

# Global Assurance Alert

## COVID-19 outbreak: Considerations for assurance engagements – Inventory observations

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### Executive Summary

The coronavirus (COVID-19) outbreak continues to rapidly evolve with unprecedented measures being enacted worldwide. This communication provides considerations specifically related to inventory observation.

### Introduction

Professional standards require that, if inventory is material, the engagement team attend the physical inventory counting, unless impracticable to do so. Attendance at the inventory physical count enables the engagement team to:

- Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting
- Observe the performance of management's count procedures
- Inspect the inventory
- Perform test counts.

There is no definition of what constitutes "impracticable" for purposes of the standard. Each member firm will need to determine, based on their jurisdiction, whether the announcement by the World Health Organization (WHO) that the COVID-19 virus is a pandemic makes attendance at the entity's inventory observation impracticable. In making this determination the member firm needs to consider:

- Public health risks associated with close contact between individuals and the recommendation of social distancing
- Travel restrictions and work stoppages that have been put in place.

### Purpose

The purpose of this alert is to provide guidance on procedures that the engagement team may perform in addition to (or in place of) physical inventory observations to obtain evidence regarding the existence of inventory. The procedures necessary will vary depending on the following:

- Risk of material misstatement over the existence of inventory
- Nature of the processes and control over inventory

- Nature of the inventory.

Due to the COVID-19 outbreak, the engagement team may face the following situations:

- The entity is operating as normal
- The entity is closed and will not be performing a year-end count
- The entity will be performing an inventory a count and will allow the engagement team to attend.

Depending upon the current state of the operating environment based on COVID-19 within their jurisdiction, member firms may consider establishing consultation policies when the engagement team is unable to attend the physical inventory count in person.

## Entity performs count but engagement team unable to attend

In situations where the entity is operating as normal and performing their annual inventory count, for example, grocery distribution centers, but due to various restrictions placed by either management or the firm, the engagement team is unable to attend the physical inventory count, the engagement team may consider one or more of the following:

- If the entity performs cycle counts and the engagement team has not previously relied on the cycle counts, consider if the engagement team can now rely on those cycle counts by testing the results of the cycle counts and observing the cycle counts in the future when the engagement team is able to attend, i.e., travel restrictions are cleared
- If the entity performs cycle counts and the engagement team attended a recent cycle count, perform roll forward procedures to the period end balances for a selection of inventory items
- If the entity has an internal audit function, consider using them for direct assistance, if allowed in your jurisdiction. In determining the extent of direct assistance, the engagement team considers:
  - The amount of judgment involved in:
    - Planning and performing the relevant audit procedures; and
    - Evaluating the audit evidence gathered
  - The assessed risk of material misstatement; and
  - Their evaluation of the existence and significance of threats to objectivity and level of competence of the internal auditors who will be providing the assistance.
- If the engagement team has determined that attendance at the inventory count is impracticable request management to live video feed the performance of their inventory count to the engagement team. When live feeding the inventory count the objective of the engagement team is the same as if they were attending the inventory count; therefore, the engagement team does the following:
  - Request that someone independent from the warehouse staff, i.e., a member of the accounting staff video the inventory count
  - Request management to video the entire facility to assess management's count process and replicate how the engagement team would observe the inventory; such as:
    - Organization of the count
    - Use of dual count teams
    - Segregation of inventory that is received during the account

- Segregation of damaged or obsolete inventory
- Lack of inventory movement so that items cannot be counted more than once
- Request the count team to open boxed inventory to inspect contents if the risk assessment identifies that inventory may be falsified or intentionally misrepresented (for example, where there is a fraud risk factor as the entity has asset backed lending)
- Request that the video capture the reconciliation of control documents such as obtaining copies of management's completed physical count records to assist the engagement team in performing subsequent audit procedures to determine whether the entity's final inventory records reflect the actual inventory count results
- If the engagement team is able to go to the facilities within a few months of the video, the engagement team may perform some test counts at this later time and test management's roll-back of the quantities to the original date of the video.
- If the entity is not able to live feed the video,
  - Understand the reasons why not and consider whether this is a fraud risk
  - Request management to record the performance of the inventory control on video for the engagement team to review. (Coordinate the above items with the person responsible for the recording.)
- Consider engaging another auditor who is in the location of the inventory to observe the count rather than travelling (AE 7.15)
- If the entity has inventory in a location that is not affected by COVID-19, consider using another member firm to observe the count in that location.

## Entity will not be performing year-end inventory count

In situations where the entity will not be performing their year-end inventory count the engagement team considers the following:

- Once the entity is able to perform an inventory count, observe the count and perform roll-back procedures
- If the entity has performed cycle counts, use audit evidence from the cycle counts.

## Inventory count will be performed – considerations for safeguarding the engagement team

In situations where the entity will be able to count inventory and will allow the engagement team access, the member firm considers the following:

- Respect the personal preferences of engagement team members who may not want to attend to protect their own personal health and safety
- Provide appropriate approvals for attendance from the engagement partner and other firm personnel. Member firms may consider implementing a consultation policy regarding engagement team attending the entity's premises
- Follow World Health Organization and local health department recommendations to reduce transmission risk, including frequent handwashing and social distancing by firm personnel completing on-site inventory observations.

