

STATEMENT 3.231**AUDITING GUIDELINE****AUDITING STOCKS AND WORK IN PROGRESS****Introduction**

1. Paragraph 7 of Auditing Standard No. 3.101 "Audit Approach" states that:

'The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom.'

This Auditing Guideline gives guidance on how that paragraph may be applied in relation to the audit of stock and, in particular, to attendance at stocktaking. It is supplementary to, and should be read in conjunction with, auditing standards and related guidelines.

2. This Guideline relates primarily to company audits but the considerations outlined apply equally to other audits which involve auditors in expressing an opinion on the truth and fairness of the view given by the financial statements.

General considerations

3. The value of stock and work in progress ('stocks') in the financial statements of a trading entity will often be material to the profit and loss account and to the balance sheet and, as such, is of great importance to the financial statements. There are three main elements in the audit of stocks: existence, ownership and valuation.
4. It is the responsibility of the management of an entity to ensure that the amount at which stocks are shown in the financial statements represents stocks physically in existence and includes all stocks owned by the entity. Management satisfies this responsibility by carrying out appropriate procedures which will normally involve ensuring that all stocks are subject to a count at least once in every financial year. Further, where the auditor attends any physical count of stocks in order to obtain audit evidence, this responsibility will not be reduced.
5. It is the responsibility of the auditor to obtain audit evidence in order to enable him to draw conclusions about the validity of the quantities upon which is based the amount of stocks shown in the financial statements. The principal sources of this evidence are

stock records, stock control systems and the results of any stocktaking and test-counts made by the auditor himself. By reviewing the entity's stock records and stock control systems, the auditor can decide to what extent he needs to rely upon attendance at stocktaking to obtain the necessary audit evidence.

Quantities and condition of stocks

Attendance at stocktaking

6. In most circumstances, the best method by which the auditors can satisfy themselves as to the effectiveness of the application of the client's stocktaking procedures is by observation on a test basis of these procedures whilst the stocktaking is in progress. Considerations relating to clients' stocktaking procedures and suggested audit procedures regarding the ascertainment of quantities and the condition of stocks are set out in paragraphs 18-34 below.

Other audit procedures

7. Additional audit procedures to enable auditors to satisfy themselves that stocks have been properly ascertained will include such of the following as the auditors may consider appropriate:
 - a. general scrutiny of the inventory or the stock records (and comparisons with the previous year), including attention to the possibility of material omissions, or the inclusion of items such as loose tools which ought not to be included because they appear elsewhere in the financial statements;
 - b. where applicable, tests by reference to statistical information covering matters such as yields, which may be expected from given quantities, and normal losses or gains by evaporation or absorption of moisture.
8. Where stocks are defective or are obsolete or slow moving, these factors must be taken into account in determining the amount at which stocks are stated in the balance sheet. Appropriate audit tests of the entity's procedure for judging the physical condition will normally include:
 - a. scrutiny of stock records during the tests referred to in paragraphs 6 and 7, to ascertain what information as to condition and slow moving stocks has been recorded, and what action has been taken on that information;
 - b. comparison with the stock records relating to the previous balance sheet date;

- c. examination by reference to normal experience of wastage due to rejects and deterioration;
- d. examination of the relationship between stocks and turnover, including consideration of current trading conditions and any changes in sales or stockpiling policies;
- e. discussions with management.

Amount at which stocks are stated

9. Audit procedures will be designed to ascertain whether the amount at which stocks and work in progress are stated has been computed on a basis (or bases) and by methods which, consistently applied and having regard to the nature and circumstances of the business, will enable the financial statements to show a true and fair view of the trading results and financial position. The accounting principles involved are dealt with in the Society's Statement 2.103 (SSAP 3) "Stocks and work in progress".
10. After examining the principles adopted by the management, the audit procedures to test the application of those principles will normally include:
 - a. test of the stock sheets or continuous stock records with relevant documents such as invoices, costing records and other sources for the ascertainment of 'cost';
 - b. examination and testing of the treatment of overhead expenses;
 - c. tests of 'net realisable value' (or, as the case may be, 'replacement cost' — see paragraph 43 of SSAP 3);
 - d. careful enquiry of responsible officials and examination of evidence supporting the assessment of net realisable value, with particular reference to defective, obsolete or slow moving stocks, and consideration of the reasonableness of the replies from officials to the enquiries made;
 - e. tests of the arithmetical accuracy of the calculations;
 - f. tests of the consistency, in principle and in detail, with which the amounts have been computed;
 - g. consideration of the adequacy of the description applied to stocks and work in progress in the financial statements.

