

**Implementation Guide to
Standard on Auditing (SA) 501,
Audit Evidence - Specific
Considerations for Selected Items**



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

© The Institute of Chartered Accountants of India.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic mechanical, photocopying, recording, or otherwise, without prior permission, in writing, from the publisher.

Edition : May, 2013

Committee/
Department : Auditing and Assurance Standards Board

Email : aasb@icai.in

Website : www.icai.org

Price : ₹ 150/-

ISBN : 978-81-8441-637-4

Published by : The Publication Department on behalf of the
Institute of Chartered Accountants of India,
ICAI Bhawan, Post Box No. 7100,
Indraprastha Marg, New Delhi – 110 002.

Printed by : Sahitya Bhawan Publications, Hospital Road,
Agra 282 003
June/2013/1,000 copies

Foreword

Evidence obtained during a financial audit and recorded in the audit working papers is audit evidence. Specific Considerations for audit evidence relating to inventory, litigation and claims involving the entity, and segment information in an audit of financial statements are dealt in a separate Standard on Auditing (SA) 501, “Audit Evidence –Specific Considerations for Selected Items”, issued by the Institute of Chartered Accountants of India in March, 2010.

SA 501 focuses on audit evidence relating to existence and condition of inventory, completeness of litigation and claims involving the entity, presentation and disclosure of segment information in accordance with the applicable financial reporting framework. It is important to have specific considerations for these selected items of the financial statements as they involve intricacies which may require specific focus and/or procedures of the auditors.

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India in its endeavour to further facilitate implementation of Standards on Auditing has come out with an Implementation Guide to SA 501 on Audit Evidence- Specific Considerations for Selected Items. I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for bringing out this Implementation Guide.

I am confident that this Implementation Guide would prove to be immensely useful to the members and other interested readers.

May 15, 2013
New Delhi

CA. Subodh Kumar Agrawal
President, ICAI

Preface

Evidence forms the bedrock of the auditor's report on the financial statements. The nature, timing and extent of an auditor's procedures are directed towards obtaining sufficient appropriate audit evidence that supports/ corroborates the various assertions made by the auditee in respect of its financial statements. Having regard to the importance of evidence to an audit engagement, ICAI has issued a suite of Standards focussing on various aspects of audit evidence. For example, the Standard on Audit (SA) 500, *Audit Evidence*, contains the fundamental concepts relating to audit evidence such as what constitutes sufficient appropriate audit evidence, information that can be used as audit evidence, selection of items for testing to obtain audit evidence, inconsistency in or doubts over reliability of audit evidence, etc. In addition, a number of other SAs in the "Audit Evidence" series lay down principles in respect of specific items. For example, SA 505 on External Confirmations, SA 550 on Related Parties, SA 570 that deals with Going Concern, or SA 580 on Written Representations, etc. Similarly, SA 501 deals with special considerations for the auditor while obtaining audit evidence in respect of certain critical items on an entity's financial statements, viz., inventory and litigations and claims involving the entity and segment reporting.

While the Standards lay down the fundamental principles on the relevant aspects of audit, Implementation Guides are brought out to assist the auditors in practical implementation of these principles in real life audit situations. These Implementation Guides are written by experts, presenting these principles, in a simpler language and format. They contain templates, checklists, case studies, etc., as appropriate. These Implementation Guides receive warm acceptance from the practitioners and therefore, help encourage compliance with the Standards among them. Till date the Auditing and Assurance Standards Board has brought out a number of Implementation Guides. The Implementation

Guide to SA 501 is another addition to that growing implementation resource of the Board.

I am extremely grateful to CA. Subhasis Majumdar from Kolkata for sparing time out of his professional and personal preoccupations to write this extremely useful Implementation Guide.

I am also thankful to CA. Subodh Kumar Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing and Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board viz., CA. Naveen ND Gupta, Vice Chairman, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shrinivas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary, CA. Vijay K Gupta, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Niraj Kumar Jhunjunwala, CA. Sanjay Vasudeva, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh and CA. Saunak Ray for their support and guidance to the Board. I also wish to place on record my thanks to the special invitees to the Board, viz., Prof. Manoj Anand, CA. Vijay Sachdeva, Shri Sunil Kadam and CA. Nilesh S Vikamsey for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Implementation Guide its final shape.

I am confident that this Implementation Guide will help the members understand the requirements involved in SA 501 and sharpen their skill sets in this area.

May 15, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

Contents

Foreword

Preface

Snapshot of SA 501	1
Chapter 1: Introduction and Overview.....	12
Chapter 2: Existence and Condition of Inventory	17
Chapter 3: Completeness of Litigations and Claims Involving the Entity.....	52
Chapter 4: Presentation and Disclosure of Segment Information.....	60

Appendices

Appendix 1: Stock Verification Checklist.....	64
Appendix 2: Recording Cut-off Information	67
Appendix 3: Recording of Test Counts by the Auditor	69
Appendix 4: Inventory Balance Confirmation	71
Appendix 5: Letter of General Inquiry to the Entity's Legal Counsel	72
Appendix 6: Letter of Specific Inquiry to the Entity's Legal Counsel	73

Snapshot of SA 501

SA 501 (Revised)

Audit Evidence – Specific Considerations for Selected Items

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

Replaces SA 501(AAS 34), “*Audit Evidence- Additional Considerations for Specific Items*” issued in March 2005.

Overview of SA 501 (R)

- **Introduction**
 - Scope of this SA.
 - Effective Date.
- **Objective**
- **Requirements & Application**
 - Inventory.
 - Litigation & Claims.
 - Segment Information.

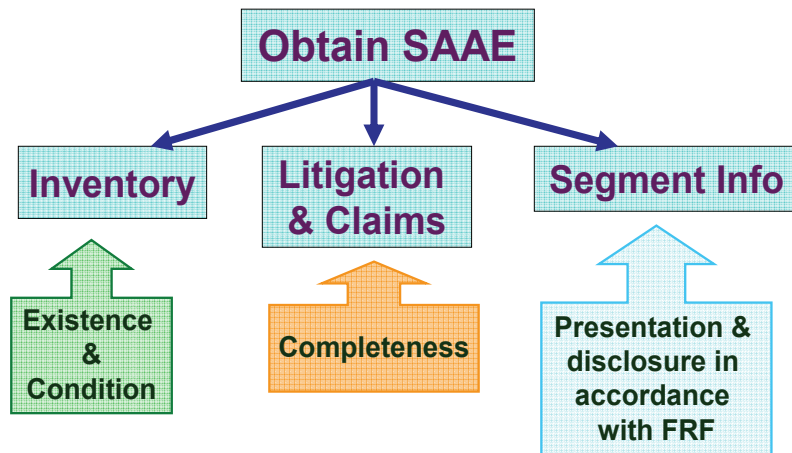
Implementation Guide to SA 501

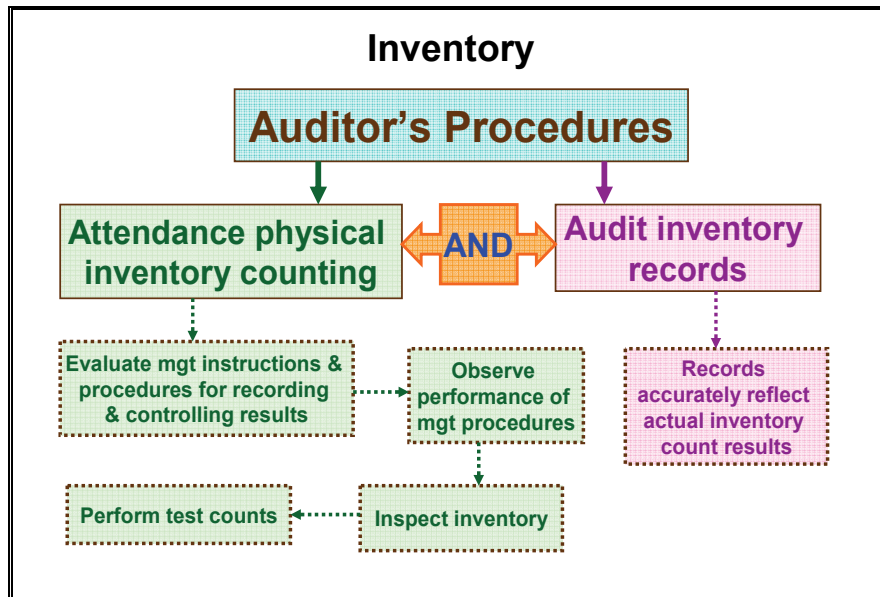
Scope

- Deals with specific considerations by the auditor,
- In obtaining SAAE,
- W.r.t. certain aspects of:
 - Inventory.
 - Litigation & claims.
 - Segment information.
- In an audit of financial statements.

SAAE in accordance with SA 330, SA 500 & other relevant SAs.

Auditor's Objectives



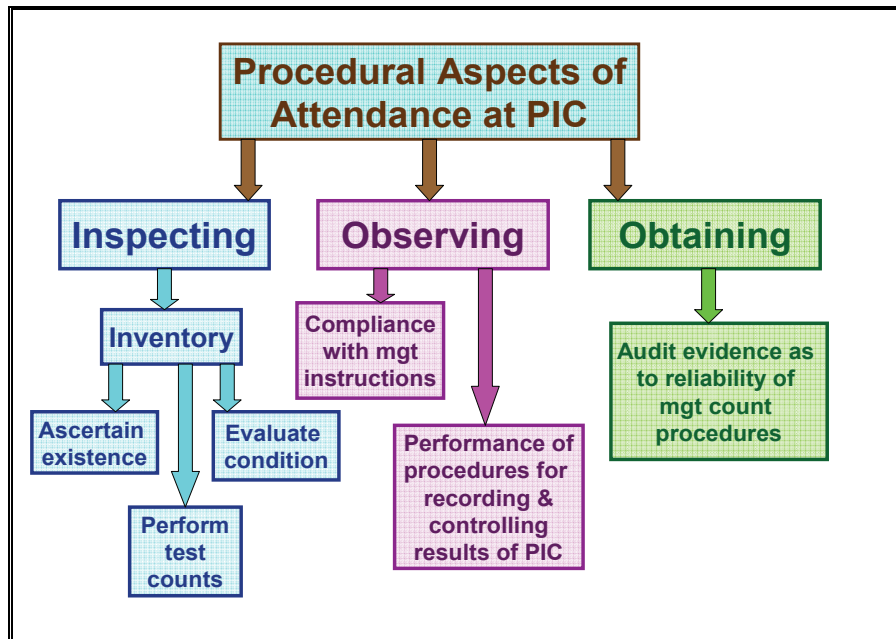


- This requirement applies when inventory is material to the financial statements. The sub-procedures under "Attendance at physical inventory counting" to be performed unless they are impracticable.

