

Agenda Item 7–E (Supplemental)

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

This Agenda Item presents a clean version of the draft of Proposed ISA 501 (Revised), as it relates to inventory.

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with Proposed ISA 330 (Revised),¹ Proposed ISA 500 (Revised)² and other relevant ISAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

Effective Date

2. This ISA is effective for audits of financial statements for:
 - (a) Periods beginning on or after December 15, 20XX for the section relating to inventory; and
 - (b) Periods beginning on or after December 15, 2009 for the sections relating to litigation and claims and segment information.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:
 - (a) Existence and condition of inventory;
 - ...

Requirements

Inventory

- 3A. If the auditor determines, in accordance with ISA 315 (Revised 2019),³ that existence and valuation (in relation to condition) are relevant assertions for inventory, the auditor's further audit procedures⁴ shall include the following depending on the circumstances: (Ref: Para. A0A–A0G)
 - (a) If the entity conducts a full inventory count, testing the entity's full inventory count in accordance with paragraphs 4–6;
 - (b) If the entity conducts cycle counts, testing the entity's cycle counts in accordance with paragraphs 4 and 6A; or
 - (c) If the entity does not conduct a full inventory count or cycle counts, testing how the entity addresses the existence and condition of inventory in accordance with paragraph 6B.

¹ Proposed ISA 330 (Revised), *The Auditor's Responses to Assessed Risks*

² Proposed ISA 500 (Revised), *Audit Evidence*

³ ISA 315 (Revised 2019), *Identifying and Assessing the Risks of Material Misstatement*, paragraph 29

⁴ Proposed ISA 330 (Revised), paragraphs 6–7

Testing the Entity's Full Inventory Count or Cycle Counts

4. When testing the entity's full inventory count or cycle counts, the auditor's further audit procedures shall include: (Ref: Para. A0H)
 - (a) Attending the entity's inventory count, unless impracticable, to: (Ref: Para. A0I–A3C)
 - (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's inventory count; (Ref: Para. A4–A4A)
 - (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) Determining whether the inventory records at the entity's count date accurately reflect the results of the entity's inventory count. (Ref: Para. A8A)

Full Inventory Count

5. If the entity's full inventory count is conducted at a date other than the date of the financial statements,⁵ the auditor shall, in addition to the procedures required by paragraph 4, perform further audit procedures to obtain audit evidence about whether changes in inventory between the entity's count date and the date of the financial statements are properly recorded. (Ref: Para. A9–A9A)
6. If the auditor is unable to attend the entity's full inventory count due to unforeseen circumstances, the auditor shall perform the following further audit procedures on an alternative date: (Ref: Para. A9B)
 - (a) Evaluate management's instructions and procedures for recording and controlling the results of the entity's inventory count;
 - (b) Inspect the inventory;
 - (c) Perform test counts; and
 - (d) Determine whether the entity's inventory records on the alternative date accurately reflect the results of the auditor's test counts.

Cycle Counts

- 6A. When testing the entity's cycle counts, the auditor shall determine whether further audit procedures in addition to those in paragraph 4 are necessary to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory at the date of the financial statements. (Ref: Para. A10–A11A)

Testing How the Entity Addresses the Existence and Condition of Inventory Where the Entity Does Not Conduct a Full Inventory Count or Cycle Counts

- 6B. When testing how the entity addresses the existence and condition of inventory where the entity does not conduct a full inventory count or cycle counts, the auditor shall: (Ref: Para. A11B)

⁵ Proposed ISA 330 (Revised), paragraphs 12 and 18

- (a) Obtain audit evidence about the operating effectiveness of the controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence regarding the existence and condition of inventory;⁶ and (Ref: Para. A11C)
- (b) Determine whether and, if so, the nature, timing and extent of additional substantive procedures, tests of controls, or a combination of both, that are necessary in the circumstances to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory at the date of the financial statements.⁷ (Ref: Para. A11D)

Attendance at the Entity's Full Inventory Count or Cycle Counts Is Impracticable

7. If the auditor's attendance at the entity's full inventory count or cycle counts in accordance with paragraph 4 is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory at the date of the financial statements. (Ref: Para. A12–A14)

Inventory Under the Custody and Control of a Third Party

8. If the auditor determines, in accordance with ISA 315 (Revised 2019),⁸ that existence and valuation (in relation to condition) are relevant assertions for inventory under the custody and control of a third party, the auditor shall obtain sufficient appropriate audit evidence⁹ by: (Ref: Para. A14A–A14B and A15A)
- (a) Requesting confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity; or (Ref: Para. A14D and A15)
 - (b) Performing inspection of that inventory or determining other types of procedures in performing substantive procedures, tests of controls, or a combination of both, appropriate in the circumstances.¹⁰ (Ref: Para. A14E–A14F)

