



HONG KONG SOCIETY OF ACCOUNTANTS

TECHNICAL BULLETIN

OPENING STOCKS — ALTERNATIVE AUDIT PROCEDURES

Introduction

1. The audit of stock and work-in-progress is usually a significant part of the audit of a manufacturing or trading company. This is recognised by the introduction to Auditing Guideline 3.231 "Auditing stocks and work in progress" which states, "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. 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."
2. Essentially the guidance given in Statement 3.231 deals with the situation where the auditor is in a position to plan his audit procedures in advance. This Technical Bulletin is intended to supplement Auditing Guideline 3.231, and be used by the auditor in situations described below, where the audit assurance on opening stocks is considered inadequate and additional procedures are to be performed in order for the auditor to give an unqualified opinion on the financial statements.
 - a. Where stocks have previously not been subject to an audit since the financial statements as a whole were not audited; or
 - b. Where, because of a limitation in scope, the previous auditor was not in a position to give a clean opinion on stocks, in particular on the existence of stocks, eg. where the auditor was appointed after the completion of the client's stocktake, was therefore unable to attend the physical stocktaking and consequently determined he was unable to form an opinion on the existence and quantity of stocks.
3. In situations where the auditor can place reliance on work performed by a previous auditor, even though his opinion may have been qualified, he should refer to the guidance contained in Auditing Guideline 3.253 "Amounts derived from the preceding financial statements".

Existing Guidance

4. Auditing Guideline 3.231 "Auditing stocks and work in progress" establishes certain procedures for auditing stocks in an environment where the auditor is planning his audit in advance of the balance sheet date, and where it is assumed opening stocks quantities and existence have been satisfactorily verified. Therefore, although some of the guidance is useful to auditors, in the situations illustrated in paragraph 2 above, the Auditing Guideline has limited application. This Technical Bulletin aims to supplement the existing guidance.

5. Certain principles of the audit of stocks and work in progress established in Auditing Guideline 3.231 have been used in the development of this Technical Bulletin.
- The method by which management ensures 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, is to ensure all stocks are subject to a count at least once in every financial year. (para 4, 3.231)
 - In most circumstances, *the best method* by which the auditor can satisfy himself 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*. (para 6, 3.231)

Application

- Clients may use different methods of stocktaking in order to satisfy their general responsibility towards maintaining and safeguarding the assets of the entity. As mentioned above this usually amounts to carrying out procedures which will ensure that all stocks are subject to a count at least once in every financial year. Two methods are commonly employed:
 - continuous stocktaking methods which involve counts or measurement of stock quantities throughout the financial year. Normally this is done on a systematic rotational basis so that all stocks have been checked at least once in the financial year;
 - full physical count of all stocks at the year end or at a selected date before or shortly after the year end.
- Continuous stocktaking methods often allow the auditor to perform procedures at any date for the purpose of ascertaining the adequacy of the procedures and verifying stock quantities and existence. Therefore, it is less likely that the auditor would face a limitation in scope along the lines referred to in paragraph 2b. above.
- Principally this Technical Bulletin focuses on entities which conduct full annual physical stocktakes. However, the principles can be applied to entities employing continuous stocktaking methods, and reference to the relevant procedures has been included where appropriate.

Conditions for Applying the Guidance

- Where stocks have previously been unaudited this guidance requires that the following conditions exist in order that the auditor can attempt to perform procedures aimed at providing him with sufficient, relevant, reliable audit evidence for forming an opinion on opening stock.
 - A client stocktake at the date used for measuring the opening balance sheet stock figure was held, or management should have counted or measured stocks during the course of the year using continuous stocktaking methods.
 - Client stocktakes are governed by adequate, documented procedures for counting, measuring and recording quantities, cut-off, identification of third party stocks, identification of obsolete and slow moving stocks, and the procedures have been applied.
 - For the purpose of establishing a reference point upon which to base the alternative procedures used to verify the opening stock figure, the auditor has attended the physical stock count held at the date used for measuring the closing balance sheet stocks figure. The date of the count should be either shortly before or shortly after the year end date. The result of this stocktake must have been satisfactory.
 - The client has maintained good internal controls over the physical movements of stocks throughout the period and the auditor has been able to satisfy himself that the controls have been operating satisfactorily throughout the period.
 - The client has maintained adequate records to identify all stock movements including movements of raw materials to work in progress, all receipts of stocks and all despatches of stocks throughout the period.