Attendance at Physical Inventory Count (PIC)

- At least once a year by mgt to:
 - Form basis for FS preparation.
 - Ascertain reliability of perpetual inventory system.
- Planning the Attendance – matters to consider:
 - Nature of Inventory.
 - Stages of completion of WIP.
 - RMM related to inventory.
 - Nature of ICs related to inventory.
 - Expectation wrt adequate procedures & of proper instructions by mgt.
 - Timing of PIC.
 - Whether entity maintains perpetual inventory system.
 - Locations at which inventory is held.
 - Whether assistance of Auditor's Expert is needed.

Implementation Guide to SA 501



Evaluating Management Instructions

Matters to consider:

- Application of appropriate control activities.
- Accurate identification of:
 - Stage of completion of WIP.
 - Slow moving items.
 - Obsolete/ damaged items.
 - Items owned by 3rd party.
- Procedures to estimate physical quantities.
- Control over movement of inventory before & after cut-off date.

Observing Performance of Management's Count Procedures

- Mgt's count procedures, e.g., controls over inventory movement before, during and after the count, assists the auditor in obtaining audit evidence that mgt instructions and count procedures are adequately designed and implemented.
- Auditor may obtain copies of cutoff information to assist the auditor in performing audit procedures over the accounting for inventory movements at a later date.

Inspection of Inventory

Assists auditor in:

- Ascertaining the existence of inventory.
 - But not necessarily re ownership.
- Identifying obsolete/ damaged/ ageing inventory.

Implementation Guide to SA 501

Perform Test Counts

- Provides evidence re completeness & accuracy of inventory records.
 - E.g., tracing select items from mgt count records to physical inventory & vice versa.
- Assists in performing subsequent audit procedures to determine whether entity's final inventory records accurately reflect actual inventory count results.

PIC After the Date of FS – Additional Procedures

- Obtain SAAE whether changes in inventory between the count date & FS date are properly recorded.
 - Effectiveness of design, implementation & maintenance of controls over change (refer SA 330).
 - Perpetual inventory system:
 - Whether records are properly adjusted.
 - Reliability of the entity's perpetual inventory records.
 - Reasons for significant differences between the information obtained during physical inventory count and perpetual inventory records.
-
- Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

Snapshot of SA 501

- **Auditor unable to attend PIC**
 - Make/ observe PIC at some other date.
 - Perform audit procedures on intervening transactions.
- **Attendance at PIC impracticable:**
 - Perform alternative procedures to obtain SAAE.
 - If these procedures are not possible, modify audit opinion (Ref SA 705).

- PIC may be impracticable:
 - 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.
- Unacceptable Reasons:
 - General inconvenience to the auditor.
 - Difficulty, time, or cost involved.
- 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 SAAE about the existence and condition of inventory.
- In other cases, however, it may not be possible to obtain SAAE 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.

**Inventory Under Control of 3rd Party –
If material to FS**

Obtain SAAE re existence & condition

- Request confirmation from 3rd party as to quantities & condition of inventory held on behalf of entity.

AND/ OR

- Perform inspection or other audit procedures appropriate in the circumstances.

- Where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. E.g.,
 - 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.

Litigation & Claims

- **Inquiry** - of management & others within the entity.
- **Review** – minutes of meetings of TCWG, communication between entity & external legal counsel.
- **Review** – legal expenses account.

If RMM re litigation/ claims is identified, auditor shall **ALSO** communicate directly with entity's external legal counsel.

Direct communication with entity's external legal counsel:

- The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.
- If unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry the auditor may seek direct communication through a letter of specific inquiry.
 - A list of litigation and claims;
 - Where available, mgt's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
 - A request that the entity's external legal counsel confirm the reasonableness of mgt's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.
- In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:
 - The auditor determines that the matter is a significant risk.

Implementation Guide to SA 501

- The matter is complex.
- There is disagreement between mgt and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.
- In accordance with SA 700 (Revised), the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained SAAE on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Need for Modified opinion (SA 705)

- Mgt refuses to permit auditor to communicate/ meet with external legal counsel.
- External legal counsel refuses to respond appropriately/ prohibited from responding.
- Auditor unable to obtain SAAE by performing alternative audit procedures.

Request mgt & where appropriate, TCWG to provide written representations that:

- all known actual or possible L&C whose effects should be considered when preparing FS have been disclosed to the auditor; and
- appropriately accounted for and disclosed in accordance with the applicable FRF.

Segment Information

Obtain SAAE re presentation & disclosure of segment info in accordance with applicable FRF:

- Obtain understanding of methods used by mgt in determining segment info
 - Evaluating whether such methods are likely to result in disclosure in accordance with applicable FRF; and
 - Where appropriate, testing the application of such methods.
- Performing analytical procedures or other audit procedures appropriate in the circumstances.

- Example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information include:
 - Sales, transfers and charges between segments, and elimination of inter-segment amounts.
 - Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
 - The allocation of assets and costs among segments.
 - Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Chapter 1

Introduction and Overview

Introduction

1.1 Unlike most of the other 'Standards on Auditing' (SA) issued under Clarity Project or earlier, which deal with broad aspects of auditing concepts and procedures, SA 501 is quite unique as it focuses on auditing procedures to be performed in relation to certain selected items of the financial statements and in particular only a few assertions in relation to those items.

1.2 Therefore the requirements set out in SA 501, *Audit Evidence – Specific Considerations for Selected Items* (hereinafter referred to as “SA 501”) need to be applied in conjunction with other Standards, in particular, SA 330, *The Auditor's Responses To Assessed Risks* and SA 500, *Audit Evidence*. The purpose of SA 501 is to draw the auditor's attention to the selected financial statements account balances and/or disclosures as set out in the objectives below and to establish requirements relevant to obtaining sufficient appropriate audit evidence about them.

1.3 This Guide provides illustrative guidance to facilitate auditors understand and implement the requirements set out in SA 501 by describing the principles in details and enlisting structured audit approach to achieve the objectives of the Standard.

Objectives

1.4 SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to:

- (a) Existence and condition of inventory (**Chapter 2**);
- (b) Completeness of litigation and claims involving the entity (**Chapter 3**); and
- (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework (**Chapter 4**).

Introduction and Overview

It is noteworthy that SA 501 does not contain any modifications *vis-à-vis* ISA 501.

Effective Date

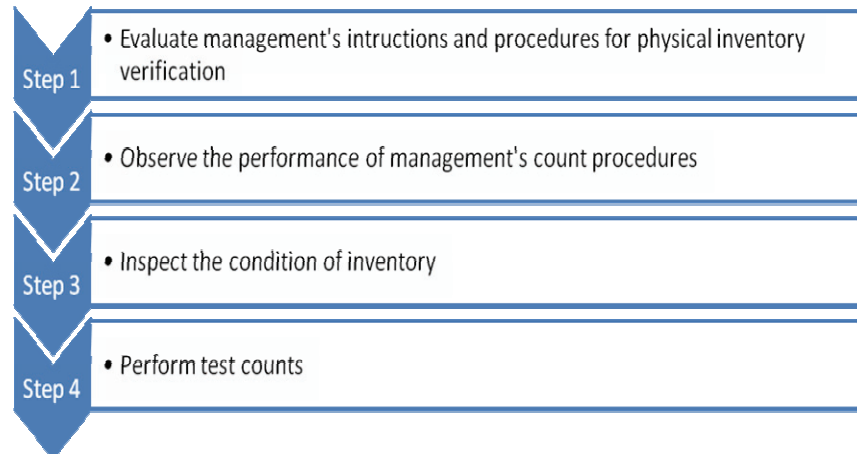
1.5 This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Existence and Condition of Inventories

1.6 In the event where inventory is material to financial statements, the auditor is required to obtain sufficient and appropriate audit evidence in accordance with SA 330, *The Auditor's Responses to Assessed Risks* regarding the assertions associated with inventory, *inter alia*, existence.

1.7 Existence of inventory could be ordinarily verified by way of attendance to management's inventory verification carried out on the date of the financial statements.

1.8 The broad steps/ procedures to be followed in course of physical verification would be as follows:



1.9 In addition, the auditor might come across following three circumstances which would have impact on the audit plan:

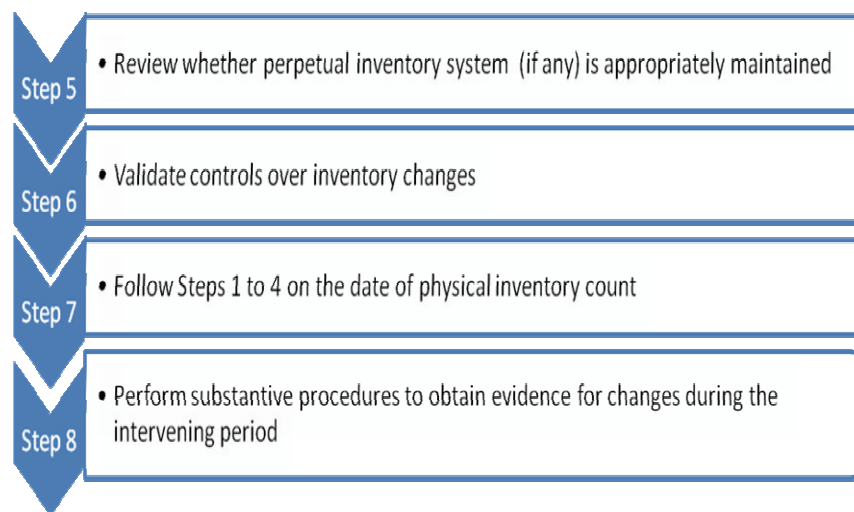
- 1) Physical inventory count is conducted at a date other than the date of financial statements.
- 2) Attendance at physical inventory counting is impracticable.

Implementation Guide to SA 501

- 3) Inventory in the custody of a third party is material to the financial statements.

