**Chapter 4**

**INVENTORIES AND COST OF GOODS SOLD**

**Inventory means:**

* goods on hand ready for sale
* goods in the process of production, and
* raw materials inventories

**Audit Procedures and Objectives for Inventory /Purchase/**

* Inventories are major items on the balance sheet
* Inventories play important role in preparation of income statement

**The processing of purchases transactions involves the following purchasing functions:**

* + - 1. Requisitioning goods and services.
      2. Preparing purchase orders.
      3. Receiving the goods.
      4. Storing goods received for inventory.
      5. Preparing the payment voucher.
      6. Recording the liability.

**Internal control over inventories and purchases control objectives**

A sound system of internal control over inventories:

* + Authorization and purchase procedures.
  + Control over goods inwards.
  + Inventory records substantiated by physical counts.
  + Control over dispatches and goods outwards.

**Control Procedures over Inventory**

* Internal control procedures for inventories affect nearly all the functions involved in:
* Producing and disposing of the company’s products,
* Purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories.

**The basic internal control procedures are the following:**

1. **Approval and Control of Documents**
2. Issues from inventories should be made only on properly authorized requisitions.
3. Reviews of damaged, obsolete and slow moving inventory should be carried out. Any write-offs should be authorized.
4. **Arithmetical Accuracy**
5. All receipts and issues should be recorded on inventory cards, cross-referenced to the appropriate goods receipt notes **/**GRN or requisition document.
6. **Control Accounts**
7. Total inventory records may be maintained and integrated with the main accounting system; if so they should be reconciled to detailed inventory records and discrepancies investigated.
8. **Comparison of Assets to Records**
9. Inventory levels should be periodically checked against the records by a person independent of the stores personnel, and material differences investigated.
10. Where perpetual inventory records are not kept adequately a full inventory count should be held at least once a year.
11. Maximum and minimum inventory levels should be pre-determined and regularly reviewed for adequacy.
12. Re-order quantities should be pre-determined and regularly reviewed for adequacy.
13. **Access to Assets and Records**
14. Separate centers should be identified at which goods are held.
15. Deliveries of goods from suppliers should pass through a goods inwards section to the stores. All goods should pass through stores and hence be recorded and checked as received.
16. Inventories should be held in their locations so that they are safe from damage or theft.
17. All inventory lines should be identified and held together e.g. in bins which are marked with all relevant information as to size, grade, origin, title for identification.
18. Access to the stores should be restricted.

**Tests of Controls**

1. Observe physical security of inventories and environment in which they are held.
2. Test procedures for recording of inventory movements in and out of inventory.
3. Test authorization for adjustments to inventory records.
4. Test authorization for write-off or scrapping of inventories.
5. Test controls over recording of inventory movements belonging to third parties.
6. Test procedures for authorization for inventory movements i.e. the use made of authorized goods received and dispatch notes.
7. Inspect reconciliations of inventory counts to inventory records (this gives overall comfort on the adequacy of controls over the recording of inventory).
8. Check sequences of dispatch and goods received notes for completeness.
9. Assess adequacy of inventory counting procedures and attend count to ensure they are carried out.

**The auditors’ objectives in the examination of inventories/ purchases and cost of goods sold:**

The auditors’ have the following objectives in the examination of inventories and purchases.

1. To consider internal control over inventories and purchases (adequate)
2. To determine the existence of inventories, and the client’s ownership of these assets.
3. To establish the completeness of inventories and purchase transaction. All inventories are recorded.
4. To establish clerical accuracy of records and supporting schedules for inventories and purchases. Inventory records and supporting schedules are mathematically correct and agree with general ledger accounts.
5. To determine that the valuation inventories is based on appropriate methods. (Approximate the lower of cost or market method).
6. To determine the statement presentation of inventories is adequate, including disclosure of classification of inventories, accounting records and any inventories pledged as collateral for loans.

