

THE AUDITING PRACTICES BOARD

Practice Note 25

Consultation Draft

Attendance at Stocktaking
(Revised)

July 2010

The Auditing Practices Board

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence,

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are not eligible for appointment as company auditors, as well as those who are so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

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The purpose of Practice Notes issued by the APB is to assist auditors in applying auditing standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice. Auditors should be aware of and consider Practice Notes applicable to the engagement.

This Practice Note, when finalised, will replace the previous Practice Note 25 which was issued in January 2004.

INVITATION TO COMMENT

This consultation draft is issued by the Auditing Practices Board (APB) for public comment.

Following the publication of the clarified International Standards on Auditing (ISAs) (UK and Ireland) in October 2009, there is a need to update the APB's Practice Notes currently in issue. The guidance in Practice Note 25 is currently also included in substance in ISA (UK and Ireland) 501, 'Audit Evidence – Additional Considerations for Specific Items.' However, it has not been included in the clarified ISA (UK and Ireland) 501 in line with the APB's aim to keep supplementary material in the clarified standards to a minimum (as was explained when the clarified standards were exposed). When this Practice Note was first issued the then extant Statements of Auditing Standards (SASs) did not directly address stocktakes. Some of the more general references within it to SASs have been replaced with more specific references to ISA (UK and Ireland) 501.

Although most of the proposed changes to Practice Note 25 are conforming changes for the clarified auditing standards the APB invites comments on any aspect of the guidance.

You are invited to send written comments on the consultation draft to APB. APB would like to receive comments from those who agree with the consultation draft as well as from those who do not. Your comments will be most helpful if they refer to the relevant paragraphs and are supported by reasoning.

APB would prefer to receive letters of comment in an electronic form that facilitates 'copy and paste': these may be sent by e-mail to k.billing@frc-apb.org.uk. If this is not possible, please send letters of comment to:

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Letters of comment should be sent so as to be received no later than **5 October 2010**. All comments will be regarded as being on the public record, unless otherwise requested, and will be posted to APB's website soon after receipt.

Practice Note 25

Attendance at Stocktaking (Revised)

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INTRODUCTION

1. International Standard on Auditing (ISA) (UK and Ireland) 501 ‘Audit Evidence – Specific Considerations for Selected Items’ includes requirements and application material relating to inventory (stock and work in progress – ‘stocks’) and, in particular, obtaining audit evidence by attendance at physical inventory counting (stocktakes). Practice Note 25 contains further guidance, including how the requirements of other ISAs (UK and Ireland) may be applied in relation to attendance at stocktaking. The guidance is supplementary to, and should be read in conjunction with, the ISAs (UK and Ireland) which apply to all audits undertaken in the United Kingdom and the Republic of Ireland.
2. The main assertions¹ relating to stocks are existence, rights to assets (ownership), completeness and valuation. Practice Note 25 is primarily concerned with audit evidence relating to the existence assertion.
3. ISA (UK and Ireland) 501, paragraph 4, requires that, if inventory is material to the financial statements the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by, in addition to other procedures, attendance at physical inventory counting unless impracticable.
4. While the principal reason for attendance at a stocktake is to obtain evidence to substantiate the existence of the stocks, attendance can also enhance the auditor’s understanding of the business by providing an opportunity to observe the production process and/or business locations at first hand and providing evidence in relation to the:
 - completeness and valuation of stocks,
 - ‘cut-off’ for recording stock inwards and outwards movements, and the resultant impact on revenues and costs, and
 - design and operation of an entity’s internal control relating to stocks.
5. It is the responsibility of those charged with governance of an entity to ensure that the amount at which stocks are recorded in the financial statements represents stocks physically in existence and includes all stocks of the entity. To achieve this, entities may maintain detailed records of stocks and check these by regular test counts. In some entities where the accounting records are less detailed, the amount of stocks may be determined by way of a full physical count of all stocks held at a date close to the entity’s balance sheet date.
6. In the case of a company incorporated under the Companies Act, management also has responsibilities to keep adequate accounting records and to include any statements of stocktakings in those records².

¹ ‘Assertions’ are the representations of those charged with governance that are embodied in the financial statements and are more fully described in ISA (UK and Ireland) 315 ‘Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment,’ paragraph A111.

² In the United Kingdom - Section 386 of the Companies Act 2006; in the Republic of Ireland - Section 230.3(c) of the Companies Act 1990.