Situation 1

1.10 If the physical inventory count is conducted at a date other than the date of financial statements following additional step would need to be performed:



Situation 2

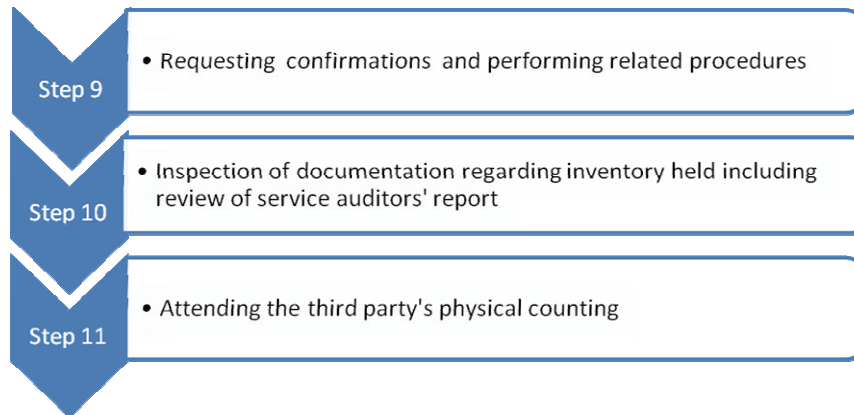
1.11 In the event where attendance to physical inventory count is impracticable due to nature and location of inventory, alternative audit procedures would need to be performed. These would include:

- a) Review of the effectiveness of internal controls on inventory to validate the book records and gain comfort on existence by perusing them.
- b) Inspection of documents to support purchase of such stock held at the date of financial statements as recorded in the books of the entity and also review of subsequent sale of such items of stock.

Introduction and Overview

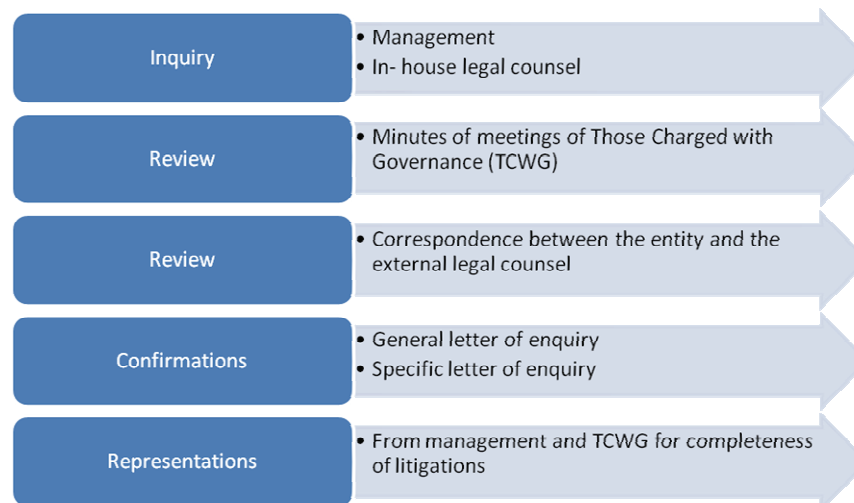
Situation 3

1.12 When inventory held by third parties is material to the financial statements, the auditor needs to perform following audit procedures:



Completeness of Litigation and Claims Involving the Entity

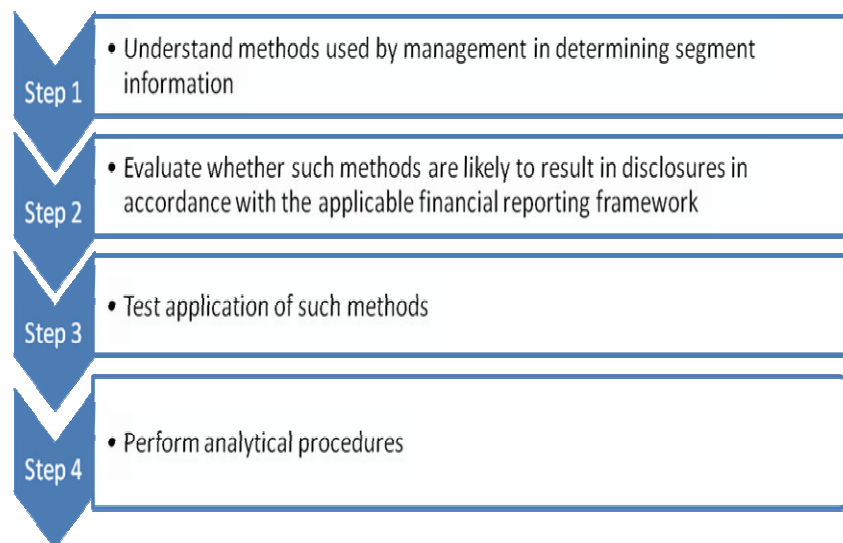
1.13 The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. Such procedures include:



Implementation Guide to SA 501

Segment Information

1.14 The audit procedures in connection with obtaining evidence regarding the presentation and disclosure of segment information include following steps:



Chapter 2

Existence and Condition of Inventory

Definition of Inventories

2.1 Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Physical Verification of Inventories

2.2 Since inventories are tangible assets, usually management ascertains the accuracy and completeness of physical quantities of inventories (denoted in numbers, measurements, weighments etc. depending on nature) through physical verification. Such verification/count is carried out at least once a year nearer to or as on the date of the financial statements to serve as a basis for preparation of the financial statements. In order to facilitate such annual stock count, management generally plans to stop stock movements wherever practicable during course of the verification.

2.3 The physical quantity of inventories is not expected to differ from the recorded stock in case records are updated regularly and accurately for all planned stock movements. However discrepancies arise between physical stock and book records on account of following reasons:

- Breakage and wastage due to improper storage/ handling.
- Natural causes such as shrinkage.
- Natural calamities and accidents.
- Pilferage.

Implementation Guide to SA 501

- Inaccurate updation of book records by way of omissions or errors or fraudulent practices.
- Mismatch between issues and receipts.

2.4 The physical verification process enables management to detect such discrepancies and adjust these in the books and records so that the stock balances which form the basis of valuation of inventories in the financial statements are not misstated.

2.5 At times management follows a structured programme of continuous stock verification wherein items of stock are verified several times during the year. Such count usually forms integral part of perpetual inventory system. As there is an element of surprise check in this system of continuous stock-taking, effective control over stock is exercised on a continuing basis. Further perpetual inventory system does not necessitate closing down of the manufacturing process or suspension of receipts and dispatches of stock to facilitate stock-taking. However in view of higher frequency, this method is expensive and is adopted by big concerns only.

Auditor's Responsibilities

2.6 If inventories are material to the financial statements, the auditor designs the audit plan to place reliance on the assertion of existence by attending the physical count carried out by management. Attendance at such inventory count provides corroborative evidence to the existence of such stock and therefore is an elementary audit procedure.

2.7 In course of audit procedures, the auditor broadly uses the following audit techniques:

Inquiry	of management whether instructions are being issued in relation to stock count procedures and for resolution of inconsistencies, if any
---------	---

Existence and Condition of Inventory

Observation	of compliance with management's instructions and ensuring the procedures for recording and controlling results are in line with the laid down guidance
Inspection	of inventories at the site(s) to determine these actually exist in consonance with the description and condition these are recorded in the books
Reperformance	of management's procedures by performing test counts independently
Inspection	of documents by tracing test counts to the final inventory listing considered for valuation

Timing of Audit Procedures

2.8 Usually if such physical count is carried out on the date of financial statements or a date nearer to the date of financial statements, the auditor attends such count as part of his audit plan to perform substantive procedures.

2.9 When management establishes perpetual inventory procedures, the auditor attends such count to evaluate the controls in relation to such process and considers the results of such attendance in determining the audit plan.

Impact on the Audit Plan

2.10 In planning the audit of financial statements as per guidance provided in SA 300, *Planning an Audit of Financial Statements*, the auditor is also required to plan the strategy in relation to the physical verification of inventories.

2.11 Following from that, the auditor is required to be responsive to the assessed risks of material misstatements and accordingly determine the nature, timing and extent of the substantive audit procedures to address risks identified in relation to the assertion of existence of inventories as well as

Implementation Guide to SA 501

determination of the condition of such inventories.

2.12 In short, the auditor exercises professional judgement to determine whether the assessed risk of misstatement at the assertion level (i.e., existence) is a significant risk and accordingly perform substantive audit procedures to specifically address this risk.

2.13 In order to determine the significance, likelihood and impact of the risk associated with the assertion, the auditor needs to consider matters which could impact the design of the audit plan. Such matters have been mentioned in the following table:

Matters for consideration	Impact on Audit Plan
Nature of inventories	<p>Following attributes of inventories being counted have bearing on the audit procedures to be planned:</p> <ul style="list-style-type: none">• Categories of inventory – Inventories held by an entity can be of varied types such as :<ul style="list-style-type: none">• Raw materials• Stores and spare parts• Work-in-progress• Manufactured finished goods• Trading merchandise <p>Specific issues wrt work-in-progress has been stated below.</p> <ul style="list-style-type: none">• Physical form of inventory – such as solid, liquid or gas. The basis of count and complexities would vary based on the physical form of the inventories.• Unit used – The unit of count or measurement or weightment would

Existence and Condition of Inventory

	<p>need to be ascertained and the relation between such unit and the unit used for stock valuation would need to be established. For example, liquid (example oil) may be measured using a dipstick in a barrel whereby the height is measured. However the circumference of the container would need to be ascertained to compute the volume of the liquid. Further the mathematical formula to compute the volume of such liquid needs to be validated.</p> <ul style="list-style-type: none">• Whether estimation procedures would need to be applied considering the dimensions of inventory or its storage. For example, quantities of coal in piles are estimated based on the dimension as well as the manner in which these are stacked. The basis of estimation is required to be established and understood to determine the reportable count.• Conditions which makes inventory obsolete or unusable – such as medicines which are rendered unusable on account of related expiry dates. In case specific expiry dates are not determined (example perishable items such as food grains), conditions which make such stock obsolete need to be assessed. <p>The auditor is required to have sufficient understanding of the aforesaid aspects prior to attendance to the stock count in order to design the audit plan accordingly and derive requisite</p>
--	---

