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# ISA (UK) 501 *Audit Evidence - Specific Considerations for Selected Items*

(Effective for audits of financial statements for periods ending on or after 15 December 2010)

## Introduction

### Scope of this ISA (UK)

1. This International Standard on Auditing (UK) (ISA (UK)) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with ISA (UK) 330 (Revised July 2017),<sup>1</sup> ISA (UK) 500<sup>2</sup> and other relevant ISAs (UK), with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

<sup>1</sup> ISA (UK) 330 (Revised July 2017), *The Auditor's Responses to Assessed Risks*

<sup>2</sup> ISA (UK) 500, *Audit Evidence*

### Effective Date

2. This ISA (UK) is effective for audits of financial statements for periods ending on or after 15 December 2010.

## 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.

## 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 (UK) 705 (Revised June 2016).<sup>3</sup> (Ref: Para. A12-A14)

<sup>3</sup> ISA (UK) 705 (Revised June 2016), *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)

## 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 (UK)) 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. ISA (UK) 600 (Revised June 2016)<sup>4</sup> deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. ISA (UK) 620 (Revised June 2016)<sup>5</sup> deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

<sup>4</sup> ISA (UK) 600 (Revised June 2016), *Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>5</sup> ISA (UK) 620 (Revised June 2016), *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 (UK) 330 (Revised July 2017) establishes requirements and provides guidance on substantive procedures performed at an interim date.<sup>6</sup>

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<sup>6</sup> ISA (UK) 330 (Revised July 2017), 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 (UK) 200 (Revised June 2016),<sup>7</sup> 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.

<sup>7</sup> ISA (UK) 200 (Revised June 2016), Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK), 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 (UK) 705 ((Revised June 2016) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.<sup>8</sup>

<sup>8</sup> ISA (UK) 705 (Revised June 2016), paragraph 13

## *Inventory under the Custody and Control of a Third Party*

### Confirmation (Ref: Para. 8(a))

A15. ISA (UK) 505<sup>9</sup> establishes requirements and provides guidance for performing external confirmation procedures.

<sup>9</sup> ISA (UK) 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 501.04-08 | 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 [ISA | 7745.6699]

### — What relevant procedures do we perform when the entity has inventory? [ISA | 7745.6732]

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

ISA 501.04-08 | 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 [ISA | 7747.6713]

### — 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
<b>Category of inventory</b>	<p>Understanding the categories of inventory helps us understand the approach for <b>all</b> inventory categories and also helps us identify those categories that may have an increased risk of material misstatement.</p> <p>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.</p>
<b>Nature of inventory</b>	<p>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.</p>

<b><i>Inventory balance and composition</i></b>	<p>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.</p> <p>Factors relevant to understanding the composition include:</p> <ul style="list-style-type: none"> <li>• Whether inventory is specifically identifiable or not,</li> <li>• The number of products/SKUs,</li> <li>• Volume of transactions/movements, and</li> <li>• Whether there are any high value items.</li> </ul>
<b><i>Changes in inventory during the period</i></b>	<p>We consider planning analytical procedures performed and make inquiries of management to understand:</p> <ul style="list-style-type: none"> <li>• the nature and extent of changes in the types and locations of inventories over the period;</li> <li>• the degree of fluctuation in inventory levels;</li> <li>• any notable developments with inventories that have occurred during the period (e.g. unexpected shortages of inventory reported or unexpected growth in inventory balances).</li> </ul>
<b><i>Locations where inventory is held and whether locations are homogeneous, if applicable</i></b>	<p>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.</p> <p>We also think about whether the entity holds any consignment inventories and at which location(s).</p>
<b><i>Whether inventory is held at a third-party location</i></b>	<p>Inventory may be maintained at an entity owned location or a third-party warehouse.</p>
<b><i>Whether a perpetual or periodic inventory system is used</i></b>	<p>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.</p>
<b><i>The entity's approach to inventory counts</i></b>	<p>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.</p>
<b><i>How inventory quantities are measured</i></b>	<p>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.</p> <p>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)).</p>
<b><i>Whether the entity uses automated procedures</i></b>	<p>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.</p>
<b><i>Whether the entity uses a management specialist</i></b>	<p>We understand whether management uses a management's specialist to assist with identifying, quantifying and/or assessing the condition of the inventory.</p>

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 onsite but not recognized on the balance sheet (e.g. 'bill and hold' sales) or significant inventories recognized on the balance sheet but not onsite (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 listing 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 in historic counts might be an indication that the control activities over the existence of inventory are inadequate or not effective.

Briefing IN/B/001/KAEG provides further guidance on understanding the entity's inventory.

**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
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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 [ISA | 7747.6714]

— 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	<p>This may be assessed by detailed production plans and listings of included materials attached to the WIP or assessed through estimates (percentage of completion).</p> <p>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.</p>
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	<p>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.).</p> <p>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).</p>
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.

ISA 501.04-08 | 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 onsite 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 [ISA | 7746.6706]

### — When do we attend the management's count(s)? [ISA | 7746.6860]

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

- The inventory balance is quantitatively 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 quantitatively 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.