Unable to Obtain Sufficient Appropriate Audit Evidence

- 8A. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, the auditor shall modify the opinion in the auditor's report in accordance with ISA 705 (Revised).¹¹ (Ref: Para. A14 and A14B)

Application and Other Explanatory Material

Inventory (Ref: Para. 3A)

Relationship Between the Valuation Assertion and the Condition of Inventory

⁶ Proposed ISA 330 (Revised), paragraph 14

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

⁸ ISA 315 (Revised 2019), paragraph 29

⁹ Proposed ISA 330 (Revised), paragraphs 6–7

¹⁰ Proposed ISA 330 (Revised), paragraph 7(b)

¹¹ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13

A0A. 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 all audit evidence regarding the valuation assertion.

Examples:

Performing the audit procedures required by this ISA may not provide audit evidence regarding the valuation assertion of inventory on matters such as:

- The assessment of net realizable value, including expected selling prices and costs to complete; and
- The consideration of obsolescence other than the condition of inventory, market conditions, demand trends, and pricing volatility.

[Moved from paragraph A0C]

Further Audit Procedures Addressing the Existence and Condition of Inventory

A0B. The manner in which the entity verifies the existence and condition of inventory may vary.

Examples:

An entity may:

- Conduct a full inventory count at or near the date of the financial statements;
- Conduct cycle counts by counting a subset of inventory items on a rotating basis throughout the reporting period;
- Rely on controls, including general IT controls, relating to an automated inventory system; or
- Apply a combination of the above approaches.

A0C. This ISA requires that the auditor's further audit procedures include those described in paragraph 3A, taking into account the auditor's understanding of how the entity addresses the existence and condition of inventory obtained in accordance with ISA 315 (Revised 2019),¹² including:

- The nature of the entity's inventory and the type of inventory system used;
- The entity's use of technology in managing inventory; and
- The relevant IT applications, direct controls (e.g., manual or automated controls) and indirect controls, including general IT controls. [Moved from paragraph A0A]

A0D. Matters relevant in designing and performing further audit procedures in accordance with paragraphs 4–8 of this ISA may include:

- The assessed risks of material misstatement at the assertion level, including the reasons for the assessment of inherent risk and of control risk for the existence and condition of inventory in accordance with ISA 315 (Revised 2019).

¹² ISA 315 (Revised 2019), paragraphs 19–26

- The nature of the entity's inventory (e.g., inventory susceptible to damage, deterioration and obsolescence).
- The nature, extent and complexity of technologies the entity uses in managing inventory.
- The design and implementation of controls relevant to the existence and condition of inventory.
- The type of inventory system the entity maintains (e.g., a periodic or perpetual inventory system).
- The locations at which inventory is held, including the materiality of the inventory, the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate.
- Whether the involvement of members of the engagement team with specialized skills or knowledge, or an auditor's expert is needed to assist the auditor in obtaining sufficient appropriate audit evidence regarding the existence and condition of inventory.

Examples:

- Evaluating the inventory's condition where specialized skills are needed.
- Evaluating the accuracy and completeness of system-generated inventory records.

ISA 620¹³ deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence. [Moved from paragraph A3]

Inventory Held in Multiple Locations

A0E. In addition to aggregation risk,¹⁴ risks associated with inventory at multiple locations may relate to:

- Inconsistent application of counting procedures or other controls across locations.
- Timing differences and cut-off errors arising from goods in transit between locations at period-end.
- When multiple IT systems are used, system integration issues affecting the reliability of consolidated inventory records.

When Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

A0F. In applying ISA 315 (Revised 2019),¹⁵ in obtaining an understanding about the information processing activities and controls related to the entity's inventory management system and processes, the auditor may identify controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence. In such case, Proposed ISA 330 (Revised)¹⁶ requires the auditor to test the operating effectiveness of those controls.

