CHAPTER FOUR

INVENTORIES AND COST OF GOODS SOLD

- Inventories are major items on the **balance sheet**, i.e. in total assets, especially in the current asset section.
- Inventories play also a very significant and important role in preparation of income statement and determination of net income or loss.

- The processing of purchases transactions involves the following purchasing functions:
  - Requisitioning goods and services.
  - Preparing purchase orders.
  - Receiving the goods.
  - Storing goods received for inventory.
  - Preparing the payment voucher.
  - Recording the liability.

4.2 THE AUDITORS' OBJECTIVES IN THE EXAMINATION OF INVENTORIES AND PURCHASES

- The auditors' have the following objectives in the examination of inventories and purchases.

i. To consider internal control over inventories and purchases.

ii. To determine the existence of inventories, and the client's ownership of these assets

iii. To establish the **completeness of inventories** and purchase transaction.

iv. To establish **clerical accuracy** of records and supporting schedules for inventories and purchases.

v. To determine that the **valuation of inventories** is based on appropriate methods.

vi. To determine the statement presentation of inventories is adequate, including disclosure of classification of inventories, accounting records and any inventories *pledged as collateral for loans*.

4.3 INTERNAL CONTROL OVER INVENTORIES AND PURCHASES

CONTROL OBJECTIVES

- Although inventory records may vary considerably from client to client, the control objectives of a sound system of internal control over inventories are the same in all cases, namely:

- Authorization and purchase procedures.
- Control over goods inwards.
- Inventory records substantiated by physical counts.
- Control over dispatches and goods outwards.
- Inventory levels should be controlled so that materials are available when required but that inventory is not unnecessarily large.

- Internal control procedures for inventories affect nearly all the functions involved in producing and disposing of the company's products, purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories.

The basic internal control procedures are the following:

Approval and control of documents

- Issues from inventories should be recorded only on properly authorized requisitions.
- Reviews of damaged, obsolete and

Arithmetical accuracy

- All receipts and issues should be recorded on inventory cards.
- The costing department should allocate direct and overhead costs to the value of **work – in – progress** according to the stage of completion reached.

Control accounts

- Total inventory records may be maintained and integrated with the main accounting system.

Comparison of assets to records

- Inventory levels should be checked against the records by a person independent of the stores personnel, and material differences investigated.
- Where continuous inventory records are not kept adequately a full count should be held at least once a year.
- Maximum and minimum inventory levels should be pre – determined and regularly reviewed for adequacy.

Assess to assets and records

- Separate centers should be identified at which goods are held.
- Inventories should be held in their locations so that they are safe from damage or theft.
- All of inventories should be identified and held together.

4.4 AUDIT PROCEDURES

- The following audit procedures for the verification of inventories and purchases may be used by auditors:

(A) CONSIDER INTERNAL CONTROL FOR INVENTORIES AND PURCHASES

(1) Obtain an understanding of **internal control for inventories and purchases**.

- In obtaining an understanding of internal control over inventory, the auditor should become thoroughly conversant with the procedures for purchasing, receiving, storing, and issuing goods as well as acquiring an understanding of the cost accounting system and the perpetual records.

(2) Assess **control risk and design additional tests** of control for inventories and purchases.

- After obtaining an understanding of the client's internal control over inventories and purchases, the auditors perform their initial assessment of control risk for the various financial statement assertions.

(3) Perform additional tests of controls.

- Tests directed toward the **effectiveness of controls help to evaluate the client's internal control** and to determine the extent to which the auditors are justified in reducing their assessed level of control risk for the assessments about the inventory and purchase accounts.

The following are examples of typical additional test.

a. Examine significant aspects of a **sample of purchase transactions**.

b. Test the cost accounting system.

(4) Reassess control risk and design substantive tests.

B.SUBSTANTIVE TEST.

1. Obtain listings of **inventory and reconcile to ledgers**.
2. Evaluate the client's planning of physical inventory.
3. Observe the taking of physical inventory and make test counts.
4. Review the year – end cutoff of purchases and sales transactions.
5. Obtain a copy of the completed physical

6.Evaluate the bales and methods of inventory pricing.

7.Review inventory quality and condition.

8.Perform analytical procedures.

9.Determine whether any inventories have been pledged/assured and review purchase and sales commitments.

10.Evaluate financial statement presentation of inventories, including the **adequacy of disclosure.**

END OF CHAPTER 4

THANK YOU!