ASSESSMENT OF RISKS AND INTERNAL CONTROLS

7. **ISA (UK and Ireland) 315: ‘Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment’** requires that the auditor shall identify and assess the risks of material misstatement at (a) the financial statement level, and (b) the assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedures. (paragraph 25)
8. Factors relating to the risk of material misstatement in the context of the existence of stocks include the:
- reliability of accounting and recording systems and related controls for stocks including, in relation to work in progress, the systems that track location, quantities and stages of completion;
 - timing of stocktakes relative to the year-end date, and the reliability of records used in any ‘roll-forward’ of balances;
 - location of stocks, including stocks on ‘consignment’ and those held at third-party warehouses;
 - physical controls over the stocks, and their susceptibility to theft or deterioration;
 - objectivity, experience and reliability of the stocks counters and of those monitoring their work;
 - degree of fluctuation in levels of stocks;
 - nature of the stocks, for example whether specialist knowledge is needed to identify the quantity, quality, identity and/or stage of completion of items of stocks; and
 - difficulty in carrying out the assessment of quantity and/or stage of completion of items of stocks, for example whether a significant degree of estimation is involved.
9. When planning the audit, the auditor also assesses the risks of material misstatement due to fraud³. Based on this risk assessment, the auditor designs audit procedures so as to have a reasonable expectation of detecting material misstatements arising from fraud. Fraudulent activities which can occur in relation to stocks include:
- ‘false sales’ involving the movement of stocks not yet sold by the entity to a location not normally used for storing stocks;
 - movement of stocks between entity sites with stocktakes at different dates;
 - the appearance of stocks being misrepresented so that they seem to be of a higher value/greater quantity;
 - the application of inappropriate estimation techniques;
 - stocktake records prepared during stocktakes deliberately being incorrectly completed or altered after the event; and

³ ISA (UK and Ireland) 240 ‘The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.’

- additional (false) stocktake records being added to those prepared during the count.

AUDIT EVIDENCE

10. ISA (UK and Ireland) 501: ‘Audit Evidence – Specific Considerations for Selected Items’ requires that, if inventory is material to the financial statements the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by, in addition to other procedures, attendance at physical inventory counting unless impracticable. (paragraph 4)

11. Attendance at stocktaking can provide evidence to the auditor in respect of the existence, completeness and valuation assertions (including a consideration of possible obsolescence and deterioration). The extent and nature of evidence required will depend upon the auditor’s assessment of the risk of material misstatement.

12. The principal sources of evidence relating to the existence of stocks are:

- evidence from audit procedures which confirm the reliability of the accounting records upon which the amount in the financial statements is based;
- evidence from tests of the operation of control activities over stocks, including the reliability of counting procedures applied by the entity; and
- substantive evidence from the physical inspection tests undertaken by the auditor.

13. The nature of the auditor’s procedures during attendance at a stocktake will depend upon the results of the assessment of the risks of material misstatement carried out in accordance with ISA (UK and Ireland) 315. In cases where the auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that relevant controls for confirming the existence of stocks are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures), the auditor may attend a stocktake to obtain evidence regarding the operating effectiveness of those controls as well as performing substantive procedures.

14. Where entities maintain detailed records of stocks and check these by regular test counts the auditor performs audit procedures designed to confirm whether management:

- maintains adequate records of stocks that are kept up-to-date;
- has satisfactory procedures for stocktaking and test-counting; and
- investigates and corrects all material differences between the book records of stocks and the physical counts.

The auditor attending a stocktake considers whether the checking of stocks as a whole is effective in confirming that accurate records of stocks are maintained. If the entity’s records of stocks are not reliable the auditor may need to request management to perform alternative procedures which may include a full count at the year end.

15. In entities that do not maintain detailed records of stocks the quantification of stocks for financial statement purposes is likely to be based on a full physical count of all stocks at a

date close to the entity's year end. In such circumstances the auditor recognises that the evidence of the existence of stocks provided by the stocktake is greater when the stocktake is carried out at the end of the financial year. Stocktaking carried out before or after the year end may also provide acceptable evidence for audit purposes provided the auditor is satisfied that the records of movements of stocks in the intervening period are reliable.

PROCEDURES

16. When the auditor attends an inventory count in compliance with ISA (UK and Ireland) 501, the auditor is required to:

- (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
- (ii) Observe the performance of management's count procedures;
- (iii) Inspect the inventory; and
- (iv) Perform test counts.

The auditor is also required to perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. (paragraph 4)

17. The following paragraphs set out the principal procedures which may be carried out by auditors when attending a stocktake, but are not intended to provide a comprehensive list of the audit procedures which the auditor may find it necessary to perform during attendance at stocktaking.