11. Net realisable value can be defined as the amount which it is estimated, as at the balance sheet date, will be realised from the disposal of stocks in the ordinary course of business, either in their existing condition or as incorporated in the product normally sold, after allowing for all expenditure to be incurred on or before disposal. In estimating this amount, regard should be had to excess and obsolete stocks, the trend of the market and the prospects of disposal. It is normal to estimate net realisable value by reference to all available information, including changes in selling prices since the balance sheet date, so far as the information is of assistance in determining the realisable value of the stocks at the balance sheet date.
12. In many instances the estimation of net realisable value requires the exercise of judgement by officials of the entity who are responsible for the sale or realisation of the stocks or work in progress. While, therefore, the auditors' review of such estimates will include consideration of the explanations given by the responsible officials, it will be necessary for the auditors to review and test supporting evidence available to them, in order to form an opinion as to whether the estimates of realisable value are fair and reasonable.

Work in progress

13. Appropriate audit tests in relation to work in progress will include examination and testing of available records, including costing records and work tickets attached to unfinished articles, and, where there are long-term contracts, examination of the relevant contracts, including any modifications thereof, and other information such as subsequent cost reports and estimates of costs to completion, and agreement of the calculation of the inclusion or otherwise of profit or provision for loss as stated in SSAP 3 paragraphs 45-55. Physical checking of work in progress will often not be possible by methods similar to those adopted for stocks but, as explained in paragraph 19 below, a physical inspection of the work in progress may provide additional audit evidence. Reference to costing records is frequently necessary and it may not be possible to separate the question of physical quantity from the question of the amount to be attributed to the work in progress. Where it is not possible or practicable to identify the work in progress with either the components which have gone into it or the products which will emerge from it, the auditors will be particularly concerned to ascertain:

- a. the costing system used to record work in progress;
- b. whether the costing system is reliable and, in particular, whether it is integrated with the financial accounting system;
- c. the extent to which checks are made by reference to statistical information concerning output of main products and of by-products (if any), which ought to be obtained from materials used;
- d. the system of inspection and reporting thereon to enable allowance to be made in the costing records for scrapping and rectification;
- e. the basis on which overheads are dealt with in the costing records;
- f. any profit element included for which adjustments are required.

Overall tests

14. Audit tests which may often be appropriate by way of overall assessment of the reliability of the records will include, according to circumstances:
 - a. reconciliation of changes in stock quantities as between the beginning and end of the financial year, with the records of purchases, production and sales;
 - b. comparison of the quantities and amounts of stocks in the various categories with those included at the previous balance sheet date, and with current sales and purchases;
 - c. consideration of the gross profit ratio shown by the financial statements and its comparison with the ratio shown in previous years;
 - d. consideration of the rate of turnover of stocks and its comparison with previous years;
 - e. consideration of the relationship of the quantities ready for sale and in course of production, with the quantities shown in operating and sales budgets;
 - f. where applicable, examination of standard costing records and consideration of the variances shown thereby, and their treatment in the financial statements.

Other matters

Independent stocktakers

15. In some trades it is a common practice to employ firms of independent surveyors and valuers. These stocktaking firms are specialists and, provided the auditor is satisfied as to their independence and standing, it is usual to accept their stock counts as reliable. The auditors, however, should ascertain directly from the stocktaking firm the basis of valuation used, and assure themselves that proper cut-off procedures were operated.
16. Sometimes the circumstances are such that physical count and valuation are virtually one operation, where it is not practicable for the auditors to make any independent test of the basis of appraisal, so that they will have to rely on the independent stocktaker. A case in point might be an inventory of precious stones but the situation may be met in a number of types of business. Nevertheless, the fact that auditors are obliged to rely on reports of independent stocktakers does not relieve them of their responsibility for forming an opinion on the amount at which stocks are stated in the balance sheet.

