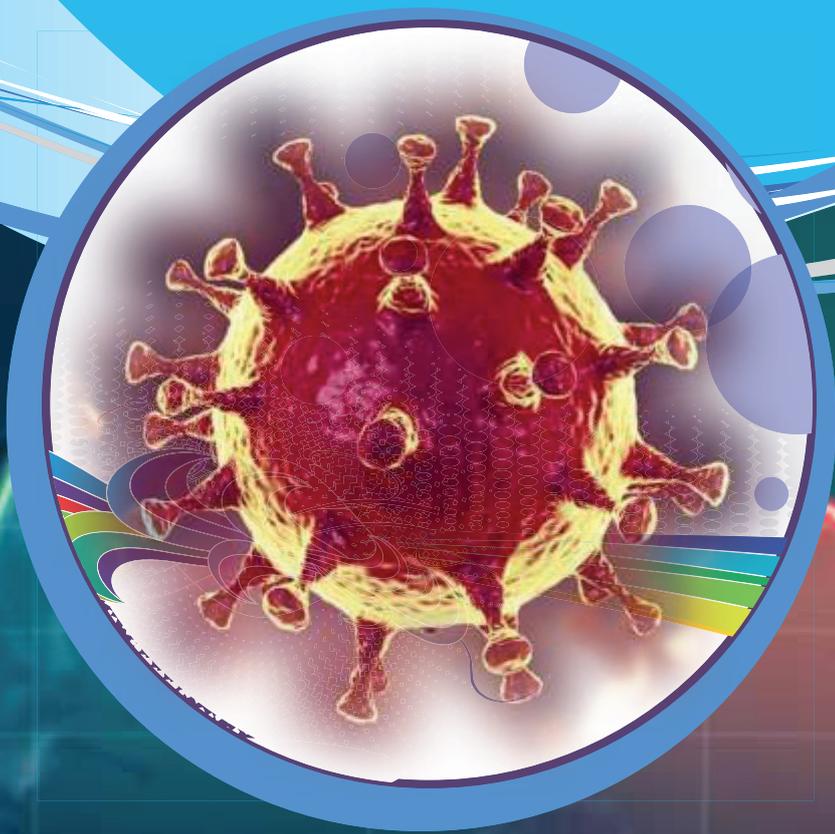


Physical Inventory Verification Key Audit Considerations amid COVID-19



Auditing and Assurance Standards Board (AASB)
The Institute of Chartered Accountants of India



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CA. (Dr.) Debashis Mitra
Vice Chairman
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CA. G. Sekar
Chairman
Auditing and Assurance Standards Board



OTHER AUDITING GUIDANCE ON COVID-19 ISSUED BY AASB

- March 27, 2020: ICAI Accounting and Auditing Advisory - Impact of Coronavirus on Financial Reporting and the Auditors Consideration (issued jointly with Accounting Standards Board of ICAI).

Website Link: <https://resource.cdn.icai.org/58829icai47941.pdf>

- May 10, 2020: Going Concern - Key Considerations for Auditors amid COVID-19.

Website Link: <https://resource.cdn.icai.org/59473aasb48392.pdf>



A. BACKGROUND

Physical verification of inventory is the responsibility of management of the entity. Management is required to establish procedures under which inventory is physically counted at least once a year to ensure existence, condition and support valuation of inventory.

The Companies (Auditor's Report) Order, 2016 (CARO 2016) also requires auditors to comment on "Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account".

SA 500, "Audit Evidence" prescribes that the objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. When inventory is material to the financial statements, SA 501, "Audit Evidence - Specific Considerations for Selected Items" requires that the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless **impracticable** to:
 - i. Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - ii. Observe the performance of management's count procedures;
 - iii. Inspect the inventory; and
 - iv. Perform test counts; and
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

The term "impracticable" has been explained in paragraph A12 of SA 501 as below:

*"A12 In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, **for example, where inventory is held in a location that may pose threats to the safety of the auditor.** The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive."*



B. AUDITOR'S CONSIDERATIONS IN VARIOUS SCENARIOS

The COVID-19 outbreak could create several potential challenges for management of an entity to conduct physical inventory counting and for the auditors to attend these counts. With scenarios like lockdown, travel restrictions etc. as imposed by Government of India, physical inventory counting would be challenging and in some cases it would be impracticable. Possible challenges in this regard are discussed below.

B.1 Management unable to conduct physical inventory counting as on the date of financial statements

Due to Government imposed restrictions, there could be situations where management is unable to conduct physical inventory counting as on the date of financial statements for example, inventory is held in locations which are closed due to Government imposed lockdown. In such a scenario, management should inform the auditors and those charged with governance the reasons of not conducting the inventory counting.

