

## **Inside the Audit: Part 8 - Inventory**

### **Objective**

To verify whether inventory reported by the company exists, is complete, is owned by the entity, is accurately valued, is recorded in the correct period, and is properly presented and disclosed in the financial statements in accordance with Accounting Standards / Ind AS, Schedule III and CARO requirements.

### **Step 1: Control Testing (Check Internal Controls)**

- Perform a walkthrough of the inventory process from purchase → receipt → storage → issue → sale.
- Trace one inventory transaction from Goods Receipt Note (GRN) to stock records and accounting entry.
- Understand controls over vendor selection, purchase approval and receipt of goods.
- Review controls over inward and outward movement of inventory including gate entry and issue notes.
- Understand inventory valuation method and system configuration.
- Review frequency and process of physical verification and reconciliation with books.

### **Step 2: Substantive Testing (Detailed Inventory Verification)**

#### **A) Obtain and verify population**

1. Obtain inventory records / stock ledger item-wise and location-wise as at year end.
2. Reconcile total inventory value with Trial Balance and Financial Statements.
3. Obtain inventory valuation workings and ageing reports.

#### **1. Existence (Inventory recorded actually exist)**

- Attend physical stock count where practicable and perform test counts.
- Observe inventory condition, storage and identification during physical verification.
- Trace items from stock records to physical inventory (sheet to floor).
- Review management's physical verification report and investigate shortages or excesses.

#### **2. Completeness (All inventory that should be recorded are included)**

- Trace physical inventory to stock records (floor to sheet).
- Verify cut-off of goods received but not recorded by reviewing GRNs and vendor invoices.
- Check goods in transit and ensure proper recognition.
- Review scrap and slow-moving inventory records for completeness.

#### **3. Accuracy & Valuation (Inventory is valued correctly)**

- Verify inventory valuation method such as FIFO / Weighted Average is consistently applied.
- Check valuation is at lower of cost and net realizable value (NRV).
- Recalculate cost for selected items including material, labour and overheads.
- Review NRV working to identify slow-moving, obsolete or damaged inventory.
- Verify provision for obsolete or non-moving inventory.

#### **4. Cut-off (Inventory recorded in the correct accounting period)**

- Verify purchases and sales cut-off by testing GRNs and dispatches around year end.
- Ensure goods dispatched before year end are excluded from closing stock.
- Ensure goods received before year end are included in closing stock even if invoice is pending.

#### **5. Rights & Obligations (Company has ownership over inventory)**

- Verify inventory is owned by the company and not held on consignment.
- Review agreements for inventory held on approval or return basis.
- Identify inventory pledged or hypothecated against borrowings and verify disclosure.

#### **6. Classification & Presentation**

- Verify classification between raw materials, work-in-progress, finished goods, stores and spares.
- Ensure inventory is classified as current asset as per Schedule III.
- Verify disclosure of valuation method and inventory break-up in financial statements.

#### **7. Analytical Review**

- Compare inventory levels and turnover ratios with prior periods.
- Review gross profit margins and correlate with inventory valuation.
- Analyse slow-moving and non-moving inventory trends.
- Review abnormal write-offs or provisions during the year.

#### **(B) CARO 2020 – Inventory Focus Areas**

- Physical verification of inventory and reporting of material discrepancies.
- Adequacy of coverage and frequency of physical verification.
- Reconciliation of stock statements submitted to banks with books of accounts.

#### **(C) Concept Clarity Byte**

##### **• Goods in Transit:**

Inventory for which ownership has passed to the company before year end should be included in closing stock even if physically not received.

##### **• Lower of Cost or NRV:**

Inventory should be written down when NRV is lower than cost due to damage, obsolescence or market decline.