

SA 501 – Audit Evidence-Specific Considerations For Selected Items

Objective

The objective of the auditor is to obtain SAAE regarding the:

- Existence and condition of inventory
- Completeness of litigation and claims involving the entity and
- Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Topics related to inventory

- SAAE Regarding Existence and condition of inventory
- Attendance at Physical Inventory Counting
- Matters Relevant in Planning Attendance at Physical Inventory Counting
- Physical inventory counting is conducted at a date other than the date of the FSs
- If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances
- Attendance is impracticable
- Inventory under the custody and control of a third party

SAAE Regarding Existence and condition of inventory			
When?	When Inventory is material		
How?	Attendance at physical inventory counting, unless impracticable, to:	Evaluate	management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
		Observe	the performance of management's count procedures;
		Inspect	The Inventory
		Perform	Test Counts
	Performing audit procedures	over the entity's final inventory records	

Inventory

SAAE Regarding Existence and condition of inventory

When inventory is material to the FSs, 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:
 - i. Evaluate **management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
 - ii. **Observe** the performance of management's count procedures;
 - iii. **Inspect** the inventory; and
 - iv. Perform **test counts**; and
- b. **Performing audit procedures** over the **entity's final inventory records** to determine whether they accurately reflect actual inventory count results.

- Auditor reviews the written instructions given to warehouse staff about how to tag and record items.
- Auditor watches employees count boxes of goods to ensure they follow instructions properly.
- Auditor checks expiry dates on perishable goods and notes damaged items.
- Auditor counts 10 items from a rack and compares it with the count recorded by staff.
- Auditor checks if the quantity of laptops in the inventory system matches the physical count done on inventory day.

Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include,

- **Nature** of inventory.
- **Stages** of completion of work in progress.
- The **risks** of material misstatement related to inventory.
- The nature of the **internal control** related to inventory.
- Whether **adequate procedures** are expected to be established and proper instructions issued for physical inventory counting.
- The **timing** of physical inventory counting.
- Whether the entity maintains a **perpetual inventory system**.
- The **locations** at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- Whether the **assistance** of an auditor's **expert** is needed.

A perpetual inventory system is a method of tracking inventory where changes in stock levels are recorded in real-time, as they happen.

Physical inventory counting is conducted at a date other than the date of the FSs

When physical inventory counting is conducted on a date other than the financial statement date, the auditor should:

1. Perform additional audit procedures to obtain evidence about whether changes in inventory between the count date and the date of the FSs are properly recorded
2. Consider the following when designing audit procedures:
 - Proper adjustment of perpetual inventory records
 - Reliability of the entity's perpetual inventory records
 - Reasons for significant differences between physical count information and perpetual inventory records
- If the company counted inventory on, say, March 15th, but their financial year ends on March 31st, the auditor must verify inventory changes in those 16 days. Example: Examining shipping documents for goods sold between March 15th and 31st.
- Checking if new raw materials received on March 20th were correctly added to the inventory system.
- Auditor reviews prior accuracy history of perpetual system – if previous error rates were low (< 1%), may rely more heavily on system
- Auditor finds 500 units less in physical count than in records and checks for theft or misreporting.

If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

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.

Auditor misses the 31st March count, so attends a fresh count on 5th April. Auditors verify purchases and sales from 31st March to 5th April to adjust stock accurately.

Attendance is impracticable

- If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain SAAE regarding existence and condition of inventory.
- If not possible to do so, the auditor shall modify opinion in accordance with SA 705.
- Alternative procedures may include inspection of documentation of subsequent sale of specific inventory items acquired before counting.
- Auditor couldn't attend due to a natural disaster, so checks stock purchase and sale documents instead.
- Auditor verifies that 100 machines were sold after year-end, confirming they existed on the inventory date.
- When a warehouse fire destroys both inventory and records before auditor can verify, auditor issues a qualified opinion
- For a mining company with inaccessible underground inventory, auditor issues disclaimer of opinion if no reliable alternative procedures exist

Inventory under the custody and control of a third party

When inventory under the custody and control of a third party is material to the FSs, the auditor shall obtain SAAE 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.

- b. Perform **inspection** or other audit procedures appropriate in the circumstances.

- Auditor sends a letter to the warehouse company storing goods to confirm 1,000 units of raw material are held in good condition.
- Auditor visits the third-party warehouse to physically inspect goods for damage or expiry.

Doubtful Third-Party Integrity/Objectivity

Auditor may perform other procedures instead of/in addition to confirmation Examples of other audit procedures include

1. Attending/arranging attendance at third-party's physical count (if practicable)
2. Obtaining **service auditor's report** on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
3. Inspecting documentation (e.g., warehouse receipts).
4. Requesting **confirmation** from other parties when inventory has been pledged as collateral. (Example: Contacting a bank that holds inventory as collateral to confirm quantities and conditions.)

A service auditor is an independent professional who examines and evaluates the internal controls of a service organization like a third-party warehouse, data center, or cloud service provider.

Quality Products Limited is engaged in manufacturing bicycles. As part of manufacturing activities, it sends raw material to some business entities and procures finished components from them. As on 31st March 2024 inventories lying with such business entities are material. Being statutory auditor of Quality Products Limited, how will you obtain sufficient appropriate audit evidence regarding existence and condition of inventories lying with such business entities? (ICAI RTP, Sep 2024, NA)

Coyote Ltd. is dealing in trading of electronic goods. Huge inventory (60% approximately) of the company is lying on consignment (i.e. under the custody of a third party). CA. Star, the auditor of the company, wants to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory lying on consignment. Thus, he requested & obtained confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity, however, it raised doubts about the integrity and objectivity of the third party. Which of the following other audit procedures may be performed by CA. Star to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory under the custody of a third party?

- (a) Attend a third party's physical counting of inventory.
- (b) Arrange for another auditor to attend a third party's physical counting of inventory.
- (c) Inspect warehouse receipts regarding inventory held by third parties.
- (d) All of the above.

(Sample MCQs) (RTP, May 2019, NA)