**Chapter-Three**

**Audit of Inventories and Cost of Goods Sold**

**3.1**. **Sources and Nature of Inventories**

The interrelation ship of inventories and cost of goods sold makes it logical for the two topics to be considered together.

**Inventories –** The term inventories is used in this chapter to include (1) goods on hand ready for sale, either the merchandize of a trading concern or the finished goods of a manufacturing; (2) goods in the process of production; and (3) goods to be consumed directly or indirectly in production: raw materials, purchased parts, and supplies.

Inventories have received much attention in both the accounting and auditing literature, as well as in the discussions among professional accountants due to the following reasons.

1. Inventories often constitutes a large current assets of an enterprise and very susceptible to major errors and fraud.
2. The accounting profession sanctions numerous alternatives methods for valuation of inventories, and different methods may be used for various classes of inventories.
3. The determination of inventor value directly affects the cost of goods sold and has a major impact on net income for the year.
4. The determination of inventory quality, condition, and value is inherently a more difficult task that is the case with most other elements of financial positions. Many items, such as precious gems, sophisticated electronic parts, and construction in progress presents significant problems of identification and valuation.

**3.2. Auditors’ objectives in auditing inventories and cost of goods sold**

The auditors’ objectives in the audit of inventories and cost of goods sold are to:

1. Consider internal control over inventories and cost of goods sold.
2. Determine the existence of inventories and the occurrence of transactions affecting cost of goods sold
3. Establish the completeness of inventories
4. Establish that the client has right to the recorded inventories
5. Establish the clerical accuracy of records and supporting schedules for inventories and cost of goods sold.
6. Determine that the valuation of inventories and cost of goods sold is arrived at by appropriate methods.
7. Determine that the presentation and disclosure of inventories and cost of goods sold is adequate, including disclosure and classification of inventories, accounting methods and any inventories pledged as collateral for loans.

In conjunction with auditing of inventories and cost of goods sold, the auditors will also obtain evidences about the related purchase, sales, purchase returns, and sales returns accounts.

### 3.3. Internal controls over inventories and cost of goods sold

The study and evaluation of accounting system and internal controls relating to inventories helps the auditor in determining the nature, timing, and extent of substantive procedures to be carried out during the course of audit. The following are the general aspects of internal control relating to inventories.

* **Segregation and rotation of duties**: -
  + Are the duties relating to the inventories such as purchasing, billing, and accounting etc., are properly segregated?
  + Are the duties of various persons relating to inventories rotated periodically?

#### Authorization of purchases, receipts and other related issues

* + Are the goods are purchased with proper authorities?
  + Is there a proper system of receipt of goods?
  + Are the procedures for issue of inventories from the stores is clearly laid down?
  + Other related issues
* **Maintenance of records and documents –** Auditors may see important aspects of transactions related to inventories and cost of goods sold with respect to issues such as:
  + - * Whether there is any proper documentation of receipts of merchandize from suppliers.
      * Whether there is any proper documentation for issues inventories.
      * Whether there is any proper documentation for transfer of inventories from one department to another.
      * The king of inventory record system followed.
      * Whether there is any system for determining the cost of work in progress and finished goods.
      * Whether the overhead absorption rates properly determined.
      * Whether actual cost is compared with standard or budgeted costs and the variance is properly analyzed and adjusted.
      * Whether proper records have been maintained for waste, scrap etc.
      * Whether proper records have been maintained in respect of inventories belonging to the organization but existing with the third parties such as warehouses, consignees, customers etc.
      * Whether proper records are maintained in respect of merchandise exists with the company belong to third parties.
      * Whether adequate cut of procedures are followed.
* **Accountability for, and safeguarding of, inventories** -Auditors may see important aspects of transactions related to inventories and cost of goods sold with this regard such as:
  + - * Whether the goods are stored properly to protect against damage, deterioration in quality etc.
      * Whether the access to the place where the materials are stored is restricted.
      * Whether the materials have been insured against fire, theft etc.
      * Whether the insurance cover is adequate and reviewed periodically.
      * Whether the insurance premium is paid up to the date.
      * Whether the insurance cover notes or the policy notes are kept in proper custody.
      * What is the system for stock taking, continuous, annual, or both.
      * Whether physical verification sheets are made after checking physically.
      * Whether any variation exists with the physical verification and as per inventory records and if there is any differences, the cause for the variation has been investigated and necessary action has been taken.
* **Substantive procedures -**The auditor carries the substantive procedures in relation to inventories on the basis of his evaluation of the effectiveness of internal controls. The various substantive procedures may be as follows:

1. **Examination of Records and Documents**: The records maintained by different enterprises vary considerably. Some organizations maintain detailed records under perpetual inventory system, while others maintain the basic records relating to purchases and sales and also statements of periodic stocktaking. The records relating to the inventories are relevant to the auditor for determining the fairness of the financial statements of the organization. The auditor’s examination of the records relating to the inventories depends upon the nature of records maintained by the organization under audit. The auditor has to examine the records maintained by the client in order to determine the correctness of the figures of the ending inventories and consequently, of the cost of the goods sold or manufactured. However, in preparing the financial statements, the ending inventories are generally valued on the basis of the physical verification rather than on the basis of stock records. The auditor obtains the necessary evidence in support of inventories primarily form review or observation of physical verification and from examination of records relating to the sales and purchases. The examination of the inventory records provides only corroborative evidence to the auditor.
2. **Review/ observation of physical verification**: The physical verification is the duty of the management; it is necessary for the auditor to satisfy himself that the physical verification was carried out properly. Hence the auditor review the procedures followed by the management, the follow up action on the discrepancies found during the physical verification etc. Normally, the auditor/s/ may reviews the following points
   1. Whether clear instructions have been given to the physical verification team
   2. Whether the person in charge of the physical verification is clearly specified
   3. Whether the members of the team is independent of the stores personnel
   4. Whether the auditor or his staff has been permitted to observe the physical verification
   5. Whether proper procedures have been laid down for the physical verification
   6. Whether the movement of inventories are restricted during the physical verification
   7. Whether any specific form for the recording of physical verification for uniformity
   8. Whether there is any provision for follow up action if there is discrepancies
   9. Whether adjustments have been made for the damaged, obsolete, and defective inventories
   10. Whether cut of transactions are examined properly

#### Examination of valuation and disclosure

* 1. Examine the relevant records such as, inventory records, physical verification forms, invoices, costing records etc.
  2. Test /check/ the application of inventory valuation methods
  3. Examine the treatment of overheads in determining cost of inventories
  4. Examine the evidences in support of the assessment of the net realizable value
  5. Examine the disclosure of the inventories in the financial statements

#### Analytical procedures

* 1. Quantitative reconciliation of inventories i.e. reconciliation of quantities with the beginning inventories and purchases with the quantities sold or produced and ending inventories
  2. Comparison of the value of the inventories of the current year with that of the previous year
  3. Comparison of the ratio of various items to the total items with the ratios of the previous year
  4. Comparison of the gross profit ratio of the current year with that of the previous years
  5. Comparison of the inventory turn over ratios of the current year with the ratio of the previous year
  6. Comparison of the per unit value of the current year with that of the previous year

#### Confirmation from third parties

When the inventories of the organization is held by other parties such as consignees, agent etc examine whether a confirmation is obtained for holding the inventories and if the inventories are held by a third party without any legitimate business reason, the auditor should carry out further enquiries. The auditor should directly receive the confirmation letter. When the inventories belonging to the outsiders are held by the organization the auditor should seek a confirmation from the parties about the inventories held on their behalf

#### Management representation letter

The auditor should obtain a management representation letter from the management stating that the inventories are valued by appropriate methods, all the inventories are included, no inventory belonging to outside party are included, proper adjustments have been made for the damaged, obsolete, and/or defective materials.

**3.4. Audit Program For inventories and cost of goods sold**

The following are the procedures typically performed by auditors to achieve the objectives:

**A. Consider internal control over inventories and cost of goods sold (test of control)**

**(1).** *Obtain an understanding of internal control over inventories and cost of goods sold*. Consideration of the internal control may involve activities such as filling out of a questionnaire, writing or description memorandum, the preparation of flowcharts, depicting organizational structure and the flow of material documents.

The understanding of internal control enables auditors to be familiar with procedures for:

* Purchasing - controlling productions
* Receiving - Cost accounting systems
* Storing - Perpetual inventory systems
* Issuing goods - Other related matters

Questions that may be asked by auditors in consideration of control over inventory and cost of goods sold may include (for perpetual inventory systems)

* + Are perpetual inventory records made for each class of inventory?
  + Are perpetual inventory records verified by physical inventories at least once each year?
  + Do the procedures for physical inventory include the use of prenumbered tags with all tags numbers accounted for?
  + Are differences between perpetual inventory records and physical count investigated before the perpetual records are adjusted?
  + Is a separate purchasing department responsible for the purchase of a material supplies and equipment?
  + Does a separate receiving departments process all incoming shipments?
  + Are all materials supplies held in the custody of a stores department and issued only upon receipt of properly approved requisitions?