## General considerations

### Evaluating management's instructions

In addition to attendance at the inventory count, the engagement team evaluates management's instructions and procedures for recording and controlling the physical inventory count. Matters to consider when conducting the evaluation include:

- The application of appropriate control activities, such as the collections of used physical inventory count records (for example, count sheets or tags), accounting for unused physical inventory count records, and count and re-count procedures
- The accurate identification of the stage of completion of work in progress, slow moving, obsolete or damaged items and of inventory owned by a third party
- The procedures used to estimate physical quantities, where applicable (for example, how management estimates the physical quantity of a coal pile)
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

### Other audit evidence over existence of inventory

Attending the physical inventory observation represents only one piece of audit evidence for existence of inventory. The following procedures also provide evidence over existence:

- Price testing includes testing purchasing records to evidence the purchase was made
- Subsequent sales testing, particularly immediately after period end demonstrates the inventory was on hand at year end (this test is often combined with testing of subsequent purchases to establish the quantity on hand at a given time)
- Testing physical inventory adjustments made as a result of year end counts, cycle counts, or through normal operations (this test is especially effective when the entity uses a perpetual inventory system)
- Testing manual journal entries that adjust inventory balances outside of the inventory, purchasing, or sales sub-ledgers
- Review of internal audit or other cycle count records within one inventory turn (this procedure is especially effective when combined with purchase and sales testing within the same period)
- Video evidence of warehouses, inventory counts, and other safeguarding procedures (see section "Video evidence" below)
- Counting inventory at an interim date (or after year end) and rolling the inventory quantities forward (or back for counts occurring after the balance sheet date) to the balance sheet date.

In combination with the approaches mentioned above, these tests of the accounting records may provide sufficient evidence for the existence assertion.

### Inventory count at a date other than period-end

As mentioned earlier there may be situations where the physical inventory counting is done at a date, or dates, other than the date of the financial statements. This may be the case when the entity has shut down their facilities at period end or the engagement team is unable to attend the count due to travel or other restrictions.

In these situations, the engagement team will perform procedures to obtain evidence as to whether the inventory quantities between the count date and date of the financial statement are properly recorded. The information provided by management to support the inventory quantities at period end would be considered Information Produced by the Entity (IPE); refer to AE 4.2.6 for guidance on how the engagement team may obtain evidence regarding the completeness and accuracy of the information.

The following table provides guidance for the engagement to consider when determining the nature and extent of testing for accuracy and completeness of the information provided by management.

| Factor   | Higher risk associated with IPE  | Lower risk associated with IPE   |
|--|--|--|
| Type of IPE                                      | <ul style="list-style-type: none"> <li>Manually prepared IPE</li> <li>System-generated IPE with customization</li> </ul>   | <ul style="list-style-type: none"> <li>System-generated IPE without customization</li> </ul>   |
| Nature of IPE                                    | <ul style="list-style-type: none"> <li>Larger population of items comprising the IPE or more complex IPE</li> <li>Information produced outside of the general ledger system</li> <li>Changes in the volume or nature of IPE from prior period</li> </ul> | <ul style="list-style-type: none"> <li>Smaller population of items comprising the IPE or less complex IPE</li> <li>Information produced by the general ledger system</li> <li>Consistency in the volume or nature of IPE from prior period</li> </ul>            |
| Use of IPE                                       | <ul style="list-style-type: none"> <li>Used as audit evidence in relation to elevated inherent risk, including significant risks</li> </ul>  | <ul style="list-style-type: none"> <li>Used as audit evidence in relation to normal inherent risk</li> </ul>   |
| Prior experience                                 | <ul style="list-style-type: none"> <li>Numerous errors related to IPE in prior audit that resulted in a misstatement(s)</li> </ul>   | <ul style="list-style-type: none"> <li>Few or no errors related to IPE in prior audit that did not result in a misstatement(s)</li> </ul>  |
| Fraud risk                                       | <ul style="list-style-type: none"> <li>Contradictory evidence that IPE may not be complete or accurate due to fraud</li> <li>Identified risk of material misstatement due to fraud related to IPE</li> </ul>   | <ul style="list-style-type: none"> <li>No contradictory evidence that IPE may not be complete or accurate due to fraud</li> <li>No identified risk of material misstatement due to fraud related to IPE</li> </ul>   |
| Controls over preparation and maintenance of IPE | <ul style="list-style-type: none"> <li>Significant deficiency(ies) identified with respect to IT general controls that are relevant to the accuracy and completeness of IPE</li> </ul>   | <ul style="list-style-type: none"> <li>No significant deficiency(ies) identified with respect to IT general controls that are relevant to the accuracy and completeness of IPE</li> <li>No significant deficiency(ies) identified with respect to the</li> </ul> |

| Factor | Higher risk associated with IPE  | Lower risk associated with IPE   |
|--------|--|--|
|        | <ul style="list-style-type: none"> <li>Other significant deficiency(ies) identified with respect to the preparation and maintenance of IPE, including significant deficiencies in controls over the <b>use</b> of queries (or parameters)</li> </ul> | preparation and maintenance of IPE, including significant deficiencies in controls over the use of queries (or parameters) |

If the time period between the inventory count and period-end date is greater than 3 months the member firm may consider requiring the engagement team to consult regarding the nature and extent of work to be performed on the IPE as it may be more appropriate to use sampling versus following the guidance above related to IPE.

## Reporting

Inspecting inventory when attending physical inventory counting assists in ascertaining the existence of the inventory (though not necessarily ownership) and in evaluating its condition, such as identifying obsolete, damaged, or aging inventory. Alternative procedures implemented under these circumstances need to be aimed to achieve the same objectives. In cases where it is not possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures, the engagement team needs to consider the impact on the audit report.

If the attendance at the physical inventory counting is impracticable, and the engagement team is unable to perform alternative procedures to obtain sufficient appropriate audit evidence, the engagement team may need to issue a qualified opinion or disclaimer of opinion. Member firms may consider establishing policies for the engagement team to consult when such matters are encountered.