¹³ ISA 620, *Using the Work of an Auditor's Expert*

¹⁴ ISA 600 (Revised), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 14(a)

¹⁵ ISA 315 (Revised 2019), paragraphs 25–26

¹⁶ Proposed ISA 330 (Revised), paragraph 14

Higher Assessment of Inherent Risk

A0G. As the auditor's assessment of inherent risk increases on the spectrum of inherent risk, Proposed ISA 330 (Revised)¹⁷ requires the auditor to plan to obtain more persuasive audit evidence. This may affect the auditor's decisions regarding the extent of observation and test counts at the entity's inventory counts, including full inventory counts or cycle counts (e.g., the number of inventory locations selected to visit, the number of inventory items subject to test counts and the introduction of an element of unpredictability, such as unannounced visits to inventory locations). [Moved from paragraph A0B]

Testing the Entity's Full Inventory Count or Cycle Counts (Ref: Para. 4)

A0H. The auditor may design and perform the further audit procedures described in paragraph 4 as tests of controls, substantive procedures, or a combination of both.¹⁸ These audit procedures may be used for more than one purpose¹⁹ depending on the auditor's assessment of identified risks of material misstatement at the assertion level in accordance with ISA 315 (Revised 2019)²⁰ and the auditor's planned approach at the assertion level in accordance with Proposed ISA 330 (Revised).²¹

Attendance at the Entity's Inventory Count (Ref: Para. 4(a))

A0I. The auditor's attendance at the entity's full inventory count or cycle counts may be undertaken physically in person or, when appropriate in the circumstances, remotely through the use of technological tools.

A3. [Moved to paragraph A0D]

Physical attendance

A3A. Physical attendance at the entity's inventory count may provide more persuasive audit evidence than remote attendance using technological tools in certain circumstances.

Examples:

- When the existence or condition of inventory cannot readily be assessed using technological tools because the inventory:
 - Is susceptible to deterioration, damage or obsolescence.
 - Has characteristics that cannot be adequately observed remotely.
- When the results of prior audits increase the need for physical over remote attendance at the entity's inventory count.
- When there is increased susceptibility to fraudulent financial reporting or misappropriation of assets, such as when inventory is high value, easily portable, or readily transferable.

¹⁷ Proposed ISA 330 (Revised), paragraph 7(c)

¹⁸ Proposed ISA 330 (Revised), paragraph 7(b)

¹⁹ Proposed ISA 500 (Revised), paragraphs 10 and A26

²⁰ ISA 315 (Revised 2019), paragraph 13

²¹ Proposed ISA 330 (Revised), paragraphs 6 and 7

Remote attendance

A3B. Appendix 3 of Proposed ISA 500 (Revised) highlights factors that may assist the auditor in identifying circumstances in which the use of technological tools may be appropriate when designing and performing audit procedures to meet their intended purpose(s).

Evaluate management's instructions and procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the results of the entity's inventory count may include whether they address:

- The application of appropriate controls, including accounting for used and unused inventory count records, and count and re-count procedures.
- The assigned individuals who will perform management's count procedures, including whether those individuals possess the appropriate level of objectivity and competence.
- The 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.
- The procedures used to estimate quantities, where applicable, such as may be needed in estimating the quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.
- The process for investigating and making adjustments for identified differences between the inventory records and the results of the entity's inventory count.

A4A. When testing the entity's cycle counts, in addition to the matters in paragraph A4, matters relevant in evaluating management's instructions and procedures for recording and controlling the results of the entity's inventory count may include whether they also address:

- The frequency and coverage of the entity's cycle count program.
- The basis for selecting inventory items or inventory locations to be counted.
- The activities to monitor the cycle count coverage by inventory item or inventory location and the overall results that enable management to conclude that the entity's perpetual inventory system is sufficiently reliable.

Observe the performance of management's count procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements between the entity's count date and the date of the financial statements.

Inspect the inventory (Ref: Para. 4(a)(iii))

- A6. Inspecting inventory when attending the entity's inventory count assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in evaluating its condition by identifying, for example, obsolete, damaged or aging inventory.

Perform test counts (Ref: Para. 4(a)(iv))

- A7. Performing test counts, for example, by tracing items selected from management's count records to the actual inventory and tracing items selected from the actual inventory to management's count records, provides audit evidence about the accuracy and the completeness of those records.
- A8. In addition to recording the auditor's test counts, obtaining copies of management's completed inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's inventory records accurately reflect actual inventory count results.

Determining Whether the Inventory Records Reflect the Results of the Entity's Inventory Count (Ref: Para. 4(b))

- A8A. In determining whether the inventory records at the date of the count accurately reflect the results of the entity's inventory count, the auditor may use information produced by the entity as audit evidence. Such information may include perpetual inventory records, inventory lists, inventory transfer reports or inventory reconciliation reports. If information intended to be used as audit evidence is information produced by the entity, Proposed ISA 500 (Revised)²² requires the auditor to evaluate, to the extent necessary, the accuracy and completeness of the information to meet the intended purpose(s) of the audit procedures.