In the UK, our preferred mode of attendance is in person, and where we complete some counts virtually rather than in-person, we document our reasons for doing so. Virtual count attendance may allow us to supplement our audit evidence from counts completed in person with further counts - for example:

- We may be able to spread our inventory counts over a greater range of inventory locations, including small or remote locations, by including an element of virtual attendance to introduce an element of unpredictability
- In a group audit, we may supplement the work performed on "in-scope" components by virtually observing the performance of inventory counts for components over which neither we nor component auditors are otherwise performing procedures.

However, it is important to evaluate alternatives when determining whether to employ a small element of virtual counting:

- Difficulty, time or cost is not a valid basis not to attend counts in person if we felt that virtual counts might not be an adequate alternative.
- In the case of inventory at other locations in a group audit, we can instruct a component auditor to attend the count, even at entities which would otherwise be "out-of-scope".
- If management proposes not to permit us to attend the inventory count in person, for health and safety or other reasons, we first assess whether their reasons for doing so are appropriate.

#### 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.

In the UK, our preferred mode of attendance is in person. See '[Can we attend inventory counts virtually using real-time video technology?](#)' for instances when we may conclude that there are benefits to including an element of virtual attendance to expand our audit evidence base.

Higher proportion of virtual attendance	Lower proportion of virtual attendance
<b>Risk assessment</b>	
<ul style="list-style-type: none"> <li>• Lower inherent risk associated with the existence of inventory</li> <li>• Risk assessment conclusions consistent year-over-year</li> <li>• Previous in-person count(s) performed at the same location</li> <li>• 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)</li> </ul>	<ul style="list-style-type: none"> <li>• The auditor has never attended a count before (at that location or for the entity overall)</li> <li>• Fraud risk or significant inherent risk of error associated with the existence of inventory</li> <li>• Changes in risk assessment conclusion year-over-year</li> <li>• Type of audit engagement (multi-location audit where inventory is non-homogeneous) and audit plan (e.g. changes locations attended)</li> </ul>
<b>Nature of inventory</b>	
<ul style="list-style-type: none"> <li>• Homogeneous inventory population</li> <li>• Low complexity in determining quantities of inventory (individual units)</li> <li>• Low concentration of inventory (multiple locations)</li> <li>• Balance of inventory compared to materiality is lower</li> </ul>	<ul style="list-style-type: none"> <li>• Various types of inventory including work-in-progress inventory</li> <li>• Complexity in determining quantities of inventory (volume/weight-based measurement)</li> <li>• Specialists are needed to determine inventory quantities</li> </ul>

<ul style="list-style-type: none"> <li>• Immaterial inventory write-offs in the current or prior period</li> <li>• Low historical shrinkage/waste</li> </ul>	(significant judgment/estimation involved) <ul style="list-style-type: none"> <li>• High concentration of inventory (few locations)</li> <li>• Balance of inventory compared to materiality is higher</li> <li>• Material inventory write-offs in the current or prior period</li> <li>• High/volatile historical shrinkage/waste</li> </ul>
<b>Operations/facilities</b>	
<ul style="list-style-type: none"> <li>• Perpetual inventory system</li> <li>• Facilities are closed or well-controlled during count procedures (receiving and shipping)</li> <li>• Facilities are well organized and allow for effective and efficient counts</li> <li>• Highly automated warehouse</li> <li>• Counts completed in one day/count session</li> <li>• Segregation of duties are present when counts are conducted</li> <li>• Counts performed by individuals independent of those responsible for maintaining or managing inventory quantities (e.g. internal audit)</li> </ul>	<ul style="list-style-type: none"> <li>• Facilities remain open during count procedures (receiving and shipping) or movements are not well controlled or considered in count procedures</li> <li>• Inventory to be counted is housed in several different facilities at the location</li> <li>• Count takes multiple days/count sessions to complete</li> <li>• Insufficient count process and guidelines from the entity</li> <li>• The objectivity and competence of the entity's resource who would operate the technology cannot be assessed or is not considered adequate</li> </ul>
<b>Internal controls, misstatements and other considerations</b>	
<ul style="list-style-type: none"> <li>• 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)</li> <li>• Effective process control activities over monitoring cycle count programs, if relevant, and the recording of adjustments</li> <li>• Historically, accuracy rates of counts are high</li> <li>• Immaterial book-to-physical adjustments</li> <li>• Other audit procedures (e.g. cut-off testing, search for unrecorded liabilities, revenue procedures) corroborate the existence of inventory</li> </ul>	<ul style="list-style-type: none"> <li>• Ineffective process control activities over inventory movements (current or historical deficiencies)</li> <li>• Ineffective process control activities over monitoring cycle count programs, if relevant, and the recording of adjustments (current or historical deficiencies)</li> <li>• Inconsistent accuracy rates in historical counts</li> <li>• Material book-to-physical adjustments</li> <li>• Limited other audit procedures or disconfirming/contrary audit evidence challenge the existence of inventory</li> </ul>

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.

#### What do I need to evidence when observing or performing an inventory count virtually? [ISA | 7746.9174UK1]

Virtual attendance at inventory counting differs from attending in-person because we do not have the same control over what we see via the video feed. In order to get the same level of evidence to in-person attendance, we need to plan and execute our attendance in a way which ensures we can still make the necessary observation of the inventory location.

