Inventory

Deviations

— My test counts have identified differences between the physical number of items in stock and the number recorded in the accounts. Does this mean that I can't place any reliance on the stock count as a control?

No. If operating effectively, the client's stock count will detect and correct any errors in the stock balance recorded in the financial statements. Therefore a deviation is only identified in the control where KPMG's count differs from the client's final count and therefore an error has gone unnoticed.

Inventory costing

— The balance of finished goods in inventory includes absorbed production costs and overheads. What do I need to remember when determining my audit approach?

There are important points to remember in terms of:

- The entity's accounting policy for costs capitalised in inventory,
- The entity's process for ensuring that only valid costs are capitalised in period-end inventory in accordance with its accounting policy, and
- Evidencing our substantive procedures.

Understanding the costs capitalised in inventory

As in other areas of the audit, we understand management's accounting policies early in the audit, as part of our process understanding. Gaining this understanding early in the audit helps ensure that our process understanding captures how management identifies the amount of each type of expense which is appropriate to capitalise in inventory, and gives us the opportunity to challenge management where the entity has insufficiently considered which costs are appropriate.

IAS 2.10 states that the cost of inventory comprises "all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition". This may therefore incorporate warehouse staff time for shipping goods from the point of manufacture to the point of sale. However, warehouse staff time not directly attributable in this way would not be capitalised. Where management does not identify only permitted costs to capitalise, we challenge them to revise their approach or to demonstrate that the impact of capitalising potentially inappropriate costs in period-end inventory is clearly immaterial.

Insights into IFRS 3.8.120 provides more information on the elements of cost which are appropriate to absorb into the cost of inventory.

Understanding the entity's process

There are a number of points we need to understand about how the entity calculates absorbed costs. Absorption costing is a way of estimating the amount of overhead and labour cost attributable to each unit of inventory, and is typically determined by budgeting the total units of inventory to be produced and the expected cost which will be absorbed. Therefore our process understanding includes how these budgets are determined and, just as importantly, how frequently they are updated - for example, where production costs and volumes fluctuate over time, it is important to update absorption rates or standard costs periodically during the year to minimise the risk of incorrect amounts being capitalised in the period-end inventory balance.

As part of our PBM requests, we may request a breakdown of absorbed inventory cost to help us ensure that we have understood the flow of each type of expense through the entity's process, and to help plan our substantive procedures.

Briefing IN/B/004 Obtaining an Understanding of Standard Cost provides further guidance on the risk assessment for standard costing.

Evidencing substantive procedures

Our understanding of what management absorbs into inventory cost and why, and how they keep absorption rates/standard costs up to date tells us the elements of inventory cost we need address in our substantive testing to determine whether there is either:

- A material misstatement in the cost of period-end inventory (for inventory held at period end), or
- A material classification misstatement between Cost of Sales and other income statement captions (for inventory sold during the period), considering the possibilities of both over- and under- statement.

Example 1

In accordance with Entity Y's accounting policy, all factory overheads are absorbed into the cost of inventory. Moreover, Y shut down production for a period of three months. There was also a period of reduced productivity later in the year. Management of Entity Y used a single absorption rate throughout the period reflecting planned overheads and production levels.

- In this example:
- Overheads related to the three months of shutdown may be appropriate to absorb into the cost of inventory, and so the audit team should understand the reason for the shutdown in more detail. Insights 3.8.210 gives further information on interruptions.
- For the period of reduced productivity, test the actual volume of inventory which has been produced. One way of doing this could be to obtain a production listing for the period and agree a sample back to production orders. The audit team would need to consider additional audit evidence obtained around the completion of inventory counts, margin reviews and similar when concluding on whether sufficient evidence can be obtained over the completeness and accuracy of this listing. Any inefficiency in production is not appropriate to absorb into the cost and so should have been expensed.
- In this case, management had not first ensured that only appropriate costs were capitalised in inventory, even had there been no interruption of production. Therefore we may need to test total overheads in more detail to identify the value which should be absorbed into inventory. This may include more detailed analysis and breakdown of the costs to determine which elements are, or are not appropriate to absorb into inventory.

Example 2

- Entity Z has an accounting policy which clearly identifies expenses which are appropriate to attribute to the cost of inventory. Absorption rates are reviewed and revised as necessary on a quarterly basis, including a review as part of the year-end close down process. The business has largely met its budget and planned production levels.
- In this instance, a substantive analytical procedure over the absorbed element of period-end inventory cost may be an efficient way to conclude on the accuracy of this element of period-end inventory cost.

It is particularly important in 2020 and 2021 to remember that the costs of abnormal wastage in production are excluded from the cost of inventories (IAS 2.16), given that COVID-19 may have led to periods of suspended production and other changes which may alter the costs which can be included or the number of units of production over which it can be absorbed.

Inventory Count Attendance

– When do I need to complete the Inventory Count Approach Builder?

We shall complete the Inventory Count Approach Builder in developing our audit approach to inventory quantities, when the inventory balance, gross of any allowance, is greater than or equal to materiality, and where that inventory is capable of being counted

Inventory is capable of being counted where it may be counted or (where applicable - eg. chemicals, fuel) measured and where we may make or observe inventory counts to obtain evidence over inventory quantities. For example, the inventory of a housebuilder may consist of building materials, which are capable of being counted and for which we apply the Inventory Count Approach Builder, and also completed and part-completed houses which are also accounted for as inventory, but which we may consider as not capable of being counted and for which we may obtain audit evidence in other ways.