Before the stocktake

18. The effectiveness of the auditor's attendance at stocktaking is increased by the use of audit staff who are familiar with the entity's business and where advance planning has been undertaken. Planning procedures include:

- performing analytical procedures, and discussing with management any significant changes in stocks over the year and any problems with stocks that have recently occurred, for example unexpected 'stock-out' reports and negative stock balances;
- discussing stocktaking arrangements and instructions with management;
- familiarisation with the nature and volume of the stocks, the identification of high value items, the method of accounting for stocks and the conditions giving rise to obsolescence;
- considering the locations of the stocks and assessing the implications of this for stock control and recording;
- considering the quantity and nature of work in progress, the quantity of stocks held by third parties, and whether expert valuers or stocktakers will be engaged (further guidance on these issues is set out in paragraphs 30-34 below);

- considering internal control relating to stocks, so as to identify potential areas of difficulty (for example cut-off);
- considering any internal audit involvement, with a view to deciding the reliance which can be placed on it⁴;
- considering the results of previous stocktakes made by the entity; and
- reviewing the audit working papers for the previous year.

19. The auditor examines the way the stocktake is organised and evaluates the adequacy of management's stocktaking instructions. Such instructions, preferably in writing, should cover all phases of the stocktaking procedures, be issued in good time and be discussed with the person responsible for the stocktake to check that the procedures are understood and that potential difficulties are anticipated. If the instructions are found to be inadequate, the auditor seeks improvements to them.

During the stocktake

20. During the stocktake, the auditor ascertains whether the entity's staff are carrying out management's instructions properly and undertakes test counts to obtain evidence that procedures and internal controls relating to the stocktake are working properly. If the manner of carrying out the stocktake or the results of the test-counts are not satisfactory, the auditor immediately draws the matter to the attention of management supervising the stocktake and may have to request a recount of part, or all of the stocks.

21. When carrying out test-counts, the auditor selects items both from count records and from the physical stocks and checks one to the other to obtain evidence as to the completeness and accuracy of the count records. In this context, the auditor gives particular consideration to those stocks which the auditor believes to have a high value either individually or as a category of stocks. The auditor records in the audit working papers items for any subsequent testing considered necessary, such as copies of (or extracts from) stocktake records and details of the sequence of those records, and any differences noted between the records and the physical stocks counted.

22. The auditor determines whether the procedures for identifying damaged, obsolete and slow moving stocks operate properly. The auditor obtains (from observation and by discussion, for example with storekeepers and stock counters) information about the stocks' condition, age, usage and, in the case of work in progress, its stage of completion. In addition, the auditor ascertains that stocks held on behalf of third parties are separately identified and accounted for.

23. The auditor considers whether management has instituted adequate cut-off procedures, i.e. procedures intended to ensure that movements into, within and out of stocks are properly identified and reflected in the accounting records in the correct period. The auditor's procedures during the stocktake will depend on the manner in which the year end value of stocks is to be determined. For example, where stocks are determined by a full count and

⁴ ISA (UK and Ireland) 610 addresses 'Using the Work of Internal Auditors'.

evaluation at the year end, the auditor tests the arrangements made to identify stocks that correspond to sales made before the cut-off point and the auditor identifies goods movement documents for reconciliation with financial records of purchases and sales. Where the full count and evaluation is at an interim date and year end stocks are determined by updating such an amount by the cost of subsequent purchases and sales, the auditor performs appropriate procedures during attendance at the stocktaking and in addition tests the financial cut-off (involving the matching of costs with revenues) at the year end⁵.

24. The auditor's working papers include details of the auditor's observations and tests (for example, of physical quantity, cut-off date and controls over stocktake records), the manner in which points that are relevant and material to the stocks being counted or measured have been dealt with by the entity, instances where the entity's procedures have not been satisfactorily carried out and the auditor's conclusions.
25. Although the principal reason for attendance at a stocktake is usually to obtain evidence to substantiate the existence of the stocks, as noted in paragraph 4 above attendance can also enhance the auditor's understanding of the business by providing an opportunity to observe the production process and/or business locations at first hand and providing evidence regarding the completeness and valuation of stocks and the entity's internal control. Matters that the auditor may wish to observe whilst attending a stocktake include:

Understanding the business

- the production process;
- evidence of significant pollution and environmental damage;
- unused buildings and machinery.

Completeness and valuation of stocks

- physical controls;
- obsolete stock (for example goods beyond their sale date);
- scrap, and goods marked for re-work;
- returned goods.

Internal control

- exceptions identified by the production process (for example missing work tickets); and
- the operation of 'shop-floor' disciplines regarding the inputting of data such as movements of stocks into the computer systems.