Implementation Guide to SA 501

	assurance from the procedures followed.
Stages of completion of work in progress	<p>Manufacturing may involve multiple processes. Completion of each of these processes entails usage/consumption of raw materials/stores and spares which determines the stage of completion.</p> <p>While designing the audit plan, the auditor is required to ascertain the mechanism to determine the stage of completion by reference to the last operations performed. In case such determination is not possible independently, the auditor is required to determine the manner in which such estimate could be made.</p> <p>The auditor would need to evaluate whether use of an expert would be appropriate and sufficient. The controls around recording/updating stock movements (issue slips, stock tags etc.) would need to be considered while determining the stage of completion.</p>
Risks of material statements related to inventory	<p>The inherent risks associated with inventories arising from materiality are fundamental and as such the auditor is required to plan the attendance to stock count keeping in mind:</p> <ul style="list-style-type: none">• Value of the inventory at an aggregate level which impacts the considerations of materiality and value at individual locations. Higher coverage in terms of extent of count / locations visited would reduce the risk of material misstatement to an acceptably low level in consonance

Existence and Condition of Inventory

	<p>with the materiality set out for the audit.</p> <ul style="list-style-type: none">• Composition of inventories, i.e., number of inventory line items with divergent features. If there are multiple types of inventories, the risks associated with each of these need to be individually ascertained and addressed accordingly.• Existence of certain high value items within the stock which could be specifically covered through test counts.
The nature of internal control related to inventory	<p>The internal control framework prevalent and the reliance the auditor places on the same is an important consideration in design of the audit plan. The key control objectives which influence the audit plan are as follows:</p> <ul style="list-style-type: none">• Inventory records are recorded with accuracy and completeness in a timely manner (i.e., within the accounting period).• All updates are appropriately authorized.• Differences between quantities received and ordered quantities per purchase orders are reviewed.• The inventory sub-ledgers are updated based on actual physical movements.• Inventory returns are completely and accurately recorded in a timely

Implementation Guide to SA 501

	<p>manner and appropriately authorized.</p> <ul style="list-style-type: none">• Material movements within premises viz., raw materials/stores issued for production etc are completely and accurately recorded and appropriately authorized.• Inventory shipments are completely and accurately recorded in a timely manner and appropriately authorized.• Shipment activity is reconciled and no discrepancies exist between quantities shipped and quantities billed.• Generation and maintenance of scrap is monitored.• Receipts and shipments are adequately safeguarded.• Inventory held is appropriately safeguarded against loss from pilferage and physical deterioration. In case owing to the nature of inventories, susceptibility to theft exists, access to inventories is restricted and monitored.• Storage facilities are commensurate with nature of inventories and quantities of stock held.• Stock is subjected to periodic or continuous stock taking in terms of laid down programme. <p>The auditor is required to understand and evaluate the controls in respect of the aforesaid processes to design the plan for attendance to stock verification.</p>
--	---

Existence and Condition of Inventory

	<p>In case the reliance on controls is considered to be low, the nature and extent of testing would need to be enhanced accordingly.</p>
<p>Whether adequate procedures are expected to be established and proper instructions have been issued for physical inventory count</p>	<p>In order to validate the assertion of existence, management ensures that all items of stock are counted at least once in a year. With a view to ensure that procedures are laid down appropriately and complied with by the staff responsible for the count, management may issue instructions in relation to the stock count.</p> <p>The auditor is required to obtain the instructions issued by management, if any and evaluate them to ensure the key elements in which the counting needs to occur are addressed in such procedures. Related aspects have been covered in details in later part of this Chapter.</p> <p>While observing the count, the auditor ascertains whether the guidance and instructions are being followed by all the count teams.</p>
<p>The timing of physical inventory counting</p>	<p>As per SA 330, <i>The Auditor's Responses to Assessed Risks</i>, "Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies."</p> <p>If the physical count of inventories is carried out on the date of the financial statements, the auditor obtains corroborative evidence to address the risk of misstatement in relation to the existence assertion of the inventories</p>

Implementation Guide to SA 501

	<p>held on that date.</p> <p>However, if the timing of the physical inventory count is different from the date of the financial statements, the audit procedures would be different. This matter has been covered in later part of this Chapter.</p>
Whether the entity maintains a perpetual inventory system	<p>In case perpetual inventory system is maintained, the auditor places reliance on such procedures based on following factors:</p> <ul style="list-style-type: none">• frequency of the count during the year.• completeness on coverage over entire stock during the year.• accuracy and completeness of stock adjustments based on earlier counts during the year.• appropriateness of recording stock movements. <p>In view of continuous stock taking programme, the auditor may evaluate design and implementation of the controls and intended emphasis and reliance on the tests of controls would be higher. Related aspects have been covered in later part of this Chapter.</p>
The locations at which inventory is held	<p>The entity may maintain inventories across multiple units such as:</p> <ul style="list-style-type: none">• separate areas within factory premise earmarked for raw materials and finished goods.• different manufacturing units.

Existence and Condition of Inventory

	<ul style="list-style-type: none">• different storage facilities. <p>In case stock is held at multiple locations, coverage of locations for the purpose of audit is usually determined based on following considerations :-</p> <ul style="list-style-type: none">• Value/volume of inventories at individual locations.• Nature of inventories across each of the locations.• Reliance placed by auditor by evaluation of controls around inventory recording in all locations.• Usage of common principles by count teams across locations.• Past experience of auditors in respect of certain locations being susceptible to errors/frauds with regard to inventories. <p>In terms of SA 330, <i>The Auditor's Responses to Assessed Risks</i>, "the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively." The auditor would follow such procedures (evaluation of tests of controls and gain assurance from such procedures) in relation with the locations where the auditor does not personally attend the stock count in order to obtain reasonable assurance on existence of stock in such</p>
--	---

Implementation Guide to SA 501

	<p>locations.</p> <p>In determining the number of locations to be covered, the auditor may also use sampling techniques enlisted in SA 530, <i>Audit Sampling</i>.</p> <p>However if the auditor assesses risk of misstatements on account of susceptibility to errors/frauds experienced in the earlier periods of audit, the auditor shall maintain professional skepticism and plan to increase the coverage in accordance therewith. In such case, the auditor is required to follow the procedures laid down in SA 240, <i>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</i>'. Such procedures would include consideration of unpredictability in determination of locations by attendance to stock count at different locations or visit on an unannounced basis or target locations which would not otherwise be visited due to the immateriality of stock balance.</p>
Whether the assistance of the auditor's expert is needed	<p>At times on account of unique attributes and nature of the inventories (such as oil, minerals etc.), the skills of an expert might be essential. The guidance of involving an expert is provided in SA 620, <i>Using the Work of an Auditor's Expert</i> and key aspects of this SA are elucidated below.</p> <p>The assistance by experts could be provided both by 'management's experts' as well as 'auditor's experts'.</p>

Existence and Condition of Inventory

	<p>In case management uses an expert, the auditor's decision to use independent 'auditor's expert' would depend upon the nature, scope and objectives of the work; extent of influence by management on the expert and controls within the entity over the management expert's work. The auditor may agree with the management on using the management's expert or using independent expert based on the prevalent circumstances.</p> <p>Competence (nature and level of expertise to provide assistance in physical verification of inventories), capabilities (abilities of the expert to exercise such competencies in the circumstances of the engagement) and objectivity (possible effect of bias and conflict of interest applicable to the assignment) of the expert significantly affect whether the work performed by the expert will be adequate for audit purpose. These considerations would enable the auditor to plan the nature, extent and timing of supplemental audit procedures.</p> <p>The auditor would need to agree on the nature, scope and objectives of the work, documentation/accessibility to working papers as well as respective responsibilities with the expert.</p> <p>It is also imperative that the confidentiality and other related regulatory requirements applicable to the audit of financial statements also apply to the expert.</p>
--	--

Implementation Guide to SA 501

	<p>The auditor is required to evaluate the adequacy of the work performed by the expert. Specific procedures to be performed in this connection would include observation of the procedures followed by the expert during the course of physical verification of inventories, inquiries about process/ procedures followed, corroborating evidence through reperformance, confirming with third parties or publicly available data (where possible) as well as discussions with management.</p> <p>Factors when evaluating the relevance and reasonableness of the findings or conclusions of the expert include whether the report is consistent with industry standards, extent of reservations/limitations on use of information provided by the expert and related implications for audit.</p> <p>Where the verification of inventories involves assumptions and methods used by management, the auditor would evaluate whether the expert has adequately reviewed the assumptions and methods in accordance with any industry standards or consistent with assumptions and methods generally accepted within the expert's field.</p> <p>If the auditor is not satisfied with the conclusions of the expert or the results are inadequate for the purpose of audit, the auditor may plan alternative audit procedures by both expert and the auditor. In case the auditor had earlier</p>
--	---

Existence and Condition of Inventory

	planned to use the management's expert but considers the results to be inadequate, the auditor may engage independent 'auditor's expert' to support the audit. However if it is not possible under any circumstance to obtain requisite audit evidence, the auditor may need to express a modified opinion in keeping with SA 705, <i>Modifications to the Opinion in the Independent Auditor's Report</i> .
--	--

2.14 As part of the execution of the audit plan designed in accordance with aforesaid matters, the auditor needs to perform following procedures.

Step 1: Evaluate Management's Instructions and Procedures for Physical Inventory Verification

2.15 Management may issue instructions for the personnel responsible for count to ensure the count procedures are clearly articulated and consistently followed. Such instructions enable the counters to follow uniform approach across all locations in the expected manner and also provide comfort to the auditor to place reliance on the procedures being followed across locations not being visited by auditors.

2.16 In large multi-locational organisations, written instructions are prepared by management and issued in a timely manner. The auditor is required to obtain such instructions and take cognisance of its contents well in advance to evaluate its impact on the nature, extent and timing of audit procedures in relation to attendance at the stock count. In case verbal instructions are provided by management, the auditor is required to enquire and gain understanding of such instructions. The auditor may plan to attend the session when instructions are verbally issued to the counters.

2.17 Ordinarily the auditor expects following elements to be included in the instructions issued by management:-

- ***Coverage of locations*** – Usually management ensures that

Implementation Guide to SA 501

all items are counted at least once a year so that monitoring controls designed by the entity around stock recording/existence operate in an effective manner. In case there are multiple locations where stock is held, management would deploy different teams of stock counters so that complete coverage across locations is ensured. If all locations are not included in the annual stock count, the auditor is required to understand and assess how management gains comfort on the existence and condition of stock at such locations not covered by the count.

The details of the locations being covered in the annual stock count therefore needs to be mentioned in the instructions.

