of potential loss *(state if no evaluation can be expressed as to an unfavorable outcome and/or no range can be expressed, and explain the reasons).*

We may also determine it beneficial to set up a discussion with legal counsel and representatives of the client (see activity 'Document follow up discussions with lawyer(s) ' for more information regarding what we do when set up a discussion).

What if we are still uncertain as to a lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments after a follow-up letter and/or discussion? [ISA | 4029.2000]

If we still remain uncertain as to a lawyer's response even after a follow-up letter and/or discussion, we consider whether we have obtained sufficient and appropriate audit evidence based on what we have obtained through the legal letter and any other alternative procedures, when alternative procedures are appropriate (see question 'What types of alternative procedures can be performed when management has consulted regarding litigation, claims, and assessments with non-US based lawyers who cannot respond to auditors' inquiries? '). If we are unable to conclude, we determine the impact (if any) on our audit report (see the activities in the chapter on departures from unqualified opinions (ISA 705 , AU-C 705) for more information on determining the impact on the report).

US GAAP ONLY | What causes us to be uncertain as to the lawyer's response to our letter of audit inquiry regarding litigation, claims, and assessments and how might we evaluate them? [ISA | 4029.2100]

We may receive the lawyer's response to our letter of audit inquiry and be uncertain as to the meaning based on the language used. If we cannot sufficiently determine whether the lawyer is under the opinion that the likelihood of material loss is remote, probable, or reasonably possible, then we will send a follow-up letter or schedule a discussion (with the lawyer and representative(s) of management) to clarify. If the follow-up does not clarify sufficiently, we may decide to modify our audit report in accordance with the applicable auditing standards.

Below are examples of wording the lawyer may use that cause us to be uncertain as to the meaning.

Example wording in lawyer's response	Our evaluation
It is our belief that the entity has adequate defenses which, if established at trial, would prevent the occurrence of liability.	Nearly every defendant has defenses it can assert; the entity's legal counsel disclaims an opinion as to whether the defenses can be established at trial and, therefore, disclaims an opinion as to whether the entity will prevail.
From the information presently available to this office, it appears the entity has a good chance of prevailing on this appeal.	A "good chance" is not enough; it does not indicate the requisite degree of probable success. Moreover, the matter is on appeal and presumably the entity lost on earlier actions.
We are of the opinion that the case is without substantial merit.	The opinion does not indicate that "the entity will prevail".
The evidence elicited from the discovery conducted thus far in the suit does not, in our view, indicate the plaintiffs in either action will prevail on their claims.	The words, "thus far" suggest that the opinion may change in the future and the opinion does not indicate that "the entity will prevail".

From other evidence available to us in this litigation, we think the balance of the claim is grossly exaggerated on a factual basis.	"Grossly exaggerated" is imprecise, and there is no opinion on the outcome of the case.
On the basis of recent decisions by various federal district courts, it would appear that there is a substantial chance the entity might prevail on a motion to determine that this lawsuit not be permitted to be brought as a class action.	The many qualifying terms: "would appear", "substantial chance" and "might prevail" indicate the outcome is almost completely in doubt.
We are of the opinion that there are meritorious defenses to this pending litigation which are more likely than not to prevail. If, however, the entity should be found liable for damages in this action, the amount of the recovery by the plaintiff class could be substantial.	The term "meritorious defenses" indicates that the entity's defenses will not be summarily dismissed by the court; it does not necessarily indicate legal counsel's opinion that the entity will prevail. Further, although indefinite, the phrase "more likely than not" suggests a reasonable possibility the entity will not prevail and "substantial" appears to mean "material to the financial statements".
We believe the action can be settled for less than the damages claimed.	This opinion does not provide an indication of the settlement amount and, accordingly, may not provide a basis for measuring the materiality of the potential loss.
In our opinion, the company has a reasonable opportunity of prevailing in this action.	The term "reasonable opportunity" and similar terms indicate more uncertainty than an opinion that the company will prevail.

