ASA 501
(April 2006)

Auditing Standard ASA 501
Existence and Valuation of Inventory

Issued by the **Auditing and Assurance Standards Board**

Australian Government
Auditing and Assurance Standards Board

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PREFACE

Reasons for Issuing Auditing Standard ASA 501 *Existence and Valuation of Inventory*

The Auditing and Assurance Standards Board (AUASB) issues Auditing Standard ASA 501 *Existence and Valuation of Inventory*, due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislative Instruments Act 2003*.

Main Features

This Auditing Standard establishes mandatory requirements and provides explanatory guidance on obtaining sufficient appropriate audit evidence regarding the existence and valuation of inventory material to the financial report.

Operative Date

This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from AUS 506 (July 2002) *Existence and Valuation of Inventory*

The main differences between this Auditing Standard and the Auditing Standard issued by the Auditing & Assurance Standards Board of the Australian Accounting Research Foundation, AUS 506 (July 2002) *Existence and Valuation of Inventory,* are that in this Auditing Standard:

1. The word 'shall', in the **bold-type** paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility is described in AUS 506 by the word 'should'.

2. The explanatory guidance paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas in AUS 506 some obligations are implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance.

3. The following implied obligation in AUS 506 has been elevated and re-stated as a specific mandatory requirement:

   (a) if the entity uses procedures to estimate the physical quantity of inventory that is material, the auditor shall design and perform audit procedures to be satisfied with the reasonableness of those procedures (paragraph 19).

4. The following additional mandatory requirement, not contained in AUS 506, is included:

   (a) if unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor shall take or observe some physical counts on an alternative date and, when necessary, perform audit procedures on intervening transactions (paragraph 13).

5. The auditor is required to attend physical inventory counting unless impracticable (paragraph 11), whereas in AUS 506 in exceptional circumstances, the auditor may judge it necessary to depart from the requirement to attend physical inventory counting in order to more effectively achieve the same objectives.

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard ASA 501 *Existence and Valuation of Inventory*, as set out in paragraphs 1 to 33, pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards* which sets out the intentions of the AUASB on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

Dated 28 April 2006

M H Kelsall
Chairman - AUASB

AUDITING STANDARD ASA 501

Existence and Valuation of Inventory

Application

1 This Auditing Standard applies to:

> **(a) an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
>
> **(b) an audit of a financial report for any other purpose.**

2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

3 This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.

Introduction

4 The purpose of this Auditing Standard is to establish mandatory requirements and to provide explanatory guidance on obtaining sufficient appropriate audit evidence regarding the existence and valuation of inventory in the financial report.

5 The auditor shall obtain sufficient appropriate audit evidence regarding the existence and valuation of inventory material to the financial report.

6 Definitions, and the method of measurement regarding inventory, are given in Accounting Standard AASB 102: *Inventories* and are adopted for the purpose of this Auditing Standard. Although the method of measurement given in AASB 102 does not apply to certain types of inventories, the guidance provided by this Auditing Standard may be suitable for the purpose of obtaining sufficient appropriate audit evidence regarding their existence and valuation.

Internal Control Structure

7 When obtaining an understanding of the internal control structure and making a preliminary assessment of control risk, ordinarily, the auditor considers the adequacy of authorisation, custodianship and recording functions relating to inventory (as well as internal controls relating to the determination of quantity and value of inventory for financial reporting purposes) to determine the nature, timing and extent of audit procedures.

8 In obtaining an understanding of the internal control structure, ordinarily, the auditor considers the records and internal controls existing over the receiving, storing, returning, utilisation and dispatch of inventory.

9 Records and internal controls ordinarily considered by the auditor regarding a manufacturer may include those relating to the movement of inventory through work in progress to finished goods, and the aggregation of costs through appropriate centres.

Attendance at Physical Inventory Counting

10 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 report or to ascertain the reliability of the perpetual inventory system.

11 The auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting unless impracticable.

12 The auditor's attendance serves as a test of controls or substantive procedures over inventory depending on the auditor's risk assessment and planned approach. Such attendance enables the auditor, for example, to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count and to provide audit evidence as to the reliability of management's procedures.

13 If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor shall take or observe some physical counts on an alternative date and, when necessary, perform audit procedures on intervening transactions.

14 **Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor shall consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation.**

15 For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

16 The auditor may audit a financial report that contains one or more reporting periods for which the auditor has not observed or made some physical count of inventory. The auditor may however be able to obtain sufficient appropriate audit evidence regarding prior period inventory by performing such procedures as:

- tests of prior period transactions;
- review of the records of prior counts; and
- the application of gross profit tests.