- *Arrangement of stock* – Inventories need to be stacked or positioned in a manner to facilitate the count with ease and accuracy. For example, inventories of similar nature and units could be assembled together in advance of the physical count in order to gain efficiency during the count. Further if stock cards are maintained, such cards should be updated and displayed prominently in the stock bays.

Instructions to the stock keepers to arrange stock properly prior to count also feature in the count instructions.

- *Duration of count*–The date(s)/timing of the count together with the estimated duration when the count is expected to be performed sets out the overall timeframe of the physical verification. In particular, where the size of the entity and volume of stock warrants stock count to continue over multiple days, it is necessary to plan the expected extent of the count in respect of each of the days.

Such duration and coverage together with intervals need to be included in the count instructions.

- *Persons responsible for various locations and competencies of such staff* – The personnel responsible for physical count should be familiar with the description of the stock and capable of identifying all items of inventories independently. The auditor would take into account

Existence and Condition of Inventory

competencies of staff based on the team composition for each location. It is also essential that such instructions are communicated to all staff concerned prior to the commencement of count.

Details of staff concerned (designation wise) could be mentioned in the instructions. Further the auditor is also required to ensure that such count instructions have been duly approved and stock count is planned to be held under appropriate supervision. The names of supervisory staff and escalation matrix for the purpose of stock verification are included in the instructions.

- *Segregation of duties* – In order to maintain objectivity, it is ideal that the counters are independent of those who are responsible for maintaining stock records as well as the stock keepers.

The auditor ensures this with reference to the staff list referred to above.

- *Coverage / extent of count* – The minimum threshold of the count at each location should be specified in the instructions, in case it is impracticable to count all items of stock on the same day. Under such limitation, the auditor is required to make an assessment on the comfort gained from count procedures and also evaluate controls around perpetual inventory system, if any.

In case such reduced coverage is planned, this needs to be specified in the instructions.

- *Identification procedures for damaged items of inventory* – The criteria for distinguishing damaged/ defective items from the rest of inventories needs to be established and mentioned in the instructions. It is fundamental to identify all such items conclusively in view of the impact of these items on the inventory valuation which is at lower of cost or net realisable value. The stock counters should also possess the ability to identify such items independently.

The objective procedures to identify the condition of the

Implementation Guide to SA 501

inventory and the parameters involved in such assessment should be stated in the instructions in clear terms.

- *Determination of slow moving items* – The criteria for identifying slow moving items within inventories with reference to last date of consumption/ sale (as the case may be) *vis-à-vis* date of manufacture / purchase needs to be stated. Identifying such stock items is fundamental to determine slow moving/ non-moving stock and obsolete stock items and consequential impact on stock valuation at lower of cost and net realisable value.

The ageing criteria to be referenced to identify such stock items should be stipulated in the instructions.

- *Consideration of inventories held on behalf of third parties* – Along with the stock owned by the entity, third party owned stock may also be physically present in the locations of the entity at the time of the physical verification. Such stock includes stock sold but not dispatched, consignor's stock at locations of consignee, components /parts received by the sub-contractor from primary manufacturer for performing further manufacturing process, stock received for repairs etc.

In order to ensure the accurate count of inventory, such stock should be excluded from count. The instructions should provide guidance on identification of such items during the count. The instructions should also state that such items be physically segregated from the stock owned by the entity.

- *Basis of estimation used* - Due to the nature of inventories, estimations may be used to determine the weighment and measurement of the stock. Such estimation techniques need to be consistently followed and should be in line with the accepted industry standards.

The instructions should include the basis / assumptions for the estimates so that uniformity can be ensured.

- *Controls around cut-off procedures* – Based on accounting

Existence and Condition of Inventory

methods followed to recognise ownership of stock by the entity, management would need to include / exclude the items of stock from records maintained and also establish requisite cut off procedures so that all stock held by the entity are subjected to physical count.

Since such information would have significant bearing in ensuring completeness of stock balance, the related principles need to be indicated in the instructions.

- *Controls over stock movement during stock count* – Usually management ensures stock movement are restricted or temporarily suspended during the course of physical verification. This facilitates to determine the exact quantity of the inventories. In case stock movements (viz., receipts of purchased goods, dispatch for sales or issuance of raw materials to manufacturing facilities) occur simultaneously while physical verification takes place, there may be errors arising from omissions or duplications which would make the count procedures ineffective. Therefore it is preferred to temporarily stop stock movements to perform physical verification in an effective manner.

However, if stock movement is expected to continue during stock count, the manner, timing and area of such would movement should be planned in advance so that counting procedures are not adversely impacted with the simultaneous movement of stock. The auditor is required to be aware of all related information in advance as an integral part of the instructions.

- *Count recording procedures including accounting for used and unused count records* – Since the counting procedures necessitate recording of the count, it is imperative to determine whether pre-numbered count sheets would be used and how the used/unused count sheets would be collected and accounted for.

The directives for recording and tracking of the count sheets should therefore be enlisted in the count

Implementation Guide to SA 501

instructions.

- *Method of summarising count results from the original count sheets / tags* – The count results recorded in rough count sheets by counters at different locations need to be compiled together so that the concise quantity of the inventories could be determined. In particular, the hand written notes and counts need to be aggregated / summarised to facilitate the process. Loss of such papers and recording the information in an unusable / illegible manner would not enable management to finalise the results of the verification.

The procedures to perform such process need to be laid down in the instructions for physical inventory counting. In absence of these instructions, the collation process may be inconsistent across locations and determination of results of physical verification may not be timely.

Evaluation of Instructions

2.18 The auditor ordinarily expects the aforesaid factors to be included in the count instructions depending on the nature of inventories and size of the business. In absence of any of these factors which are relevant for the entity, the auditor is required to enquire of management of the approach to be followed by counters in relation thereto.

2.19 In order to ensure that the count procedures are performed in the desired manner, the auditor might also discuss the features of the instructions with the counters prior to commencement of the verification and agree upon the procedures with management in advance.

Step 2 - Observe the Performance of Management's Count Procedures

2.20 SA 500, *Audit Evidence* defines 'Observation' as "looking at a process or procedure being performed by others. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the

Existence and Condition of Inventory

observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.”

2.21 Observation is a real time procedure and since it cannot be reperformed at a later stage, the audit strategy in relation thereto needs to be appropriately designed in advance to determine the audit evidence required to be gathered during the process and requisite documentation to record such evidence.

2.22 In course of observation of the performance of management’s count procedures, the auditor is required to ensure:

- Management’s instructions, if any, in relation to stock count procedures have been complied with.
- In absence of formal instructions, the auditor is required to ensure the procedures followed by the counters address the risks associated with stock count.

2.23 At times, the entity might use computer-enabled hand held scanners to record inventories directly and physical count sheets are not necessary. In such circumstances, the IT general controls and automated controls need to be evaluated to ensure computerised inventory records have correctly updated.

2.24 Suggested checklist which could be used for the purpose of ensuring the appropriateness and completeness of requisite audit procedures in relation to physical verification of inventories has been set out in **Appendix 1** of this Guide.

Cut-off Information

2.25 In addition, the auditor is required to obtain copies of cut off information (both receipts and dispatches) to perform subsequent audit procedures over accounting for stock movements and establish ownership of inventories. Such information is critical to determine accuracy of revenue recognition or ownership of the stock held by the entity on the date of the count.

2.26 Following items need special emphasis while obtaining the

Implementation Guide to SA 501

cut-off information:

- Stock already sold but not dispatched which would lie within the locations of the entity but would no longer form part of the inventories. The auditor is required to examine the sales invoices and dispatch documents to ensure such stock are excluded from count.
- Stock received at the last moment from suppliers would form part of inventories (in case the quality / quantity has been accepted) however all related documents (say supplier's invoice) might not be readily available. The auditor is required to examine the inward receipts to ensure such item has been inventorised and counted. In case the stock items are likely to be rejected on account of quality parameters, such stock should be specifically segregated and not included in the stock listing.

2.27 Suggested template to record cut-off information in course of physical count of inventories has been set out in **Appendix 2** of this Guide.

Step 3 - Inspect the Condition of Inventory

2.28 As per SA 500, *Audit Evidence*, inspection is one of the procedures to obtain audit evidence and such procedure includes physical examination of assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence in the present form.

2.29 However such procedure does not provide any reasonable assurance about the entity's rights on the assets (ownership) or the valuation of the assets. For instance, if an entity holds stock already sold to customers awaiting despatch which is no longer owned by the entity, such stock could be physically present and therefore could be subjected to inspection at such location of the entity however the entity would not have ownership rights of such items of inventory. Similarly, the valuation of inventory determined in accordance with accounting policies followed by the entity would not be ascertained by mere inspection of such stock.

2.30 But inspection of such inventories facilitates assessment of

Existence and Condition of Inventory

'condition' of such inventories which has a bearing on the valuation of inventories. 'Condition' would indicate the usability and marketability of the inventories and assessment of these attributes are essential to ensure that the valuation of inventories is not materially misstated. In particular, it is fundamental to identify the damaged / defective stock (example, broken or unworkable items) and obsolete items (example, non moving stock with reference to ageing or perishable items exceeding expiry dates) so that adjustments could be made to value such stock at net realisable value (which might be lower than cost on account of non-usable condition).

2.31 SA 501 requires the auditor to obtain sufficient appropriate audit evidence about the existence and 'condition' of inventory. 'Condition' is not an assertion in terms of SA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and 'condition' is also not equivalent to 'valuation' although there is a direct correlation between 'condition' and 'valuation' as mentioned above. However 'valuation' of inventories is beyond the scope of the Standard therefore the principles surrounding valuation are not covered in this Guide.

2.32 Stock verification enables the auditor to determine, as far as the auditor is able to ascertain, the condition of the inventory held. Assessing apparent condition of stock provides the auditor with an opportunity to assess any distinct requirement for devaluation of stock.

2.33 At times the condition of the stock may not be ascertainable by mere observation by the auditor. Also on account of the nature of stock it may not be possible for the auditor to determine the condition of inventories in some cases. In both these circumstances, the auditor may involve an expert in line with guidance provided in SA 620, *Using the Work of an Auditor's Expert*.

Discrepancies Noted during Count

2.34 It is imperative to ensure that the stock records reconcile to the stock so counted in terms of both the quantity as well as

Implementation Guide to SA 501

condition. In case adjustments are required due to shortage / surplus / change in condition, the auditor is required to ensure that such discrepancies are noted / collated and adjusted in the inventory records. Such adjustments may occur immediately prior to the completion of the inventory verification or may happen at a later date depending on the accounting systems and approval process followed by the entity.