Full Inventory Count

If the Entity's Full Inventory Count Is Conducted Other than at the Date of the Financial Statements (Ref: Para. 5)

- A9. For practical reasons, the entity's full inventory count may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory count or by using technological tools in conducting the full inventory count, or whether the entity maintains a perpetual inventory system. In all cases, the design, implementation and operating effectiveness of controls over changes in inventory determines whether the conduct of the entity's full inventory count at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. Proposed ISA 330 (Revised) establishes requirements and provides guidance on the timing of substantive procedures and tests of controls, including those performed at an interim date.²³
- A9A. The following are examples of audit procedures that auditors may perform if the entity's full inventory count is conducted at a date other than the date of the financial statements to address whether the changes in inventory between the entity's count date and the date of the financial statements are properly recorded.

²² Proposed ISA 500 (Revised), paragraph 12

²³ Proposed ISA 330 (Revised), paragraphs 12–13 and 18

Examples:

- Tests of details over:
 - Management's reconciliation of inventory records between the count date and the date of the financial statements.
 - Inventory movements between the count date and the date of the financial statements by tracing such movements from the inventory records to source documents.
- Tests of controls over inventory movements, including those relevant to the intervening period.

If the Auditor Is Unable to Attend the Entity's Full Inventory Count Due to Unforeseen Circumstances
(Ref: Para. 6)

A9B. If the auditor is unable to attend the entity's full inventory count due to unforeseen circumstances, the auditor is required to perform further audit procedures on an alternative date in accordance with paragraph 6 and may consider the matters described in paragraphs A4 and A6–A9A.

Examples:

Unforeseen circumstances may include:

- Severe weather events.
- Transportation disruptions.
- Sudden illness of the auditor.

Cycle Counts (Ref: Para. 6A)

A10. Where the entity has a perpetual inventory system, management may perform cycle counts instead of, or in addition to, full inventory counts or other control activities to ascertain the reliability of the entity's perpetual inventory system.

A11. When testing the entity's cycle counts, relevant matters in determining whether further audit procedures are necessary in addition to those required by paragraph 4 may include:

- The assessed risks of material misstatement at the assertion level, including the reasons for the assessment of inherent risk and of control risk for the existence and condition of inventory in accordance with ISA 315 (Revised 2019).
- The reliability of the entity's perpetual inventory system, including the results of the cycle counts and the reasons for significant differences between the entity's perpetual inventory records and the results of the entity's cycle counts. These differences may indicate that the entity's cycle count program is not designed, implemented or operating effectively.
- The period between the date the auditor tested the cycle count and date of the financial statements.²⁴

²⁴ Proposed ISA 330 (Revised), paragraph 21

A11A. If there are differences between the entity's perpetual inventory records and the results of the entity's cycle counts, the auditor may:

- Obtain more persuasive audit evidence through substantive procedures by performing test counts of inventory quantities and by inspecting the condition of inventory near or at the date of the financial statements.
- Where mitigating or compensating controls exist that address the existence and condition of inventory, obtain audit evidence about the operating effectiveness of those controls.
- Request management to conduct a full inventory count near or at the date of the financial statements.

Testing How the Entity Addresses the Existence and Condition of Inventory Where the Entity Does Not Conduct a Full Inventory Count or Cycle Counts (Ref: Para. 6B)

A11B. In some entities, management may not perform a full inventory count at or near the date of the financial statements nor cycle counts throughout the reporting period. Instead, the entity may rely on controls related to an automated perpetual inventory system. These may include:

- Direct controls over the receipt, shipment or transfer of inventory;
- Indirect controls that support the operation of direct controls, including general IT controls; and
- Controls over the reconciliation between the entity's automated inventory system and the general ledger.

A11C. In such circumstances, the auditor may have determined, that it is impossible or impracticable to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence regarding the existence and condition of inventory. This may be case where the nature and scale of automation of an inventory system indicates that its reliability depends on controls that operate continuously as the inventory moves through the inventory system. If so, paragraph 6B(a) of this ISA requires the auditor to perform tests of controls that address risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence²⁵ regarding the existence and condition of inventory. Proposed ISA 330 (Revised)²⁶ provides guidance on matters that the auditor may have considered in determining whether substantive procedures alone do not provide sufficient appropriate audit evidence.