B.2 Physical inventory counting conducted by management at a date other than the date of financial statements

- Where an auditor decides to observe the physical inventory counting at a date other than the date of the financial statements, the auditor would need to comply with the procedures given in paragraphs 5 and 6 of SA 501 read with paragraphs A9 to A11 of SA 501.
- Attending inventory counting at an alternative date may involve attending inventory counting at a later date from the date of the financial statements with performing roll-back procedures to the balance sheet date, or, if an inventory counting was conducted by the entity and attended by the auditor at an interim date before the date of the financial statements, it may be possible to use those findings and perform roll-forward procedures to the balance sheet date.
- Roll-forward or roll-back procedures may also be a viable option where the entity has a continuous inventory counting system. Auditors should also consider whether the time between the balance sheet date and the date of the inventory counting being performed reflects the appropriate assessment of the physical condition of inventory.
- It should be noted that auditors should not take a blanket approach to all their audit clients as there may be some industries in which business has not been adversely affected, and thus above mentioned approach may not be appropriate in such circumstances.
- Any approach to the audit of inventory involves the consideration of the quality of the entity's inventory records and internal controls over inventory movements and records. Auditors should exercise professional skepticism and consider whether inventory records and internal



controls have deteriorated as a result of current events, including assessing any additional actions taken by the entity regarding its security. Accordingly, auditors should appropriately consider the impact of the aforesaid on their opinion on internal financial controls under section 143(3)(i) of the Companies Act, 2013.

- Reference may also be made to paragraphs 2.47 to 2.62 of the “Implementation Guide to SA 501” issued by the Auditing and Assurance Standards Board of ICAI.

B.3 Alternative audit procedures where it is impracticable for auditors to attend physical inventory counting

Due to various restrictions imposed due to COVID-19 outbreak, in certain cases it could be impracticable for auditors to physically attend the inventory counting. In such cases, the auditor would need to comply with the procedures given in paragraph 7 of SA 501 read with paragraphs A12 to A14 of SA 501. These paragraphs are given below:

“7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705(Revised). (Ref: Para. A12-A14)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705(Revised) requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.”

Reference may also be made to paragraph 2.61 of the Implementation Guide to SA 501 which states as below:

“Such audit procedures include:

- *Evaluation of control design in respect of inventory process and testing whether such controls have operated effectively during the period of audit. Such controls would encompass the processes around purchase and sales which eventually impact the stock balance held at the date of the financial statements.*



- *Verification of documentation supporting purchases and subsequent sale of specific inventory items. These procedures would indirectly provide evidence that stock balance which was not physically verified actually existed as on the date to enable subsequent sales and indirectly support and corroborate the assertion of existence.”*

B.3.1 The use of alternative audit procedures may include one or more of the following:

(a) Using the work of internal auditor

Paragraph A16 of SA 610(Revised), “Using the Work of Internal Auditors” states as below:

“Examples of work of the internal audit function that can be used by the external auditor include observations of inventory counts.”

As stated in paragraph A16 of SA 610(Revised), the external auditor can use the work of internal auditor regarding inventory verification. However, it needs to be noted that the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor’s use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. It also needs to be noted that the external auditor’s use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement would also depend on the assessment of the risk regarding existence of inventory. Paragraph 18 of SA 610(Revised), inter alia, states the external auditor shall plan to use less of the work of the internal audit function and perform more of the work directly if the assessed risk of material misstatement at the assertion level (existence) is higher and with special consideration given to risks identified as significant.

If the external auditor intends to use the work of the internal audit function or internal auditors to provide direct assistance on the engagement, in addition to complying with the requirements of SA 610(Revised), **the external auditor shall also perform the following procedures:**

1. Understand and evaluate the competence, independence and objectivity of the internal auditor.
2. Obtain and evaluate the adequacy of the inventory physical verification instructions prepared and issued by the management to determine if the instructions provided are appropriate and comprehensive.
3. Issue instructions to the internal auditor on the procedures to be performed by the internal auditor, including indication of the samples selected by the external auditor for verifying inventory from the books to the floor. The external auditor shall also specify the sample size for verification by the internal auditor of inventory from the floor to the books and the indicative qualitative / quantitative factors that should be considered by the internal auditor when selecting the samples.
4. Issue a copy of the instructions issued by the management (as stated in point 2 above) to the internal auditor and instruct the internal auditor to assess compliance with the instructions during the physical verification process.



5. Issue any other instructions to the internal auditor regarding the inventory counting as may be deemed necessary considering the external auditor's assessment of the risk and understanding of the entity's business and operations.
6. Inform the internal auditor of the deliverables like inventory counting reports, memorandum of observations on the inventory counting, conclusions reached, etc. that are to be prepared and provided to the external auditor after the inventory counting.