26. Some entities use computer-assisted techniques to perform stocktakes; for example hand held scanners can be used to record items of stocks which update computerised records. In some situations there are no stocks-sheets, no physical count records, and no paper

⁵ ISA (UK and Ireland) 501, paragraph 5, requires the auditor to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

records available at the time of the count. In these circumstances the auditor considers the IT environment surrounding the stocktake and considers the need for specialist assistance when evaluating the techniques used and the controls over them. Relevant issues involve systems interfaces, and the controls over ensuring that the records of stocks are properly updated for the stocktake information.

The auditor considers the following aspects of the stocktake:

- how the test counts (and double counts where two people are checking) are recorded,
- how differences are investigated before the records of stocks are updated for the counts,
- how the records of stocks are updated, and how stocktake differences are recorded.

After the stocktake

27. After the stocktake, the matters recorded in the auditor's working papers at the time of the count or measurement, including apparent instances of obsolete or deteriorating stocks, are followed up. For example, details of the last serial numbers of goods inwards and outwards records and of movements during the stocktake may be used in order to check cut-off. In addition, copies of (or extracts from) the stocktake records obtained by the auditor during the stocktake and details of test counts, and of the sequence of stocktake records may be used to check that the results of the count have been properly reflected in the accounting records of the entity.
28. The auditor reviews whether continuous records of stocks have been adjusted to the amounts physically counted or measured and that differences have been investigated. Where appropriate, the auditor considers whether management has instituted procedures to ensure that all movements of stocks between the observed stocktake and the period end have been adjusted in the accounting records, and the auditor tests these procedures to the extent considered necessary to address the assessed risk of material misstatement. In addition, the auditor follows up queries and notifies management and those charged with governance of serious problems encountered during the stocktake.
29. In conclusion, the auditor considers whether attendance at the stocktake has provided sufficient appropriate audit evidence in relation to relevant assertions (principally existence) and, if not, the other procedures that should be performed.

Work in progress

30. Management may place substantial reliance on internal controls designed to ensure the completeness and accuracy of records of work in progress. In such circumstances there may not be a stocktake which can be attended by the auditor. Nevertheless, inspection of the work in progress may assist the auditor in understanding the entity's relevant internal

control. It will also assist the auditor in planning further audit procedures, and it may also help on such matters as the determination of the stage of completion of construction or engineering work in progress. For this purpose, the auditor identifies the accounting records that will be used by management to produce the work in progress figure in the year-end accounts and, where unfinished items are uniquely identifiable (for example by reference to work tickets or labels), the auditor physically examines items to obtain evidence that supports the recorded stage of completion. In some cases, for example in connection with building projects, photographic evidence can also be useful evidence as to the state of work in progress, particularly if provided by independent third parties or the auditor.

The use of expert valuers and stocktakers

31. Prior to attending a stocktake, the auditor establishes whether expert help, such as that provided by a quantity surveyor, needs to be obtained by management to substantiate quantities, or to identify the nature and condition of the stocks, where they are very specialised. In cases where the entity engages a third party expert the auditor complies with the relevant requirements in ISA (UK and Ireland) 500, ‘Audit Evidence’, including evaluating the competence, capabilities and objectivity of the expert, obtaining an understanding of the work of the expert, and evaluating the appropriateness of the expert’s work as audit evidence for the relevant assertion⁶.
32. Management may from time to time appoint stocktakers from outside the entity, a practice common for stocks at, for example, farms, petrol stations and public houses. The use of independent stocktakers does not eliminate the need for the auditor to obtain audit evidence as to the existence of stocks. In addition, as well as considering the competence and objectivity of the independent stocktakers, the auditor considers how to obtain evidence as to the procedures followed by them to ensure that the stocktaking records have been properly prepared. In this connection the auditor also has regard, where relevant, to ISA (UK and Ireland) 402 ‘Audit Considerations Relating to an Entity Using a Service Organization’.

Stocks held by third parties or in public warehouses

33. If inventory under the custody and control of a third party is material to the financial statements, ISA (UK and Ireland) 501 requires the auditor to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory by performing one or both of:
 - (a) requesting confirmation from the third party as to the quantities and condition of the inventory held on behalf of the entity;
 - (b) performing inspection or other audit procedures appropriate in the circumstances. (paragraph 8)

34. ISA (UK and Ireland) 501 gives examples of other procedures that may be appropriate:

⁶ ISA (UK and Ireland) 500, paragraph 8.

- 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.

Other audit procedures may also include testing the entity's procedures for investigating the custodian and evaluating the custodian's performance. If the custodian is acting as a service organisation, ISA (UK and Ireland) 402 is relevant.

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