f. All records in relation to the above have been retained by the entity. Summaries alone would not generally allow the auditor to perform adequate checks of detail.

10. Where the previous auditor qualified his audit opinion in respect of stock based on his inability to attend a stocktake, and no alternative procedures were available, then prima facie the above factors were not in existence to the satisfaction of that auditor. The current auditor must satisfy himself that all of the above conditions exist, and be able to justify why his evaluation of the records and controls is satisfactory for forming his opinion, even when another auditor could not form such an opinion.

11. If the auditor is not satisfied that the above conditions apply then he will have to consider the appropriateness of qualifying the opening stock figure and therefore the results for the current year.

Roll-back Procedures

12. Having established closing stocks to the auditor's satisfaction following the guidance in Auditing Guideline 3.231, the auditor should then try to evaluate whether, based on the following procedures, opening stocks are materially misstated.

13. The auditor should reconcile or examine the client's reconciliation of closing stocks per the client stocktake, attended by the auditor, to the closing stocks balances per the stock records. The auditor should be satisfied that these are not materially different before proceeding, since if they are then he has evidence that the stock records are not reliable.

14. The auditor should perform substantive tests on stocks movements during the period between the closing stocktake and opening stocktake. In respect of the intervening period between the stocktake dates the auditor should gain assurance by:

- a. selecting issues or receipts of stocks from the stock records and checking with supporting documentation.
- b. selecting from issues and receipts documents such as despatch notes or goods received notes, and tracing the details to the stock records.

c. reviewing the sequence of pre-numbered issues and receipts documents.

15. The auditor, having satisfied himself as to the accurate recording of stocks movements per the stock records should reconcile the opening stocks balances per the stock records to the opening client stocktake. Again, this is a procedure which should not produce material errors for the roll-back procedure to be considered satisfactory.

16. Having performed roll-back procedures and reconciliations, it is usual for the stock quantities generated by the stocktakes to be used in the preparation of the financial statements, since there is greater assurance these stocks were in existence than the balances in the stock records. The balance of opening stocks, if necessary, can be derived by adjusting closing stocks for the movements during the period.

17. For additional assurance regarding the evaluation of opening stocks the auditor may perform calculations and reconciliations based upon sales and purchases from the general ledger movements as well as the stock records.

Evaluation of Alternative Procedures

18. In evaluating the roll-back procedures and the reconciliation of the stocktake results the auditor should be satisfied that the following have been met:

- a. No other audit evidence gathered from other audit tests such as on debtors or creditors, should materially conflict with the resultant opening stock figures produced.
- b. A review of the internal controls relating to stocks physical security and movements during the period has been successfully completed and results of compliance tests performed are satisfactory.

19. Since roll-back procedures are only estimates to within a margin of material error, auditors should be aware that it is difficult to perform the procedures with the degree of accuracy required over extended roll-back periods.

Overall Tests

20. Overall assessment of the reliability of the records may often be appropriate and results of the above procedures 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. gross profit ratio analysis and comparison with previous years;
 - d. rate of turnover of stocks and 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. examination of standard costing records, variances and their treatment in the financial statements.
- Consideration should be given to performing such procedures for key stocks items or product lines as well as for stocks in total.

This Technical Bulletin has been prepared by the Auditing Standards Committee to provide timely guidance to members. Statement 3.231 will be amended in due course to reflect the above guidance.