17 In planning attendance at the physical inventory count or the alternative procedures, the auditor ordinarily considers the following:

- 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 the count;
- the locations at which inventory is held; and
- whether an expert's assistance is needed.

18 When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.

19 **If the entity uses procedures to estimate the physical quantity of inventory that is material, the auditor shall design and perform audit procedures to be satisfied with the reasonableness of those procedures.**

20 ASA 540 *Audit of Accounting Estimates*, provides mandatory requirements and explanatory guidance on the audit of accounting estimates.

21 When inventory is situated in several locations, under paragraph 5 of this Auditing Standard, the auditor needs to consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement at different locations.

22 In certain circumstances, it may be necessary for the auditor to rely on the work performed by an expert regarding, for example, the quantity of inventory. For mandatory requirements and explanatory guidance on using the work of an expert refer to ASA 620 *Using the Work of an Expert*.

23 The auditor would ordinarily review management's instructions regarding:

- the application of control activities, for example, collection of used stocksheets, accounting for unused stocksheets and count and re-count procedures;
- 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; and
- whether appropriate arrangements are made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

24 To obtain audit evidence that management's control activities are adequately implemented, the auditor would ordinarily observe employees' procedures and perform test counts. When performing test counts, the auditor ordinarily performs procedures over both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory and items selected from the physical inventory to the count records. The auditor ordinarily considers the extent to which copies of such count records need to be retained for subsequent audit procedures and comparison.

25 The auditor ordinarily considers cut-off procedures including details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date.

26 For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the entity has designed and implemented controls over changes in inventory. The auditor ordinarily determines whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are free of material error and reasonably stated.

27 When the entity operates a perpetual inventory system which is used to determine the period end balance, the auditor would ordinarily evaluate whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.

28 Ordinarily, the auditor performs audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts.

Inventory Under Control or Custody of a Third Party

29 When inventory is under the custody and control of a third party, the auditor ordinarily obtains direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on materiality of this inventory the auditor ordinarily considers the following:

- the integrity and independence of the third party;
- observing, or arranging for another auditor to observe, the physical inventory count;
- obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded; and
- inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

Valuation of Inventory

30 The auditor shall evaluate the methods used by management in the valuation of inventory.

31 The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the valuation of inventory.

32 Such procedures may include the following:

- testing the inventory sheets or continuous inventory records with relevant documents such as invoices, cost records and other sources, to ascertain cost;
- testing standard costing records, where applicable, and testing the treatment of overhead expenses;
- testing for the lower of cost and net realisable value;
- testing the arithmetical accuracy of calculations;
- testing the consistency, in principle and in detail, with which the amounts have been computed;
- evaluating audit evidence supporting the assessment of net realisable value, with particular reference to slow moving, obsolete or damaged inventory;
- consideration of the gross profit ratio disclosed in the financial report and its comparison with the ratio shown in previous reporting periods;
- consideration of the rate of turnover of inventory and its comparison with previous reporting periods; and
- where applicable, consideration of the variances shown by the standard costing records and their treatment in the financial report.

Conformity with International Standards on Auditing

33 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 501 *Audit Evidence – Additional Considerations for Specific Items* (Part A), *Attendance at Physical Inventory Counting*, issued by the International Auditing

and Assurance Standards Board of the International Federation of Accountants. The main differences between this Auditing Standard and ISA 501 (Part A) are:

- This Auditing Standard contains mandatory requirements for the auditor to obtain audit evidence regarding both the existence and valuation of inventory material to the financial report (paragraph 5). ISA 501 (Part A) only establishes standards and provides guidance in relation to the attendance at a physical inventory counting when inventory is material to the financial statements.

- This Auditing Standard contains mandatory requirements for the auditor to be satisfied with the reasonableness of an entity's estimation procedures when used by the entity to estimate the physical quantity of inventory that is material (paragraph 19). ISA 501 (Part A) only provides explanatory guidance relating to estimation procedures.

- This Auditing Standard provides explanatory guidance relating to the internal control structure affecting inventory (paragraphs 7-9), whereas ISA 501 (Part A) does not.

- This Auditing Standard provide explanatory guidance relating to prior period inventory (paragraph 16), whereas ISA 501 (Part A) does not.

Compliance with this Auditing Standard enables compliance with ISA 501 (Part A).