Inventory letters

17. It is usual and desirable practice to obtain from a director or other responsible official of the entity a written statement outlining in detail the method of ascertaining stock quantities and bases of valuation. This statement may take the form of a separate inventory letter or may be included in a comprehensive letter of financial representations. It in no way relieves the auditors of their responsibility for forming an independent opinion on whether stocks have been fairly reported and presented in the financial statements. The significance of inventory letters is that they constitute a record of the action taken by management, and a formal reminder and acknowledgement of management's responsibility and, for this reason, considerable importance attaches to these representations.

Attendance at stocktaking

Attendance as a means of providing evidence

18. Where stocks are material in the entity's financial statements, and the auditor is placing reliance upon management's stocktake in order to provide evidence of existence, then the auditor should attend the stocktaking. This is because attendance at stocktaking is normally the best way of providing evidence of the proper functioning of management's stocktaking procedures, and hence of the existence of stocks and their condition.

19. Evidence of the existence of work in progress will frequently be obtained by a stocktake. However, as explained in paragraph 13 above, the nature of the work in progress may be such that it is impracticable to determine its existence by a count. Management may place substantial reliance on internal controls designed to ensure the completeness and accuracy of records of work in progress. In such circumstances there may not be a stocktake which could be attended by the auditor. Nevertheless, inspection of the work in progress will assist the auditor to plan his audit procedures, and it may also help on such matters as the determination of the stage of completion of construction or engineering work in progress.

Types of stocktaking

20. Physical verification of stocks may be by means of a full count (or measurement in the case of bulk stocks) of all the stocks at the year end or at a selected date before or shortly after the year end, or by means of a count of part of the stocks in which case it may be possible to extrapolate the total statistically. Alternatively, verification may be by means of the counting or measurement of stocks during the course of the year using continuous stock-checking methods. Some business entities use continuous stock-checking methods for certain stocks and carry out a full count of other stocks at a selected date.
21. Paragraphs 22 and 23 set out some special considerations in circumstances where the count is carried out at a date which is not the same as that of the financial statements or where it takes place throughout the year. The principal procedures which the auditor would normally carry out in relation to his attendance at any count of stocks are set out in paragraphs 24 to 34 of this guideline.
22. The evidence of the existence of stocks provided by the stocktake results is most effective when the stocktaking is carried out at the end of the financial year. Stocktaking carried out before or after the year end may also be acceptable for audit purposes provided records of stock movements in the intervening period are such that the movements can be examined and substantiated. The auditor should bear in mind that the greater the interval between the stocktaking and the year end the greater will be his difficulties in substantiating the amount of stocks at the balance sheet date. Such difficulties will, however, be lessened by the existence of a well developed system of internal control and satisfactory stock records.

23. Where continuous stock-checking methods are being used, the auditor should perform tests designed to confirm that management:
- a. maintains adequate stock records that are kept up-to-date;
 - b. has satisfactory procedures for stocktaking and test-counting, so that in normal circumstances the programme of counts will cover all stocks at least once during the year; and
 - c. investigates and corrects all material differences between the book stock records and the physical counts.

The auditor needs to do this to gain assurance that the stock-checking system as a whole is effective in maintaining accurate stock records from which the amount of stocks in the financial statements can be derived. It is unlikely that he will be able to obtain such assurance if the three matters above are not confirmed satisfactorily, in which circumstances a full count at the year end may be necessary.

Procedures

24. The following paragraphs set out the principal procedures which may be carried out by an auditor when attending a stocktake, but are not intended to provide a comprehensive list of the audit procedures which the auditor may find it necessary to perform during his attendance.

Before the stocktaking: planning

25. The auditor should plan his audit coverage of a stocktake by:
- a. reviewing his working papers for the previous year, where applicable, and discussing with management any significant changes in stocks over the year;
 - b. discussing stocktaking arrangements and instructions with management;
 - c. familiarising himself with the nature and volume of the stocks, the identification of high value items and the method of accounting for stocks;
 - d. considering the location of the stock and assessing the implications of this for stock control and recording;
 - e. reviewing the systems of internal control and accounting relating to stocks, so as to identify potential areas of difficulty (for example cut-off);