– What do I need to bear in mind when I perform independent inventory counts (i.e. not counting at the same time as management's counts)?

Remember that, even when we don't plan to test management's inventory count controls, ISA 501 requires us to attend management's inventory counting and perform certain specified procedures when inventory is material (ISA (UK) 501.4). This enables us to report back to management and those charged with governance if we have identified any concerns about the entity's inventory count procedures. Therefore, even when our substantive evidence will come from independent counts, we still need to attend at least one management count.

Even where we don't plan to test the operating effectiveness of the entity's inventory count controls, counting at the same time as management may give us additional insight into management's count process, so can be preferable in that respect. We should, therefore, plan our substantive test counts alongside management's counts for at least a proportion of our count attendance, where possible and practical. If we have concerns with management's counts, then it may be appropriate to perform our own independent counts, and we should document our rationale for this approach.

Note that testing the entity's inventory count controls is often the most efficient and effective approach. When considering taking a fully substantive approach because the entity has not counted its inventory, or we anticipate their counts may be ineffective, first challenge management to remediate their process; if management's process is deficient, our substantive count may identify misstatements that mean we need to ask management to investigate and correct the inventory records anyway, so it is better for them to avoid this by ensuring that their count process works before we move to our substantive testing.

– What do I do if I identify an issue during an inventory count?

For each test count performed, there will be one of three outcomes:

- KPMG's and management's counts both agree to the inventory records: The inventory records are not misstated.
- KPMG's and management's counts agree, but do not agree to the inventory records: In this case, management needs to update the inventory records. If the records are accurately updated, they are not misstated.
- KPMG's and management's counts do not agree: See below.

We only get one opportunity to observe the inventory count and obtain the audit evidence we need. If we do not resolve issues on the day, they may be more difficult to resolve after the count.

If KPMG's and management's counts do not agree, we firstly recount and agree with management what the correct quantity should be. If we conclude that management had counted incorrectly, this may represent a control deviation in management's count control (if we have not determined a tolerable difference); this control deviation exists even if management updates the inventory records in agreement with our count result.

In all cases where a difference is identified between management's and KPMG's counts, it is important for the counter to discuss with the in-charge and manager whether further work is needed. This should be done BEFORE LEAVING SITE (or before finishing the virtual count) and ensures that senior members of the engagement team can consider the potential implications of any potential deviations. This is true even if the individual count differences are not material, bearing in mind they may have a significant impact when we evaluate the control or the substantive sample (depending on the purpose of our count).

Additional information may be required around the nature and cause of the deficiency, or further test counts may be required.

Prior to leaving the count (or finishing the virtual count), it is important that we understand the process in place for any recounts and updates being made to the system. This may be later on the day of the count or potentially in the following few days after the count. The counter will need to ensure that they understand what follow up information they require, and request this prior to leaving (or finishing the virtual count). We also obtain, or request to be provided to us, copies of all count documentation (eg. count sheets) which demonstrate that all items due to be counted had been counted.

If your audit approach is a dual purpose approach where the substantive sample size has been set based on expected controls reliance you may need to reconsider RoMM and therefore sample sizes.

– The entity performs cycle counts throughout the period and we have realised close to year end that we have not attended any counts through the period, what alternative procedures can we perform?

When the entity performs cycle counts throughout the year rather than one year end count, we would normally need to attend a number of inventory counts throughout the period (see pages 19-30 of Auditing Inventory Quantities [IN/B/003]). If we identify before year end that we have not attended sufficient number of cycles counts any cycle counts during the period, we will not be able to test the cycle count control framework or rely on it for audit evidence and need to take a substantive only approach to test the inventory balance.

We should make still every effort to attend a cycle count before or as close to the year end as possible in order to meeting the ISA (UK) 501 requirement to attend a physical inventory count for any material inventory balance. Where the inventory count is also used for our substantive evidence, when the count is performed other than at period end, we need to consider inventory movements between the count date and period end. . See page 17 of Auditing Inventory Quantities [IN/B/003] for further details on roll forward or back procedures to reconcile the inventory count balance to the year end.

– Do we always need to attend an inventory count at a third party warehouse? What are the possible testing approaches?

Where there is an amount of inventory held in a third party warehouse there is no requirement to always attend an inventory count at that location. In many cases it is appropriate to only obtain an external confirmation from the third party directly as evidence of the inventory balance. We must evaluate the competence of the third party and assess the risk that they may be motivated to misreport the inventory levels when relying on such confirmations. Also, remember that a count performed by employees of the audited entity at the third party location should be considered in the same manner as a count performed by those individual's at a location controlled by the audited entity.

In some circumstances we may perform other procedures in addition to or instead of the third party confirmation, such as where we have concerns about the objectivity or integrity of the third party or the existence of inventory at that location is a significant risk balance for example. The possible procedures in line with ISA (UK) 501.A16 are:

- 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.

The extent of procedures are performed depend on the risk assessment of the inventory balance held at the third party warehouse.

There is further detailed guidance on the approach for inventory held at third parties locations on page 32 of Auditing Inventory Quantities [IN/B/003].

Other than at year end

– My client performs rolling stock counts throughout the year. Can I rely on these as part of my year end audit or should I ask them to perform a full count at the year end?

It is entirely acceptable for the client to implement a policy of performing rolling stock counts (also known as cycle counts or perpetual inventory counts) throughout the year. See the guidance on Cycle counts in Performing effective efficient inventory counts.

© 2020 KPMG LLP, a UK limited liability partnership, and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.