

Auditing Standard

AUS 506
(July 2002)

Existence and Valuation of Inventory

Prepared by the **Auditing & Assurance Standards Board** of the
Australian Accounting Research Foundation



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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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AUDITING STANDARD
AUS 506 “EXISTENCE AND VALUATION OF INVENTORY”

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Introduction

- .01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on obtaining sufficient appropriate audit evidence regarding the existence and valuation of inventory in the financial report.
- .02 ***The auditor should obtain sufficient appropriate audit evidence regarding the existence and valuation of inventory material to the financial report.***
- .03 Definitions, and the method of measurement regarding inventory, are given in Accounting Standard AASB 1019: Measurement and Presentation of Inventories in the Context of the Historical Cost System and Australian Accounting Standard AAS 2 “Measurement and Presentation of Inventories in the Context of the Historical Cost System”, and are adopted for the purpose of this Standard. Although the method of measurement given in AASB 1019 and AAS 2 does not apply to certain types of inventories, the guidance provided by this AUS may be suitable for the purpose of obtaining sufficient appropriate audit evidence regarding their existence and valuation.

Internal Control Structure

- .04 When obtaining an understanding of the internal control structure and making a preliminary assessment of control risk, the auditor would consider 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.
- .05 In obtaining an understanding of the internal control structure, the auditor would also consider the records and internal controls existing over the receiving, storing, returning, utilisation and dispatch of inventory.
- .06 Records and internal controls 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.

Existence of Inventory

- .07 ***When inventory is material to the financial report, the auditor should obtain sufficient appropriate audit evidence regarding its***

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existence and condition by attendance at physical inventory counting, unless impracticable. In exceptional circumstances the auditor may judge it necessary to depart from this procedure in order to more effectively achieve the same objective, however the auditor should document the justification for this departure in the audit working papers. Such attendance will enable the auditor to inspect the inventory, to observe compliance with the operation of management's procedures for recording and controlling the results of the count, and provide evidence as to the reliability of management's procedures.

- .08 In planning attendance at the physical inventory count, the auditor would consider:
- (a) inherent, control and detection risks, and materiality related to inventory;
 - (b) whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting;
 - (c) the timing of the count;
 - (d) the locations at which inventory is held; and
 - (e) whether an expert's assistance is needed.
- .09 When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the assessment of control risk at different locations.
- .10 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 reporting period, the auditor would ordinarily observe count procedures and perform test counts.
- .11 If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.
- .12 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 guidance on using the work of an expert refer to AUS 606 "Using the Work of an Expert".

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- .13 The auditor would review management’s instructions regarding:
- (a) the application of control procedures, for example collection of used inventory sheets, accounting for unused inventory sheets and count and re-count procedures;
 - (b) 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
 - (c) 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.
- .14 To obtain assurance that management’s procedures are adequately implemented, the auditor would observe employees’ procedures and perform test counts. When performing counts, the auditor may test 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 would consider the extent to which copies of such count records need to be retained for subsequent testing and comparison.
- .15 The auditor would also consider 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.
- .16 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 control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate procedures, changes in inventory between the count date and period end are correctly recorded.
- .17 When the entity operates a perpetual inventory system which is used to determine the period end balance, the auditor would assess 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.

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Alternative Procedures if Observation of Physical Inventory is Impracticable or in the Event of Exceptional Circumstances.

- .18 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:
- (a) tests of prior period transactions;
 - (b) review of the records of prior counts; and
 - (c) the application of gross profit tests.
- .19 ***When attendance is impracticable because of the nature and/or location of the inventory, or where in exceptional circumstances the auditor is able to justify not attending the physical inventory counting, the auditor should 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.*** 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.

Inventory Under Control or Custody of a Third Party

- .20 When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. Depending on the materiality of this inventory the auditor would also:
- (a) consider any apparent lack of integrity and independence of the third party;
 - (b) observe, or arrange for another auditor to observe the physical inventory count;
 - (c) obtain another auditor's report on the adequacy of the third party's internal control structure for ensuring that inventory is correctly counted and adequately safeguarded; and
 - (d) inspect documentation regarding inventory held by third parties, for example warehouse receipts, or obtain

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confirmation from other parties when such inventory has been pledged as collateral.

Valuation of Inventory

- .21 *The auditor should evaluate the bases used by management in the valuation of inventory.*
- .22 *The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the valuation of inventory.* Such procedures may include the following:
- (a) testing the inventory sheets or continuous inventory records with relevant documents such as invoices, cost records and other sources, to ascertain cost;
 - (b) reviewing the standard costing records, where applicable, and testing the treatment of overhead expenses;
 - (c) testing for the lower of cost and net realisable value;
 - (d) testing the arithmetical accuracy of calculations;
 - (e) testing the consistency, in principle and in detail, with which the amounts have been computed; and
 - (f) reviewing the evidence supporting the assessment of net realisable value, with particular reference to slow moving, obsolete or damaged inventory.
- .23 To assist the auditor in the overall assessment of the valuation of inventory, the following audit procedures may be appropriate:
- (a) testing the final inventory listing to assess whether it reflects actual inventory counts;
 - (b) reconciliation of changes in inventory quantities, as between the beginning and end of the reporting period, with the records of purchases, production and sales;
 - (c) comparison of the quantities and amounts of inventory in the various categories with those included at the previous reporting period and with current sales and purchases;
 - (d) consideration of the gross profit ratio disclosed in the financial report and its comparison with the ratio shown in previous reporting periods;

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- (e) consideration of the rate of turnover of inventory and its comparison with previous reporting periods;
- (f) consideration of the relationship of the quantities ready for sale and in the course of production, with the quantities shown in operating and sales budgets; and
- (g) where applicable, consideration of the variances shown by the standard costing records and their treatment in the financial report.

Operative Date

- .24 This AUS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AUS 506 supersedes AUS 506 “Existence and Valuation of Inventory”, as issued in October 1995.

Compatibility with International Standards on Auditing

- .25 Except for the matter noted below, the basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 501, Audit Evidence - Additional Considerations for Specific Items Part A: Attendance of Physical Inventory Counting, are consistent in all material respects:

ISA 501 Part A only establishes standards and provides guidance in relation to the attendance at a physical inventory counting. AUS 506.21 and AUS 506.22 contain black letter requirements in relation to the valuation of inventory. The Auditing & Assurance Standards Board is of the view that for completeness, it is necessary to provide guidance on valuation of inventory in addition to that provided in the equivalent ISA.