- f. considering any internal audit involvement, with a view to deciding the reliance which can be placed on it;
 - g. ensuring that a representative selection of locations, stocks and procedures are covered, and particular attention is given to high value items where these form a significant proportion of the total stock value;
 - h. arranging to obtain from third parties confirmation of stocks held by them, but if the auditor considers that such stocks are a material part of the entity's total stock, or the third party is not considered to be independent or reliable, then arranging where appropriate either for him or for the third party's auditor to attend a stocktake at the third party's premises; and
 - i. establishing whether expert help needs to be obtained to substantiate quantities, or to identify the nature and condition of the stocks, where they are very specialised.
26. The auditor should examine the way the stocktaking is organised and should evaluate the adequacy of the client's stocktaking instructions. Such instructions should preferably be in writing, cover all phases of the stocktaking procedures, be issued in good time and be discussed with those responsible for carrying out the stocktaking to ensure the procedures are understood and that potential difficulties are anticipated. If the instructions are found to be inadequate, the auditor should seek improvements to them.

During the stocktaking

27. During the stocktaking, the auditor should ascertain whether the client's staff are carrying out their instructions properly so as to provide reasonable assurance that the stocktaking will be accurate. He should make test counts to satisfy himself that procedures and internal controls relating to the stocktaking are working properly. If the manner of carrying out the stocktaking or the results of the test-counts are not satisfactory, the auditor should immediately draw the matter to the attention of the management supervising the stocktaking and he may have to request a recount of part or all of the stocks.
28. When carrying out test-counts, the auditor should select items both from count records and from the physical stocks and should check one to the other to gain assurance as to the completeness and accuracy of the count records. In this context, he should give particular consideration to those stocks which he believes, for example from the stock records or from his prior year working

papers, to have a high value either individually or as a category of stock. The auditor should include in his working papers items for subsequent testing, such as photocopies of (or extracts from) rough stocksheets and details of the sequence of stocksheets.

29. The auditor should determine whether the procedures for identifying damaged, obsolete and slow moving stock operate properly. He should obtain (from his observations and by discussion e.g. with storekeepers) information about the stocks' condition, age, usage and, in the case of work in progress, its stage of completion. Further, he should ascertain that stock held on behalf of third parties is separately identified and accounted for.
30. The auditor should consider whether management has instituted adequate cut-off procedures i.e. procedures intended to ensure that movement into, within and out of stocks are properly identified and reflected in the books of account. The auditor's procedures during the stocktaking will depend on the manner in which the year end stock value is to be determined. For example, where stocks are determined by a full count and evaluation at the year end, the auditor should test the arrangements made to segregate stocks owned by third parties and he should identify goods movement documents for reconciliation with financial records of purchases and sales. Alternatively, where the full count and evaluation is at an interim date and year end stocks are determined by updating such valuation by the cost of purchases and sales, the auditor should perform those procedures during his attendance at the stocktaking and in addition should test the financial cut-off (involving the matching of costs with revenues) at the year end.
31. In addition, the auditor should:
 - a. conclude whether the stocktaking has been properly carried out and is sufficiently reliable as a basis for determining the existence of stocks;
 - b. consider whether any amendment is necessary to his subsequent audit procedures; and
 - c. try to gain from his observations an overall impression of the levels and values of stocks held so that he may, in due course, judge whether the figure for stocks appearing in the financial statements is reasonable.
32. The auditor's working papers should include details of his observations and tests, the manner in which points that are relevant and material to the stocks being counted or measured have been dealt with by the client, instances where the client's procedures have not been satisfactorily carried out and the auditor's conclusions.

After the stocktaking

33. After the stocktaking, the matters recorded in the auditor's working papers at the time of the count or measurement should be followed up. For example, details of the last serial numbers of goods inwards and outwards notes and of movements during the stocktaking should be used in order to check cut-off. Further, photocopies of (or extracts from) rough stocksheets and details of test-counts, and of the sequence of rough stocksheets, may be used to check that the final stocksheets are accurate and complete.
34. The auditor should ensure that continuous stock records have been adjusted to the amounts physically counted or measured and that differences have been investigated. Where appropriate, he should ensure also that management has instituted proper procedures to deal with transactions between stocktaking and the year end, and also test those procedures. In addition, he should check replies from third parties about stocks held by or for them, follow up all queries and notify senior management of serious problems encountered during the stocktaking.