2.35 In this regard, the auditor is also required to assess whether any inherent weakness is identified in this process which may have a bearing on the financial statements. If any major control weakness is identified in course of the verification, the auditor may consider whether to report the same separately.

Step 4 - Perform Test Counts

2.36 Based on the audit plan, the auditor would determine the extent of coverage during the stock count and test checks to be performed to independently obtain reliance on such procedures. Such reperformance of the management's procedures would in effect supplement the observation on the management's count procedures and in turn provide additional corroborative evidence to the auditor.

2.37 In this regard, the test count would have to be carried out in following manner:

- a) *Recounting items of inventory recorded as 'counted' by management.* Such test counts provide evidence that counting has been performed with accuracy. This is an elementary procedure to support existence of stock and provide reliance on the recordings on the count sheets by the counters.

In case the auditor notes that results of independent recount of stock does not agree with management's count, such discrepancy (which might arise due to inappropriate understanding and application of instructions / methods, omissions/ duplications, issues with overall control over the count etc) needs to be resolved on a real time basis. In case rectification is necessary to be made to the

Existence and Condition of Inventory

management's records or it is felt that there are fundamental errors with following instructions, the auditor is required to assess whether any reliance could be placed on the entire count procedures. In such case, the auditor may consider the option of requesting management for a fresh recount to get reasonable assurance on the accuracy of the count.

- b) *Independently counting items from floor and tracing the same to management's count records* – Apart from recounting certain items as mentioned above which supports the assertion of accuracy, the auditor is also required to ensure the listing used for the purpose of the counting is complete. This can be validated through independent counting of certain items on the floor and tracing them back to the count sheets.

In case such an item counted is not found in the listing or results of the count does not agree with the count sheets, the auditor would need to assess whether the population being considered for such count (represented by the inventory listing) is complete and therefore would bring the facts to the notice of the counters immediately. These would have to be reconciled as these might pertain to stock held on behalf of third parties, items on repair etc. However instances of genuine omissions might indicate that the inventory records are not reliable.

2.38 Both these aforesaid procedures enable the auditor to validate different assertions and are essential to meet the objectives of the count. The auditor cannot plan to obtain reasonable assurance on the existence of inventories just on the basis of observation of the count carried out by the management. The test checks performed in this manner provides evidence to this effect.

2.39 SA 501 does not suggest the number of stock items to be

Implementation Guide to SA 501

counted either way; the auditor is required to apply professional judgement to determine the number of test counts. Based on the criteria influencing the count (such as number of locations, counters, stock items etc.), the auditor might distribute the aggregate test counts across these criteria so that coverage across all such attributes is considered. Each such distinguishing parameter might have different risk considerations associated with them and would need to be addressed separately in terms of coverage. In case of homogeneous population, the entire stock balance could be considered as a single unit.

2.40 When the auditor requires higher degree of evidence in support of the existence, the number of test counts would need to be increased commensurately. The auditor might use audit sampling techniques in accordance with SA 530, '*Audit Sampling*' to determine the sample size to be counted and satisfy on a real-time basis that the procedures as designed have been followed and the results are recorded with accuracy and completeness.

2.41 Sample format to record test counts by the auditor has been set out in **Appendix 3** of this Guide.

2.42 Certain decisions might need to be taken in course of the stock verification depending on the circumstances on a real time basis and therefore it is imperative that the audit team attending the stock count is appropriately experienced and skilled to exercise such professional judgement.

Completion of the Count Procedures

2.43 Prior to the completion of the count process, the auditor might also obtain following:

- Representation from counters and their supervisors that instructions issued by management in connection with stock verification have been followed.

- Signed copies of management's final and completed physical inventory count records which the auditor would use subsequently to determine the entity's final inventory

Existence and Condition of Inventory

records accurately reflect actual inventory count results.

Tracing counts to final inventory records used for stock valuation

2.44 In course of the substantive audit procedures performed subsequently, the auditor is required to ensure that inventory counted during physical verification is accurately and completely recorded in the final inventory listing. The extent of such subsequent testing would depend on the related controls and the level of assurance the auditor seeks from such tests.

2.45 The procedure could be performed in following manner:-

- Trace certain items from the count sheets to the final inventory listing to ensure accuracy.
- Trace certain items from the final inventory listing to count sheets to ensure completeness. 2.46 In case discrepancies are noted either way, the auditor is required to inquire management of the reasons and get the final inventory listing updated in all respects.

Physical inventory Count is Conducted at a Date Other the Date of the Financial Statements

2.47 For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may happen irrespective of when:

- Management determines inventory quantities by an annual physical inventory counting.
- The entity maintains a perpetual inventory system.

Steps 5 to 7 - Perpetual Inventory System

2.48 Where a perpetual inventory system is maintained, an entity would use periodical counts to ensure all items of inventory are counted at least once during the year and some items (particularly high value ones) are counted several items during the year. Such periodical counts provide assurance to the management about the existence of stock on an ongoing manner

Implementation Guide to SA 501

and no major surprise from shortage / surplus on physical verification occurs at the date of financial statements. Such procedure form part of the control framework management intends to set up. In accordance with such plan, the differences which are noted during the periodical physical counts are investigated and reconciled on a timely manner and adjusted in the accounting records.

2.49 Testing the effectiveness of the periodical counts where perpetual inventory records are maintained is therefore a predominantly a test of control. While performing the test, the auditor performs following:

- Evaluate controls over the perpetual inventory process, i.e., recording of stock movements on timely manner.
- Testing whether the discrepancies in periodical stock count during the year has been reconciled and adjusted on a timely manner.
- Attendance to certain counts and observing the procedures followed.

2.50 In course of determining the extent of testing of such controls, the auditor is required to take cognisance of:

- Completeness and frequency of perpetual inventory system covering all items of stock / locations.
- Effectiveness of the count procedures, viz., approved plan for counts, availability/compliance with instructions, capabilities / objectivity of counters, procedures followed, records maintained (count sheets, results).
- Reliability of the entity's perpetual inventory records.
- Appropriateness of adjustments including reconciliation process and relative approval mechanism.

2.51 In some cases, the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls

Existence and Condition of Inventory

over changes in inventory are not operating effectively. In such case, the reliance expected to be placed on the process would diminish accordingly and substantive audit procedures in form of tests of details would have to be performed.

Step 8 - Additional audit procedures if physical verification is held at a date other than date of financial statements

2.52 In case the annual stock count is performed at a date other than the date of financial statements, the auditor is required to perform substantive procedures to ensure that the stock balances reflected at the date of financial statements are in consonance with the balances counted at the time of the physical verification. The auditor needs to assess the reliance to be placed on the controls over inventory movements and perform procedures to verify movements during the interim period between the date of the stock count to the date of the financial statements.

2.53 It is fundamental to evaluate the operating effectiveness of controls during the intervening period to determine the extent of testing through use of audit sampling techniques or otherwise. The inherent and fraud risks and susceptibility of errors assessed based on past experience would also need to be considered. The effectiveness of the process would also be dependent on the time gap between the interim assessment of existence and the date of the financial statements.

2.54 In terms of reperformance, the movements of stock in nature of receipts and issues during the intervening period need to be adjusted to derive the expected closing balance of inventories at the date of the financial statements. Such reperformance and verification of underlying information with sufficient appropriate audit evidence (purchase and sales documentation) would provide reasonable assurance on the stock balance reported at the date of financial statements.

2.55 Adjustments of such nature could occur in following manner:

- a) If the stock count is held prior to the date of the financial

Implementation Guide to SA 501

statements and physical balances need to be roll-forward, the adjustments would be :

	Balance physically verified as on date of stock count
Add:	Receipts from the date of stock count to the date of financial statements
Less:	Issues from the date of stock count to the date of financial statements
	Expected stock balance as on date of financial statements

- b) If the stock count is held subsequent to the date of the financial statements and physical balances need to be roll-back, the adjustments would be :

	Balance physically verified as on date of stock count
Add:	Issues from the date of stock count to the date of financial statements
Less:	Receipts from the date of stock count to the date of financial statements
	Expected stock balance as on date of financial statements

2.56 Based on aforesaid calculations, the auditor would be able to determine the expected stock balance at the date of the financial statements. In case differences are noted between such derived stock balance and the stock listing used by management for the purpose of financial statements, the auditor would request management to reconcile the difference.

Attendance at physical inventory count is impracticable

Existence and Condition of Inventory

2.57 In certain circumstances, attendance at physical inventory counting may not be feasible. 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. However such instances would be exceptional as ordinarily it would be possible for the auditor to attend such count.

2.58 In case of multi-location audit (i.e., when inventories are held in multiple locations), the auditor would determine the extent of coverage in terms of locations where attendance is necessary based on assessed risks.

2.59 While considering rationale for not attending physical count, the auditor should merely not consider general inconvenience or difficulties in arranging staff to attend counts in multiple locations. SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Standards on Auditing* clarifies that “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”. SA 200 further states that “there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise. Consequently, it is necessary for the auditor to plan the audit so that it will be performed in an effective manner.”

2.60 However if attendance is actually impracticable, alternative audit procedures are performed to ensure that alternative audit evidence is obtained to ensure validation of existence of inventories in appropriate conditions.

2.61 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

Implementation Guide to SA 501

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.

2.62 Extent of such testing would be determined based on the materiality of the inventories not being subject to physical count, risks of non-existence envisaged based on past experience and the control environment prevalent in the entity.

When sufficient appropriate audit evidence is not obtained

2.63 However, in some rare instance, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventories and the aforesaid alternative audit procedures cannot be performed effectively. This would happen when the reliance on controls around the procurement process is not strong and the inventories held at the end of the period of audit might not have been sold in the subsequent period and no other evidence exists to support existence of the inventories. In such infrequent occasions, the auditor may consider implications in keeping with SA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

Inventory under the Custody and Control of a Third Party

2.64 On certain occasions, stock could physically be held under the custody of parties other than the entity which owns the stock. Instances when such situations arise could be as follow:

- Bonded warehouses and godowns for storage purpose.
- Sub-contractors for manufacturing process.
- Consignees for sale.
- Clearing and forwarding agents.
- Stock sent to manufacturer for repair or servicing.