**Audit procedures for inventories and cost of goods sold:**

The following audit procedures for the verification of inventories and purchases may be used by auditors:

1. **Consider internal control for inventories and purchases**
   1. **Obtain an understanding of internal control for inventories and purchases.**

* In obtaining an understanding of internal control over inventory, the auditor should become thoroughly conversant with the procedures for purchasing, receiving, storing, and issuing goods as well as acquiring an understanding of the cost accounting system and the perpetual records.
  1. **Assess control risk and design additional tests of control for inventories and purchases.**
* After obtaining an understanding of the client’s internal control over inventories and purchases, the auditors perform their initial assessment of control risk for the various financial statement assertions.
  1. **Perform additional tests of controls.**
* Tests directed toward the effectiveness of controls help to evaluate the client’s internal control and to determine the extent to which the auditors are justified in reducing their assessed level of control risk for the assessments about the inventory and purchase accounts.

The following are examples of typical additional test.

* + - * 1. Examine significant aspects of a sample of purchase transactions.
        2. Test the cost accounting system.
  1. **Reassess control risk and design substantive tests.**

**B) Substantive Test**

1. Obtain listings of inventory and reconcile to ledgers
2. Evaluate the client’s planning of physical inventory
3. observe the taking of physical inventory and make test counts
4. Review the year-end cut off of purchases and sales transactions
5. Obtain a copy of the completed physical inventory, determine its clerical accuracy, and trace test counts
6. Review inventory quality and condition
7. Evaluate the bases and method of inventory
8. test the pricing of inventories
9. perform analytical procedures
10. Determine whether any inventories have been pledged and review purchases and sales commitments.
11. Evaluate financial statement presentation of inventories and cost of goods sold, including the adequacy of disclosure

**Summary**

This chapter described details of the controls over inventories and cost of goods sold, the auditors' consideration of these controls, and substantive tests of inventories and cost of goods sold.

* The audit of inventories presents the auditors with significant risk because: (*a*) they often represent a very substantial portion of current assets, (*b*) numerous valuation methods are used for inventories, (*c*) the valuation of inventories directly affects cost of goods sold, and (*d*) the determination of inventory quality, condition, and value is inherently complex.
* Effective internal control over inventories requires appropriate controls over purchasing, receiving, and issuing, supplies and materials, producing and shipping products, and cost accounting. A perpetual inventory system is also important.
* The auditors' objectives in the audit of inventories and cost of goods sold are to: (*a*) consider inherent risks; (*b*) consider relevant controls; (*c*) establish the existence of, and the client's rights to, inventories; (*d*) establish the completeness of inventories; (*e*) determine that inventories and cost of goods sold are valued in accordance with GAAP; and (*f*) determine that presentation and disclosures of inventory accounts are appropriate.
* The auditors' consideration of inherent risks and the controls over inventories, purchases, and production will allow them to design appropriate substantive tests of inventory and cost of goods sold accounts.
* In the audit of inventories, auditors are primarily concerned about the existence assertion, that is, the possibility of overstatement of year-end balances. Therefore, a primary substantive test for inventory accounts is observation of the client's physical inventory. Other substantive procedures include price tests of the valuation of inventory items, cutoff tests, analytical procedures, and tests of the financial statement presentation and disclosure.

Procedures:

* Describe the nature of inventories and cost of goods sold.
* Describe the auditors' objectives for the audit of inventories and cost of goods sold.
* Describe the documents, records, and accounts that are involved in the purchases and production (conversion) cycles and the fundamental controls over inventories, purchasing, and production.
* Assess the risks of material misstatement (inherent and control risks) of inventories, purchases, and cost of goods sold.
* Design typical tests of controls used by auditors to support the assessed risks of material misstatement (inherent and control risks) for the financial statement assertions related to inventories and cost of goods sold.
* Explain how the auditors design substantive audit procedures to address the risks of material misstatement of inventories and cost of goods sold.