Segment Information

International Standards on Auditing: ISA 501.13

Segment Information

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)

(a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)

(i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

(ii) Where appropriate, testing the application of such methods; and

(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

ISA Application and Other Explanatory Material: ISA 501.A26-A27

Segment Information (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

Understanding of the Methods Used by Management (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

How do we comply with the Standards? [ISA | KAEGHDWC]

1 Evaluate segment information when applicable [ISA | 4482]

What do we do?

Obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information, in accordance with the applicable financial reporting framework, by performing specific procedures.

Why do we do this?

Because investors and other stakeholders rely on the financial statements, including the disclosures, all of our audit work is directed toward the primary objective of determining whether the financial statements

are fairly presented. In addition, those financial statements are accompanied by our audit opinion, which is the ultimate product of our audit. Those facts underscore the importance of performing procedures to evaluate whether segment information is presented fairly, when applicable.

Execute the Audit

What is segment information in the financial statements? [ISA | 4482.1300]

Segment information is information in the financial statements regarding distinguishable components, or industry and geographical aspects of an entity.

Some financial reporting frameworks require the disclosure of segment information. If not, some entities may choose to disclose it anyway.

What is our responsibility with respect to segment information? [ISA | 4482.1400]

Our responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements as a whole. Accordingly, we are not required to perform the level of audit procedures necessary to express an opinion on the segment information presented on a stand-alone basis.

What audit procedures do we perform on segment information? [ISA | 4482.1500]

At its simplest, the audit procedures we perform on segment information are:

Procedures	More specifically:
Obtain an understanding of the method the entity used in determining segment information and evaluate whether it is appropriate.	• We make inquiries of management concerning their method for identifying operating segments. • We determine whether the method used by management to determine and disclose segment information is appropriate considering the requirements of the applicable financial reporting framework. We may ask ourselves: 'Is the method reasonable based on the characteristics of operating segments described in the financial reporting framework?' 'Is there an alternative way to present segment information that is more appropriate based on the circumstances of the entity?' • We determine whether the method used by management has been applied correctly by: - inspecting the reconciliations (including supporting schedules) prepared by management to the totals in the financial statements and - reconciling the information in the segment disclosure to the underlying accounting records that we audited. - assessing the adequacy of: 1) sales, transfers, and charges between segments and elimination of intersegment amounts

	and 2) the allocation of assets, liabilities, income and costs among segments.
Perform analytical procedures and other audit procedures	• We perform analytical procedures on the segment information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual and may indicate misstatements. Analytical procedures consist of, for example: - comparison of the segment information with comparable information for the immediately preceding period and/or - comparison of the segment information with any available related budgeted information for the current period. • We examine other relevant documents and assess whether the segment disclosure is consistent with those documents. For example: - information that the entity uses to assess performance and allocate resources; - material presented to the board of directors; - minutes from the meetings of the board of directors; - other information that management provides in the annual report (e.g. "Management Discussion and Analysis" or "Operating and Financial Review", as applicable); and - information that management provides to financial analysts. • We assess whether the segments identified for disclosure are consistent with our understanding of the entity. • We evaluate the adequacy of disclosures in accordance with the applicable financial reporting framework.

In addition, we may obtain management's written representation that operating segments are appropriately identified and disclosed in accordance with the financial reporting framework.

What do we do when we identify a misstatement in the segment information? [ISA | 4482.1600]

As with any other misstatement, we:

- accumulate it in the SAM, if it is not clearly trivial; and
- evaluate whether it is material, individually or in combination with other uncorrected misstatements, considering both quantitative and qualitative factors. The qualitative factors we consider are:
  - the significance of the misstatement to a specific segment - e.g. a misstatement of a segment that is represented by management to be important to the future profitability of the entity;
  - the pervasiveness of the misstatement -i.e. whether it affects the amounts and presentation of numerous items in the segment information; and

- the effect of the misstatement - e.g. whether it distorts the trends reflected in the segment information.

See activity 'Accumulate, communicate and evaluate misstatements ' for further information on misstatements.

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