Existence and Condition of Inventory

2.65 In these circumstances, the entity owning the stock has limited control on the physical custody of the stock. The locations where such inventories are held are also different from that of the entity. The auditor ordinarily has no direct access to these items of stock and generally does not attend the physical count of inventories held in such locations. Under such circumstances, the auditor is required to obtain alternative audit evidence to support the existence of inventories.

2.66 An effective audit procedure to obtain reasonable assurance in this regard is through obtaining confirmations from the third party who is the custodian of such stock. SA 505, *External Confirmations* outline the requirements and provides guidance for performing external confirmation procedures. Related guidance in this regard has been described below.

Step 9 - Salient Features of Confirmations Process

- *Requesting confirmations* - Such auditing procedures would include requesting information of inventory balances from the third parties physically holding the stock. These could be generally through positive external confirmation requests asking the third party to reply directly to the auditor, either by indicating the confirming party's agreement with the inventories balances stated in the confirmation requests, or by asking the confirming party to provide information of stock held by them. The extent of coverage for such procedure could be determined by using the principles laid down in SA 530, *Audit Sampling*.

Suggested template which auditor could use for requesting such information has been set out in **Appendix 4** of this Guide. The template has been designed in order to request positive confirmation of balance held by third parties. The auditor is required to customise the template in case he plans to send a negative confirmation request (a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request).

Implementation Guide to SA 501

- *Limitation on circularisation of confirmations* – In case management does not allow the auditor to send a confirmation request to the third parties holding stock on behalf of the entity, such refusal may be considered as a limitation on audit evidence the auditor may wish to obtain and may be indicative of fraud in certain cases. The auditor is therefore required to inquire as to the reasons for the exclusion of those third parties and validate the reasonableness of the reasons.
- *Responses and results* – If the third parties respond to the auditors directly and the information provided thereby is in agreement with management records, the auditor may consider this is sufficient appropriate audit evidence. However in case of unreliable / contradictory responses as well as non-responses, the auditor may need to gather evidence through alternative procedures as stated below. In this connection, the auditor may also need to evaluate whether a fraud risk factor exists in accordance with SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

Steps 10 to 11 - Additional Audit Procedures

2.67 Depending on the circumstances, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

2.68 Examples of other audit procedures include:

- 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. Such test would enable the auditor to assess whether any reliance could be placed on the information provided by the third party.

SA 402, *Audit Considerations Relating to an Audit Using A Service Organisation* sets out guidance in relation to the

Existence and Condition of Inventory

assurance the auditor can place on the design effectiveness and operating effectiveness of controls at service organisation.

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts and dispatch notes. Based on the reliance placed on control framework, examination of records would provide greater comfort to the auditor on the existence of inventories held by third parties. The auditor would have to determine the level of comfort required and reliability of evidence while performing such procedure.
- Requesting confirmation from other parties when inventory has been pledged as collateral. Such situation would arise where the inventories are collaterally held by banks/ lenders who provide financial assistance to the entity and independent stock audits are held to corroborate the assertion of existence/ valuation on a periodical basis.
- Arranging for another auditor to attend, the third party's physical counting of inventory, if practicable in accordance with SA 600, *Using the Work of Another Auditor*.
- If practicable, the auditor can attend the stock verification carried out at the third party locations and observe the count / perform other audit procedures. This would enable the auditor to corroborate the inventory balance independently. Such consideration would however depend on the requisite access to such locations at which such inventories are maintained by third parties and presence of management representatives along with the auditors.

Chapter 3

Completeness of Litigations and Claims Involving the Entity

Litigations and Claims

3.1 Every entity is required to be compliant with the legal and regulatory requirements it is subjected to. Further every entity also needs to adhere to the terms and conditions of the major contractual obligations it has entered into in course of its business.

3.2 In relation to the above, there may be a number of litigations and claims involving the entity, for example, disputes with tax authorities on claims against the entity or litigations by regulatory authorities on legislative matters or lawsuits for breach of contractual arrangements. In view of the nature and magnitude of such claims, at times these individually or in aggregate may have material effect on the financial statements.

3.3 *SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* provides guidance relevant to the auditor's considerations of litigations and claims requiring accounting estimates or related disclosures in the financial statements (for example, accounting estimates on amount and timing of cash flows being dependent on the uncertainty around judgement in a litigation).

Completeness of Litigations and Claims

3.4 SA 501 states that the objective of the auditor is to obtain sufficient appropriate audit evidence regarding the completeness of litigations and claims involving the entity.

3.5 In order to ensure this, the auditor is required to gain understanding of the regulatory framework within which the entity operates and be aware of the developments within business operations using the guidance provided in SA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*.

Completeness of Litigations and Claims

3.6 Based on such preliminary assessment, the auditor is required to perform the following steps at a minimum to identify the litigations against the entity:

<p>Inquiry of management</p>	<p>The auditor needs to seek information from the management about existence of claims and litigations against the entity and obtain a list from management which has been considered for the purpose of preparation of financial statements. Such queries need to be made to both financial and operational management.</p> <p>There could be lawsuits against the entity which would have no financial implications. In such cases the auditor would inquire of management how such assessments have been made.</p> <p>The auditor also needs to assess how the lawsuits are reported to management and evaluate the controls around such process of identifying claims.</p> <p>While performing such audit procedure, the auditor would be able to ascertain whether the litigations considered by management (in particular the financial staff who are responsible for accounting and disclosure of such litigations) are accurate and complete in all respects.</p> <p>In this connection, the auditor may also obtain copies of significant contractual arrangements entered into by the entity including arrangements for banking, loan and guarantees. The auditor is required to review such documents to identify whether potential non-compliance of the related covenants could result in litigation against the entity.</p>
------------------------------	---

Implementation Guide to SA 501

	<p>The auditor is required to ensure that the accounting implications of the litigations have been duly considered. For this purpose, the auditor would need to assess the probable outcome of each such litigation through appropriate inquiry and review of corroborative documents. The probable outcome would play a key role in accounting and disclosure of such litigations in terms of the applicable financial reporting framework.</p>
<p>Inquiry of in-house legal counsel</p>	<p>In case the entity maintains an internal legal cell or engages an in-house legal counsel who oversees and handles litigations against the entity, the auditor may be able to obtain the comprehensive list of all claims from such counsel. In case tax related matters are separately handled by in-house tax department within the entity, the auditor would need to probe the facts from such cell.</p> <p>In case there are discrepancies between the list considered by management and the list maintained by the in-house counsel, the auditor is required to gain comfort over the process of transmission of relevant information to the finance department.</p>
<p>Reviewing minutes of meetings of Those charged with governance</p>	<p>Generally all key matters including major litigations the entity is involved in are brought to the notice of Those charged with governance by the management. The summary of discussions and decisions taken in the meetings of Those charged with governance are recorded in the minutes of the related meetings.</p>

Completeness of Litigations and Claims

	<p>The auditor is required to inspect the minutes of all such meetings held during the period of financial statements and subsequent period thereof to ascertain the completeness of the list of litigations. In case the auditor identifies references of litigations in the minutes of meetings which are not included in the list provided by management, the auditor is required to inquire the management as well as Those charged with governance for clarifications.</p>
Reviewing correspondence between the entity and its external legal counsel	<p>In case the entity appoints external legal counsel to represent the entity in litigations and other legal matters, the auditor is required to inspect the correspondence between the entity and the legal counsel. The auditor would be able to gain understanding and perspective of the matters including the terms of reference, the progress made so far as well as probable outcome of the litigations by reviewing these correspondence.</p>
Reviewing legal expense accounts	<p>Another test which the auditor would be able to perform to identify the litigations is through review of the legal expenses incurred by the entity. The auditor may scrutinise legal expenses accounts and trace the expenses incurred to the supporting documents, i.e., invoices from external legal counsels. The auditor would be able to gain comfort on the existence of relationship with any legal counsel by way of such procedure. However such procedure would be required in case the auditor places less reliance on the audit evidence obtained from all the aforesaid</p>

Implementation Guide to SA 501

	procedures.
Obtaining management representations	The auditor is also required to request written confirmation from management and 'Those Charged with Governance' in keeping with SA 580, <i>Written Representations</i> that all known actual or possible litigations and claims which have impact on the financial statements have been disclosed to the auditor and have also been accounted for / disclosed in accordance with applicable financial reporting framework.

Communication with the Entity's External Legal Counsel

3.7 Subsequent to aforesaid procedures, the auditor may identify risks of material misstatements around litigations and claims, for example, in case it is envisaged that the probable outcome of the litigation may have significant financial consequence including impact on going concern assumption. In certain cases on account of inconsistent information provided by management, the auditor may not have adequate comfort on the completeness of list of litigations provided by management. Under such circumstances, the auditor may evaluate whether direct communication with the external legal counsels are necessary for the purpose of the audit.

3.8 Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims have been properly identified and management's estimates of the financial implications of such litigations, including cash flows and costs, are reasonable.

3.9 For the purpose of identifying external legal counsel, any legal counsel who handles legal matters of the entity needs to be considered. These might even include counsels who are

Completeness of Litigations and Claims

infrequently used by the entity.

Procedures of Direct Communication with External Legal Counsel

3.10 In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry.

3.11 For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of the following:

- any litigation and claims that the counsel is aware of.
- an assessment of the probable outcome of the litigation and claims.
- a reliable estimate of the financial implications, including costs involved.

3.12 Suggested template of a general enquiry letter to the entity's external legal counsel is included in **Appendix 5** to this Guide.

3.13 If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry.

3.14 For this purpose, a letter of specific inquiry includes:

- a list of litigation and claims as provided by management;
- where available, management's assessment of the probable outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- a request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is

Implementation Guide to SA 501

considered by the entity's external legal counsel to be incomplete or incorrect.

3.15 Illustrative template of a specific enquiry letter has been set out in **Appendix 6** of this Guide.

Evaluation of Responses Received from Legal Counsels

3.16 Estimates and disclosures considered by management relative to the litigations and claims need to be validated based on responses received from legal counsels in form of the letters of general / specific enquiry.

3.17 For this purpose, the responses would need to be understood properly and disclaimers with reference to scope of work performed as well as representations made by the counsels would have to be comprehended with clarity to assess the actual circumstances. In case of ambiguous responses, further information might need to be sought through a letter of specific enquiry if comfort need to be placed on the response.

3.18 In case the opinion expressed by the legal counsel is inconsistent with other information / evidence available in relation to such litigation, such contradictions need to be resolved with assistance from management. In such circumstance, the auditor may consider meeting the legal counsel together with management's representatives. Further, the auditor may consider personal meetings to discuss the outcome and implications of the lawsuit with legal counsel when:-

- The matter poses to be of significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel.