(b) Engaging other Chartered Accountant(s) to attend physical verification

Where due to lockdown restrictions imposed by the Government, the auditor is not able to attend the physical verification of inventory, the auditor in discussion with the management may appoint other Chartered Accountant(s), who is resident of the location of the entity's warehouse/ factory/ inventory, to observe the physical counting. The auditor should issue instructions to the other Chartered Accountant(s) as described in points 1 to 6 given in paragraph B.3.1.(a) above. In addition the auditor, where feasible, may virtually participate in the observation of the physical verification being conducted by the management through video applications as this would enable him to assess the efficacy of the internal controls operating during the physical verification process for determining its impact on his audit procedures.

Additionally, the auditor should also perform the following procedures:

- Inquiring for any relationships that may create a threat to objectivity of Chartered Accountant(s).
- Determine the nature and extent of work to be assigned.
- Communicate planned use of Chartered Accountant(s) with those charged with governance.
- Obtain written agreements from the entity for the use of Chartered Accountant(s) and from Chartered Accountant(s) for providing direct assistance.

The auditor should direct, supervise and review the work performed by Chartered Accountant(s) providing direct assistance, including providing instruction / work program, including sample selection.

For supervising the work of such Chartered Accountant(s), the auditor may use web or mobile-based video-conferencing technologies (i.e., Microsoft Teams, Facetime, Whatsapp, Zoom).

(c) Use of technology in inventory counting

In certain situations where physical attendance by auditors at inventory counting is not possible, they may be able to observe the inventory counting remotely via video call with the help of technology. Auditors would need to ensure the security on these applications. Auditors would need to understand the technological and practical constraints to observing an inventory counting remotely. If auditors are observing an inventory counting remotely, they



would need to perform the same procedures as required in case of physically attending the inventory counting.

Virtual attendance

If the entity intends to conduct a full inventory counting, auditors may be able to attend virtually, for example using video call facilities. This method of gathering audit evidence should be approached with caution as there are inherent weaknesses with this. For example, obsolete or damaged stock may be hidden from view and records-based alternative audit procedures may not detect this. This should be used only in circumstances wherein the inventory items can be identified with a unique reference number etc. so that there are no chances of replacement of inventory during/ after inventory counting. Further, auditors may carry out additional procedures to mitigate the increased risk which might include increasing sample sizes and following up on items tested at a later date. Also, auditors should consider the previous experience while conducting inventory counting at an earlier date (e.g. inventory counting conducted at an interim date before the year end).

Leveraging technology to help with inventory counting

Standards on Auditing do not prohibit use of technology when performing inventory observations. If auditors are satisfied with the inventory counting process, they may be able to utilize technologies to observe these counts. Of course, auditors may need to ensure there is some level of comfort that the videos are live feeds of client inventory locations, perhaps by confirming visually with key staff and using voice technology to have cameras moved to specified locations on command and direct certain boxes to be opened.

B.4 Inventory held by a third party

Where the entity has inventory under the custody and control of a third party, it may be possible, in accordance with SA 501 to place reliance on confirmation received from that third party regarding the quantities and condition of the inventory held on behalf of the entity. However, in such cases, auditors would need to exercise professional skepticism and perform a careful evaluation of such confirmations since auditors themselves have not been able to attend the physical inventory counting. It would be preferable that such confirmations are obtained by the direct confirmation requests addressed to the auditor directly without the management being involved in the process.

In this regard, the auditor should read and understand the contract with the third party to determine if the contract specifies the responsibility of the third party to track and record the inventory of the entity separately and any consequential impact on the ability of the auditor to rely on such confirmation from the third party.

B.5 Inventory in transit / cut-off procedures

Due to the lockdown situation, it might be possible that inventory purchased or sold might be locked up in transit. Auditors should obtain suitable audit evidence regarding the location and condition of the inventory including documentary records about purchases/sales. Appropriate cut-off procedures need to be employed to ensure appropriate quantities are considered in the inventory.



C. IMPLICATIONS FOR THE AUDITOR'S REPORT

- C.1 The primary responsibility of the auditor is to physically attend the inventory counting either at/ prior to/ post the balance sheet date as required by SA 501. Even in situations where the auditor opts for alternative audit procedures as envisaged in paragraph B.3 above, the auditor is not absolved from the primary responsibility in respect of attendance at physical inventory counting and thus cannot include a division of responsibility in the auditor's report in respect of alternative audit procedures carried out.
- C.2 The implications of an inability to attend inventory counting on the auditor's opinion will depend on the quality and reliability of audit evidence obtained by performing alternative audit procedures. Where such alternative audit procedures provide sufficient appropriate audit evidence to conclude that inventory is free from material misstatement, the auditor's opinion need not be modified in respect of inventory.
- C.3 However, if it is not possible to perform alternative audit procedures to obtain sufficient appropriate audit evidence in relation to material inventory balances, the auditor should modify the opinion in the auditor's report in accordance with SA 705(Revised). In many cases, this will result in a modified auditor's opinion due to a limitation of scope. Nature of modification i.e. qualification vis-à-vis disclaimer would depend on whether the matter is pervasive to the financial statements.