The following steps help ensure that we get the best possible evidence from our virtual attendance. **It is important to document in our work papers how we have done each of these things.**

Considerations	What it means in practice
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Directing our view of count procedures to enable us to get the evidence we require without attending	<ul style="list-style-type: none"> <li>• We <b>"drive" our view of the count attendance</b> to replicate the ability to look around, had we been there in person. It is like playing a computer game, not watching a film; we navigate the person in the warehouse to perform tasks such as moving around the warehouse and moving items out of the way so that you can see them and count them on the video-link;</li> <li>• We <b>still select the sample that we wish to count</b>, and do not allow management to make the selection. In order to assist with this, it is highly beneficial to obtain the pro forma inventory count sheets (i.e. the blank inventory counts that the entity will use to perform the count) or electronic equivalent, together with a map of the warehouse prior to the count, so that we can still select floor to sheet - i.e. by looking at the map and saying that they want the staff member to go to the third shelf in row A3 and count product code 19000 and to watch management move each item to allow counting by the auditor, and sheet to floor by selecting from the physical inventory;</li> <li>• We need to <b>see the items at each location clearly</b>, so that we can count all the items there, without stock items being excluded from the camera's view. If the picture cuts out, the camera moves too quickly, or we have not seen everything that we wanted to, it is important to ask the warehouse personnel to stop and to go back, so that we are confident in the quantities we counted. On poor connections, we may need to do this several times, so this needs patience from us and from the warehouse staff.</li> <li>• We <b>confirm the completeness and accuracy of our counted quantities by panning to the left and right, and up and down, from the stock item being counted</b> to verify that there are no additional such items that should be counted that are out of view at that location. As usual, we expect management to open boxes, inspect parts and demonstrate any identifying product codes on the inventory for us to see, so that we can verify that they have seen all of the items and ensure that they are counting the correct item.</li> </ul>
Practical and technology considerations	<ul style="list-style-type: none"> <li>• <b>Plan for the possibility of technology limitations.</b> Test in advance that the view via the entity's camera will be not be overly restricted and is sufficiently of high quality to allow us to see how the stock count procedures are carried out (not too dark or grainy to observe the condition of inventory, as well as the number of inventory items).</li> <li>• In outside locations, there may be a dependence on the 4G signal, which might be less able to support a sufficiently stable, high quality picture to observe the count satisfactorily. In the same way, in case the Teams connection drops, it is important to ensure in advance that the count staff are briefed to dial back into the call and not give up on the remote count. This requires management-level support for, and recognition of the importance of, our count attendance;</li> <li>• <b>We only have one opportunity to observe management's count</b>, so we may need to pause the counters to ensure we are able to observe all the relevant information. <b>This may entail using a more senior engagement team member</b> to perform the count, or carefully instructing the team member who does so. In many cases, it may be appropriate for the in-charge or manager to observe the count, and to be on hand when needed.</li> </ul>

#### Is real-time video technology a software audit tool? [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 [ISA | 7746.9192]

— [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 controls 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 controls of cycle counts?](#)' for additional considerations when taking a dual-purpose approach.

In the UK, our preferred mode of attendance is in person. See '[Can we attend inventory counts virtually using real-time video technology?](#)' for instances when we can attend some locations virtually.

#### 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.

In the UK, our preferred mode of attendance is in person. See '[Can we attend inventory counts virtually using real-time video technology?](#)' for instances when we can attend some locations virtually.

#### 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.

ISA 501.04-08 | 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 [ISA | 7749.6727]

— 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.

ISA 501.04-08 | 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 [ISA | 7750.6738]

#### — [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 controls (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 if no instructions have been issued?** [ISA | 7750.6956]

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 controls (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 | 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 | 7750.6961]

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.

ISA 501.04-08 | 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 [ISA | 7751.6745]

— [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;
- 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.

— [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.

ISA 501.04-08 | 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 [ISA | 7752.6752]

### — 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.

### — 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.

ISA 501.04-08 | 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 [ISA | 7753.6759]

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

We:

- compare our test count results to management's 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.

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 controls 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 listing for 'zero-quantity bins' - designated warehouse locations where the records indicate inventory quantities are nil - and confirming that, in fact, there is no 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 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 the 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 management as to the appropriate quantity and, if management's count is incorrect we record the difference as a misstatement. 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.

ISA 501.04-08 | 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 [ISA | 7754.6766]

### — 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:

- 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.

- evaluate whether the level of adjustments is appropriate;
- 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 transaction level controls 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 final adjusted inventory listing? [ISA | 7754.6960]



If management's subsequent investigation has determined inventory records (i.e. the final adjusted inventory listing) 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.

ISA 501.04-08 | 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 [ISA | 7755.6773]

— 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 controls 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:

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Factor	Circumstances that indicate more persuasive evidence is necessary	Circumstances that indicate less persuasive evidence is necessary
The effectiveness of the control environment and other relevant controls	We identify weaknesses in the control environment and other relevant controls.	We conclude that the control environment is, and other relevant controls 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.