Timing of the Response

3.19 In accordance with SA 700, *Forming an Opinion and Reporting on Financial Statements*, the auditor is required to date

Completeness of Litigations and Claims

the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel to take appropriate cognisance of any subsequent events which might have a bearing on accounting and disclosure requirements. While determining whether updated information is required, the auditor is required to consider whether the likelihood of interim developments are probable or remote and the significance as well as impact of the developments in the intervening period. Therefore the time gap between the date of response received and the date of the audit report is critical to determine this aspect.

Unable to Communicate or Meet Legal Counsel

3.20 If the auditor faces restrictions from management to communicate with the legal counsel (through letters of enquiry or meetings as deemed necessary), the auditor is required to consider whether there is a limitation in performing audit procedures. Further, the auditor may be unable to obtain sufficient appropriate audit evidence since the legal counsel does not respond the enquiries of the auditor appropriately. In both cases, the auditor is required to consider the impact on the auditor's opinion as required by SA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

Chapter 4

Presentation and Disclosure of Segment Information

Segment Information

4.1 Ordinarily information about different types of products or services of an enterprise and different geographical locations where the entity operates are collectively known as segment information. Such information is relevant to assessment of risks and returns of a diversified and multi-locational entity.

4.2 Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements.

Auditor's Responsibilities

4.3 The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand-alone basis.

Audit Procedures

4.4 In order to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework, the auditor is required to perform the following procedures:

Obtaining an understanding of the methods used by management in determining segment information	<p>The auditor would need to primarily gain understanding about the operations of the entity using the guidance provided under SA 315, <i>Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment</i>.</p> <p>Understanding of the operations of the</p>
---	--

Presentation and Disclosure of Segment Information

	<p>entity and its encompassing regulatory framework would assist the auditor to identify the divergence in risks and returns of the different operations of the entity which are distinguishable in terms of products or services it provides or the geographical locations it is connected with.</p> <p>This would eventually enable the auditor to understand the methods used by management in determining segment information. The auditor would also need to be familiar with the internal reporting framework prevalent in the entity which is used by management to ascertain such information.</p>
Evaluating whether such methods are likely to result in appropriate disclosures in conformity with the applicable financial reporting framework	<p>The auditor would need to assess whether the methods deployed by management is sufficient and appropriate to provide comfort to management that the presentation and disclosure requirements as set out in the applicable financial reporting framework could be adhered to.</p> <p>Such evaluation would predominantly be performed through inquiry of management regarding the mechanism and methods adopted.</p> <p>Certain key aspects which may be relevant in this connection would be procedures followed by management regarding adjustments of:-</p> <ul style="list-style-type: none">• Sales, transfers and charges between segments• Elimination of inter-segment amounts.• Comparisons with budgets and other expected results, for example,

Implementation Guide to SA 501

	<p>operating profit as a percentage of sales.</p> <ul style="list-style-type: none"> • Allocation of assets and costs among segments. • Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.
Testing the application of such methods	<p>In case the auditor is satisfied with design of the methods deployed by management in order to present and disclose segment information in accordance with applicable financial reporting framework, the auditor is required to verify the application of such methods.</p> <p>Such tests would include tests of controls around the internal reporting structure within the entity, and evaluation of supporting documentation/calculations to determine segment information.</p> <p>The overall segment information needs to reconcile with the financial statements in aggregate and internal adjustments as stated above are also required to be made ensuring accuracy and completeness of all aspects.</p> <p>In case the methods are not consistent with previous reported periods, the auditor needs to validate reasonableness of the proposed change and also consider whether any additional disclosure is required to reflect such change.</p>
Performing analytical procedures or other audit procedures	<p>The auditor is not required to perform audit procedures that would be necessary to express an opinion on standalone basis in respect of presentation and disclosure of segment information. This requirement affects the risks associated with the</p>

Presentation and Disclosure of Segment Information

	<p>disclosure and enables the auditor to place significant reliance on analytical procedures to obtain requisite evidence in relation thereto. This is supported by SA 330, <i>The Auditor's Responses to Assessed Risks</i>, which states that "if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence".</p> <p>In terms of SA 520, <i>Analytical Procedures</i> the term "analytical procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount." Ordinarily performance of such procedures would be able to provide sufficient appropriate audit evidence to the auditor.</p> <p>In exceptional cases, where the reliance on controls around internal reporting framework operative in the entity is low, the auditor may need to perform further procedures to gain comfort on the presentation and disclosure of segment information reported in the financial statements.</p>
--	---

Appendix 1

Stock Verification Checklist

Name of the entity:

Year / period ended:

Location:

Date of count:

Categories of stock:

Basis and unit of count/ weightment / measurement of stock:

Particulars of counters / supervisors to count:

	Questionnaire	Yes / No / NA	Remarks
1.	Has management issued instructions for stock verification? If yes, has auditor obtained a copy and evaluated the instructions?		
2.	Does the physical verification cover all items of stock? If no, how does management gain comfort on existence of such uncounted stock items?		
3.	Are the stock items arranged properly to ensure effective count? If no, how would the counters ensure accuracy and completeness of stock?		
4.	Are the stock items easily		

Appendices

	<p>identifiable?</p> <p>If not, what procedures would the counters follow?</p>		
5.	<p>Are the counters independent of persons maintaining stock records and those who handle stock movements?</p> <p>If not, are there any issues anticipated due to inadequate segregation of duties?</p>		
6.	<p>Are there stock movements during the course of the count?</p> <p>If yes, what controls exist over omissions and duplications during count?</p>		
7.	<p>What procedures are followed by the counters to record the count together with description (if any)?</p> <p>If there are multiple count sheets, what controls are in place for distribution and collation of count sheets?</p>		
8.	<p>Are there items of stock within the location which are held on behalf of third parties?</p> <p>If yes, have such items been excluded for the purpose of stock count?</p>		
9.	<p>Have slow moving and non-moving items of stock been identified and counted?</p>		
10.	<p>Have defective, damaged and obsolete items of stock been identified and counted?</p>		

Implementation Guide to SA 501

11.	Does the entity have work-in progress? If yes, how is the stage of completion and materials held for internal consumption determined?		
12.	Has cut-off information for last receipt and issues noted?		
13.	Has the auditor independently counted a sample of items from the count sheets to floor and another sample from floor to the count sheets?		
14.	Are there any uncounted stock items lying in the location? If yes, have they been accounted for?		
15.	Have the management's instructions been followed?		
16.	Are any apparent weaknesses in control environment around stock movement / storage noted?		
17.	In case of any discrepancies, has the auditor immediately followed up with the supervisor to stock count and reconciled the same?		
18.	In course of observations and test counts, is the auditor satisfied that the documentation of physical count represent the description/quantity/ condition of stock?		

.....

(Signature of audit team member attending stock verification)

Appendix 2

Recording Cut-off Information

Receipts

Last Goods Receipt Note (GRN) Reference	Date	Description	Quantity	Physically verified – Yes / No?	Supplier Invoice Reference – (where available)

The auditor is required to ensure that the stock received prior to the noted GRN (including the above) has been inventorised in the proper accounting period and stock received subsequent to the aforesaid GRN has been accounted for in the subsequent accounting period.

Internal Issues to Manufacturing Process

Last Material Issue Note Reference	Date	Description	Quantity	Physically verified – Yes / No?	Consumption records updated – Yes / No?

The auditor is required to ensure that issue of materials for consumption during manufacturing process has been accounted for in the appropriate accounting period with reference to the Material Issue Note.

Implementation Guide to SA 501

Dispatches

Last Sales Invoice Reference	Date	Description	Quantity	Excluded from stock if held within premises – Yes / No?	Challan reference (where available)

The auditor needs to ensure that the sales recorded prior to the above invoice (including the same) has been considered for revenue recognition in the appropriate accounting period and revenue recognition in respect of subsequent invoices is considered in the next accounting period.

Appendix 3

Recording of Test Counts by the Auditor

Items selected from inventory listing and physically recounted along with management's stock counters

Count sheet reference	Description per inventory listing	Identification mark (part number etc)	Unit	Location (where applicable)	Quantity counted	Comments (Condition etc)
					These need to agree with management's count to ensure accuracy	

Items independently counted from floor and traced back to management's count sheet

Description per inventory listing	Identification mark (part number etc)	Unit	Location (where applicable)	Quantity counted	Count sheet reference	Comments (Condition etc)
					Stock counted needs to	

Implementation Guide to SA 501

					be traced	
					back to	
					the count	
					sheets to	
					ensure	
					comple-	
					teness	

Appendix 4

Inventory Balance Confirmation

[Date]

[Particulars and Address]

Dear Sirs

As an audit requirement, you are requested to confirm the following list of stock items held by you on our behalf as on...(date of financial statements) directly to our auditors...(Name and Address of the auditor)

Description of stock

Quantity

xxxx

yyyy

Please confirm this on the attached copy of this letter by signing and duly returning it to our auditors. If the balance stated does not agree with your books and records please provide the data as per your records, including balances not listed above.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

.....

(Signature and particulars of management representative)

Appendix 5

Letter of General Inquiry to the Entity's Legal Counsel

[Date]

[Name of Counsel and Address]

Dear Sirs

As an audit requirement, you are requested to provide the following information directly to our auditors.....(Name and address of the auditor):

- a) List of litigations and claims involving us as on.....(date of financial statements) for which legal advice or representations have been sought from you.
- b) Evaluation of the outcome of the aforesaid litigations and claims and whether the likelihood of potential favourable judgement in our favour is probable or remote.
- c) Your estimate of the financial implications of the lawsuits.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

.....

(Signature and particulars of management representative)

Appendix 6

Letter of Specific Inquiry to the Entity's Legal Counsel

[Date]

[Name of Counsel and Address]

Dear Sirs

As an audit requirement, we have made assessment of the outcome of the litigations and claims against us in respect of which we have sought your legal advice and representations.

List of lawsuits	Assessment of outcome	Financial implications and estimated costs
------------------	-----------------------	--

xxxx

yyyy

zzzz

You are requested to evaluate the reasonableness of our assessments and confirm the same directly to our auditors..... (Name and address of the auditor). In case the aforesaid list is considered incomplete or incorrect as per your records, please provide additional information directly to the auditor.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

.....

(Signature and particulars of management representative)