A11D. The auditor may determine, in applying paragraph 6B(b), that additional substantive procedures, tests of controls, or a combination of both, are necessary in the circumstances to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. This may include performing:

- Tests of controls in addition to the controls already tested in accordance with paragraph 6B(a). This may be the case, for example, where the auditor determines that additional evidence about the operating effectiveness of controls is necessary to support the auditor's assessment of control risk.
- Additional substantive procedures. This may be the case when the results of tests of controls

²⁵ Proposed ISA 330 (Revised), paragraph 14

²⁶ Proposed ISA 330 (Revised), paragraph A48

do not provide an appropriate basis for confirming the auditor's assessment of control risk,²⁷ or performing tests of controls alone to respond to risks of material misstatements relating to the existence or condition of inventory is not appropriate in the circumstances.²⁸ This may include:

- Performing test counts of inventory quantities and inspecting the condition of inventory near or at the date of the financial statements.
- Testing adjustments to inventory records and investigating significant or unusual adjustments.

Attendance at the Entity's Full Inventory Count or Cycle Counts Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance (whether physical or remote) at the entity's inventory count may be impracticable (see paragraph A1). Impracticable circumstances arise when, despite reasonable efforts by the auditor to attend the entity's inventory count, attendance cannot reasonably be accomplished due to factors such as the nature and location of the inventory.

Examples:

- Where inventory is held in a location that may pose threats to the safety of the auditor (e.g., inventory locations affected by war, civil unrest or outbreaks of disease).
- When the nature of the inventory is subject to stringent safety, security or regulatory restrictions (e.g., inventory that are radioactive or inventory held by pharmaceutical manufacturers).

A12A. 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 ISA 200,²⁹ 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 at the entity's inventory count is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the entity's inventory count, may provide sufficient appropriate audit evidence about the existence and condition of inventory. This may be the case when the assessed risk of material misstatement at the assertion level is such that the inherent risk is not assessed on the higher end of the spectrum of inherent risk and no such risks are determined to be significant risks.

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. This may be the case, for example, when the audit evidence obtained by performing alternative procedures is not sufficiently persuasive compared to the audit evidence obtained by attending the

²⁷ Proposed ISA 330 (Revised), paragraph 26

²⁸ Proposed ISA 330 (Revised), paragraph 16

²⁹ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A53

entity's inventory count. In such cases, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.³⁰

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, including being affected by the inventory arrangements between the entity and the third party. 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.
- The commingling of the entity's inventory with that of other entities being held by the same third party.

A14B. In addition to the matters described in paragraph A0D, other matters that are relevant in designing and performing further audit procedures for inventory under the custody and control of a third party may include:

- The design and implementation of controls at the entity and at the third party.
- Whether or not the inventory arrangements between the entity and the third party limits the auditor's ability to perform certain audit procedures. For example, the auditor may be unable to inspect the inventory when access to the third-party custodian's premises is restricted. Where such limitations prevent the auditor from obtaining sufficient appropriate audit evidence regarding the existence and condition of inventory held by the third party, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.³¹

A14C. [Moved to paragraph A15A]

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

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

Examples:

External confirmation from a third-party custodian may not, on their own, provide sufficient appropriate audit evidence regarding:

- Existence – When inventory is commingled with that of other entities as it may be difficult for the confirming party to distinguish the entity's inventory.
- Condition – When inventory is susceptible to damage, obsolescence or deterioration.

³⁰ ISA 705 (Revised), paragraph 13

³¹ ISA 705 (Revised), paragraph 13

A14E. If the auditor decides to use external confirmation procedures in accordance with Proposed ISA 330 (Revised),³² Proposed ISA 505 (Revised)³³ establishes requirements and provides guidance for performing external confirmation procedures. [Moved from paragraph A15]

A14F. The auditor ordinarily considers it appropriate to perform inspection of inventory held by a third party or determine other types of procedures in performing substantive procedures, tests of controls, or a combination of both, instead of, or in addition to, sending an external confirmation request to the third-party custodian if:

- The assessed risks of material misstatement at the assertion level are such that the assessment of inherent risk is not on 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, or is not expected to be, reliable.

Examples:

Other further audit procedures may include:

- Attending, or arranging for another auditor to attend, the third party's inventory count, 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 issued by a warehouse operator acknowledging that specified inventory has been received and is being held on behalf of the entity.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- Inspecting documentation regarding the inventory custody agreement between the entity and the third party to determine who is responsible for shortfalls of inventory.
- Inspecting the third party's inventory count documentation.

A15. [Moved to paragraph A14E]

When Third-Party Inventory Arrangements Are Within the Scope of ISA 402³⁴

A15A. Arrangements involving inventory held by a third party may fall within the scope of ISA 402 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 records, such as receipts, issues, or transfers.

³² Proposed ISA 330 (Revised), paragraph 11

³³ Proposed ISA 505 (Revised), *External Confirmations*

³⁴ ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

[Moved from paragraph A14C]