

Selected Preliminary Drafting for Proposed International Standard on Auditing (ISA) 501 (Revised), *Audit Evidence—Specific Considerations for Selected Items – Inventory*

This Agenda Item includes selected preliminary drafting for Proposed ISA 501 (Revised), as it relates to inventory.

Introduction

....

Objective

....

Requirements

Inventory

4. If ~~the auditor determines that~~ inventory ~~is a significant account balance in accordance with ISA 315 (Revised 2019)¹ is material to the financial statements, and that the assessed risks of material misstatement relate to the existence or condition of inventory,²~~ the auditor shall obtain sufficient appropriate audit evidence regarding the existence ~~and or~~ condition of inventory by: ~~(Ref: Para. A0A–A0C)~~
 - (a) ~~Attendance Attending the entity's at physical~~ inventory counting, unless impracticable, to: (Ref: Para. A1–A3)
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's ~~physical~~ inventory counting; (Ref: Para. A4)
 - (ii) Observe the performance of management's count procedures; (Ref: Para. A5)
 - (iii) Inspect the inventory; and (Ref: Para. A6)
 - (iv) Perform test counts; and (Ref: Para. A7–A8)
 - (b) Performing audit procedures over the entity's ~~final~~ inventory records as at the date of the count to determine whether they accurately reflect actual inventory count results.
5. If ~~physical~~ inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9–A11)
6. If the auditor is unable to attend ~~physical~~ inventory counting due to unforeseen circumstances, the auditor shall make or observe some ~~physical~~ counts on an alternative date, and perform audit procedures on intervening transactions.

¹ ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, paragraph 29

² ISA 315 (Revised 2019), paragraph 28

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 ISA 705 (Revised).³ (Ref: Para. A12–A14)
8. If the auditor determines that inventory under the custody and control of a third party represents a significant account balance in accordance with ISA 315 (Revised 2019)~~is material to the financial statements, and that the assessed risks of material misstatement relate to the existence or condition of inventory,~~⁵ the auditor shall obtain sufficient appropriate audit evidence regarding the existence ~~and or~~ condition of that inventory by performing, depending on the circumstances, one or both of the following: (Ref: Para. A14A–A14C)
 - (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A14D and A15)
 - (b) Perform inspection or other further audit procedures appropriate in the circumstances. (Ref: Para. ~~A16~~A14E–A14F)

...

Application and Other Explanatory Material

Inventory (Ref: Para. 4)

A0A. If the circumstances set out in paragraph 4 apply, this ISA requires the auditor to design and perform audit procedures to obtain sufficient appropriate audit evidence regarding the existence or condition of inventory. The auditor's assessment of risks of material misstatement at the assertion level affects the auditor's design and performance of further audit procedures in the circumstances.⁶

A0B. As the auditor's assessment of inherent risk increases on the spectrum of inherent risk, Proposed ISA 330 (Revised)⁷ requires the auditor to plan to obtain more persuasive audit evidence. This may affect the auditor's decisions regarding:

- The nature of audit procedures (e.g., to design and perform other further audit procedures together with the procedures required by paragraph 4, or to design and perform additional further audit procedures);
- The timing of audit procedures (e.g., performing procedures at or near period end, rather than at an interim date); and
- The extent of observation and test counts at inventory counts (e.g., the number of locations selected to visit, the number of items test counted and the introduction of an element of unpredictability, such as unannounced visits to inventory locations).

³ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

⁴ ISA 315 (Revised 2019), paragraph 29

⁵ ISA 315 (Revised 2019), paragraph 28

⁶ Proposed ISA 330 (Revised), paragraph 6-7

⁷ Proposed ISA 330 (Revised), paragraph 7(c)

A0C. The audit procedures required to be performed in accordance with this ISA may not by themselves provide sufficient appropriate audit evidence regarding the valuation assertion for inventory. These procedures address the condition of inventory, which is related to its valuation, but may not provide evidence, for example, relating to:

- The assessment of net realizable value, including expected selling prices and costs to complete; and
- Consideration of market conditions, demand trends, and pricing volatility.

...

Inventory under the Custody and Control of a Third Party (Ref: Para. 8)

A14A. The risks of material misstatement relating to inventory held by a third party may differ from those related to inventory held by the entity. These may include risks relating to:

- The safeguarding and physical condition of inventory.
- The accuracy and completeness of records maintained by the third party.
- The potential for unauthorized use, transfer or disposal of inventory.

A14B. The auditor's consideration of the design and implementation of controls at the entity and at the third party that are relevant to the existence and condition of inventory may influence the nature, timing and extent of audit procedures performed under paragraph 8. For example, where controls at the entity or at the third party are relevant and are expected to be operating effectively, the auditor may determine that obtaining audit evidence about the operating effectiveness of those controls address the auditor's evaluation of the reliability of information from the third party intended to be used as audit evidence.⁸ Conversely, where such controls are not suitably designed or implemented, the auditor may need to:

- Perform other audit procedures to evaluate the reliability of such information; or
- Design and perform substantive procedures to respond to the assessed risks of material misstatement at the assertion level.

A14C. Arrangements involving inventory held by a third party may fall within the scope of ISA 402⁹ when the third party's services form part of the entity's information system relevant to the preparation of its financial statements. This may be the case, for example, when the third party:

- Maintains records of inventory quantities or condition on behalf of the entity.
- Processes transactions affecting inventory balances, such as receipts, issues, or transfers.

Confirmation or Other Audit Procedures (Ref: Para. 8(a) and 8(b))

A14D. Depending on the circumstances, external confirmation procedures may not provide sufficient appropriate audit evidence regarding the existence or condition of inventory held by a third party.

⁸ Proposed ISA 500 (Revised), paragraph 10B

⁹ ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

Examples:

- Existence – When inventory is commingled with that of other entities, it may be difficult for the confirming party to distinguish the entity's inventory.
- Condition – When inventory is susceptible to damage, obsolescence or deterioration, an external confirmation from a third-party custodian may not provide sufficient information about the condition of the inventory.

~~A16A14E. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may ordinarily consider it appropriate to perform inspection or other further audit procedures instead of, or in addition to, sending an external confirmation request with to the third-party custodian if:~~ [Moved from paragraph A16]

- The assessed risk of material misstatement at the assertion level is such that the inherent risk is not at the lower end of the spectrum of inherent risk.
- Information is obtained that raises doubt about the integrity, competence, capability or objectivity of the third party or the auditor determines that a response to the external confirmation request is not reliable.

A14F. Examples of other further audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral. [Moved from paragraph A16]

A15. If the auditor decides to use external confirmation procedures, the auditor is required to comply with Proposed ISA 505 (Revised),¹⁰ which establishes requirements and provides guidance for performing external confirmation procedures.

A16. [Moved to paragraphs A14E and A14F]

...

¹⁰ Proposed ISA 505 (Revised), External Confirmations