Auditors also determine whether the policies and procedures indicated in the description (flaw chart ) are used in operation, through inquires of entity personnel, inspection of documents, and observation as to whether there is appropriate segregation of duties and varies documents such as purchase requisites purchase orders, materials requisitions , time ticked, shipping advices etc. After obtaining understanding of the controls relating to inventories and cost of goods sold, auditors will consider the types of misstatements that may occurs.

**(2).** *Assess control risk and design additional tests of controls for inventories and cots of goods sold*

Based upon their understanding, auditors determine the planned assessed level of control risk for various financial statement assertions. To support the assessments of control risk, the auditors may need to obtain additional evidences of the operating effectiveness of the client’s controls by designing additional tests of controls

**(3).** *Perform additional tests of controls for those controls which auditors plan to consider to support their planned assessed levels of control risk i.e.*

(a**)** Examine significant aspects of a sample of purchase transactions such as:

* select a sample of purchase transactions
* Examine the purchase acquisitions or other authorizations for each purchase transactions in the sample
* Examine related vendors invoices, receiving reports and paid checks for each purchase orders in the supplies
* Inspects vender’s invoices for approval of prices, freight, credits terms and accounts distributions and recomputed extensions and footings.
* Compare quantities and prices in the invoices, purchase orders and receiving reports
* Trace postings from vouchers register to general ledgers and to any applicable subsidiary ledgers.

(b) Test the accounting systems such as cost accounting systems for direct materials, direct labors, manufacturing overhead costs ie as to whether the systems accumulates actual or standard cost according to process, job, or other costing systems.

**(4)** Reassess control risk for the financial statements assertions about inventories and cost of goods sold and modify substantive tests based on information about weakness and strength of the control systems.

**B. Perform substantive tests of inventories and cost of goods sold transaction and balance**

**The objective of major substantive testing procedures of inventories and cost of goods sold balances are given in the following table.**

|  |  |
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| **Subjective Test** | **Primary audit objective to be addressed** |
| 1. Obtain listing of inventory and reconcile to ledgers **i.e.** schedules of listing of inventories is reconciled to general ledger control accounts and appropriate subsidiary ledgers. | Clerical accuracy |
| 1. Evaluate the client’s planning of physical inventory Effective and efficient inventory planning requires careful advance planning. In planning inventory count client should consider factors such as  * Selecting the best date or dates * Suspending productions in certain departments * Segregating obsolete and defective goods * Establish control over the counting process * Achieve proper cut off sales and purchased   Transactions   * Approving for services of engineers or other   Specialists to determine quantities, qualities,  Certain goods materials   1. Observe the tacking of physical inventory and make test counts- as part of the process of observing the physical inventory, the auditors may see the possibilities in including absolute and damaged inventories, infrequent sales, see records of the final receipts and sales, make test count of selected inventory items | Existence, occurrence, and Right; valuation. |
| 1. Review the year end cut- cut off of purchase and sales transactions-an accurate cut off purchase is one of the most important factors in verifying the existence and completeness of the year end-inventory i.e see whether all purchase and sale of inventory made during the period under consideration is included and non from subsequent period in included in the period under consideration. 2. Obtain a copy of the completed physical Inventory and test its accuracy ie test clerical Accuracy of extensions and footings, and that of reconciliation of inventory count to inventory recorded | Existence  Ownership right  Completeness  Clerical accuracy |
| 1. Evaluate the bases and methods of inventory pricing i.e. verify whether the basis and methods for inventory pricing and costing are in accordance with GAAP Investigation of inventory valuations may involve questions such as   - What methods of pricing does the client use?   * Is the methods of pricing the same as that   that used in prior periods?   * Has the method selected by the client   been applied consistently and accurately in  in practice?   * Other related questions.  1. Test the pricing of inventories i.e. test the pricing method applied to raw materials, purchased parts, supplies, WIP-inventories finished goods and other inventory items | Valuations |
| 1. Perform analytical procedures on items such as:  * Gross profit rate over the periods * Inventory turnover(CGS/Average inventory) * Volume of purchase from period to period * Others | Existence and ownership right Completeness  Valuations |
| 1. Determine whether any inventories have been Pledged and review commitments | Valuation  presentations and disclosure |
| 1. valuate financial statements presentations and disclosure i.e. see whether there is adequate disclosure of inventory methods, classification change in allowance for inventory, terms of inventory purchase, commitments, pledged of inventory et | Presentation and disclosure |