CHAPTER 12

Inventories and Cost of Goods Sold

Review Questions

12–1 Substantiation of the figure for inventories is an especially challenging task because of the variety of acceptable methods of valuation. In addition, the variety of materials found in inventories calls for considerable experience and skill to do an efficient job of identifying and test-counting goods on hand. The possibilities of obsolescence and of excessive stocks also create problems. Finally, the relatively large size of inventories and their significance in the determination of net income make purposeful misstatement by the client a possibility that the auditors must guard against.

12–2 Issuance of a purchase order requires approval signatures attesting that all established procedures have been observed for (a) determining the need for the item, (b) obtaining the competitive bids, and (c) obtaining approval of the financial aspect of the commitment. Since the issuance of a purchase order commits the company to a liability, the purchasing function is extremely important.

12–3 Internal control over purchasing activities is strengthened by placing exclusive authority for purchases of all kinds in a separate purchasing department, and creating another independent department to handle the receiving function. In addition, the recording of purchase transactions should be assigned to an accounts payable section within the accounting department.

In a small concern, departmentalization of operations may not be feasible to this extent, but if internal control is to be achieved, it is necessary as a minimum requirement that the functions of purchasing, receiving, and recording be assigned to different employees not subordinate to one another.

12–4 Adequate internal control of purchase transactions requires the preparation of serially numbered receiving reports by an independent receiving department and the comparison of these reports with vendors’ invoices and purchase orders by the accounts payable department prior to approval of the invoice for payment. To ascertain that these procedures are actually being followed, the auditors will make various tests including the examination of receiving reports to see that they are complete, current, legible, and controlled by serial numbers.

12–5 During an audit of a manufacturing company, the auditors consider the cost system for the following purposes:

(1) To determine that costs are properly allocated to current and future periods and hence that cost figures used in arriving at balance sheet and income statement amounts are supported by internal records. The appropriate allocation of costs to finished goods, work in process, and cost of goods sold is essential to the preparation of financial statements in accordance with generally accepted accounting principles.
(2) To obtain assurance that the cost system, as an integral part of the system of internal control, provides proper control over costs incurred and related inventories.

(3) To ascertain, as a service to management, that the cost system is economical and effectively provides information for reducing or controlling costs and for determining the cost and profitability of products, and other related data necessary for informed managerial decisions.

12–6 The independent auditors are key participants in the planning for a client's physical inventory. Although the auditors do not actually do the planning for the client, they offer advice on such matters as the assignment of a key client employee to assume responsibility for the inventory; selection of the most advantageous dates for the inventory taking; scheduling operations to minimize goods-in-process; and so on. Most important is the auditors' determination that the client's inventory instructions are adequate.

12–7 The auditors observe the taking of the physical inventory to obtain evidence supporting its existence. In addition, information relevant to valuation of and rights to inventory is obtained. Observation of the physical inventory is a major step in meeting the standard of fieldwork that requires the auditors to gather sufficient, competent, evidential matter to provide a reasonable basis for an opinion on the financial statements.

By observing the taking of the physical inventory, the auditors are seeking sufficient competent evidence as to the effectiveness of the methods of inventory taking and as to the measure of reliance that may be placed upon the client's inventory records and its representations as to inventory quantities. The auditors must ascertain that the physical inventory actually exists, that the inventory quantities are being determined by reasonably accurate methods, and the inventory is in a saleable or usable condition.

12–8 The auditors make test counts of inventory quantities during their observation of the taking of the physical inventory to ascertain that the individuals taking the inventory are making an accurate count. The extent of test counting will be determined by the inventory-taking procedures; for example, the number of the auditors' test counts would be reduced if there were two teams, one verifying, the other taking the inventory. On the other hand, the auditors' test counts would be expanded if they found errors in the inventory counts. Some test counts are recorded by the auditors for the purpose of subsequent comparison with the client's compilation of the inventory. The auditors must determine that the compilation of the inventory from the tags, sheets, or computer readable forms is accurate. In addition, the auditors seek assurance that the description and condition of the inventory items is accurate for pricing purposes and that the quantity information, such as dozen, gross, cartons, and so on, is proper.

A secondary reason for recording test counts in the audit working papers is to provide evidence of the extent of the auditors' tests in the event that audit procedures are questioned at some future date.

12–9 The test counts and tag numbers should be listed by the auditors in their working papers and later traced to the client's inventory summary sheets. By this procedure, the auditors obtain evidence that the quantities on the tags have been accurately transcribed to the summary sheets by the client employees in developing the total valuation for inventory. If a significant number of differences are found, the auditors may need to reexamine the original tags or request that the client recompile the inventory.

12–10 A physical inventory at least once a year is generally essential regardless of whether perpetual inventories are maintained. However, when perpetual inventories and good internal control are maintained, the annual physical count may be taken at a date other than the year-end. Some
companies with good perpetual inventory records prefer to take a physical inventory in one department at a time with the counting work thereby spread throughout the year. Furthermore, if statistical sampling techniques are applied in the periodic counting process and the sampling is appropriately planned and executed, the entire inventory need not be counted.

12–11 A bill and hold scheme involves transactions in which sales of merchandise are improperly billed to customers prior to delivery, with the goods being held by the seller. These transactions overstate revenues and net income. Bill and hold transactions have to meet rigorous requirements to be recognized as legitimate sales.

12–12 The auditors' analysis of the Cost of Goods Sold account of a manufacturing concern might disclose charges and credits for amounts transferred from the goods-in-process or finished goods inventory accounts, proceeds from sales of scrap, charges for idle plant and equipment, underabsorbed or overabsorbed factory overhead, variances from standard costs, writedowns for inventory shortages and obsolescence, and losses on firm fixed-price contracts.

12–13 Two general conditions must exist for the auditors to render an unqualified opinion when the physical inventory is taken on a sampling basis. First, the sampling plan must have statistical validity. Second, the allowance for sampling risk (precision) and the sampling risk (confidence) level must provide an estimate that allows a materially accurate valuation of the inventory.

12–14 The client should be asked to designate an employee to assume responsibility for the physical inventory. A written plan should be developed covering such points as exact dates of the count, possible closing of the plant, segregation of obsolete or damaged goods, design of inventory tags and summary sheets, control of incoming and outgoing shipments during the count, drafting of written instructions, and training of staff in the counting procedures.

12–15 The statement is misleading. Inventories are to be reported at the lower of cost or market. Also, the expression "valued at cost" is not sufficiently specific; the method of determining cost should be indicated.

12–16 The use of different methods of inventory valuation for different components of the company's inventory is acceptable practice and would not prevent the issuance of an unqualified audit report. Generally accepted accounting principles allow the use of different valuation methods for different components of a company's inventory.

12–17 The statement is not true. The auditors' responsibilities with respect to inventories include not only quantities and pricing, but also the quality or condition of the goods, the accuracy of extensions, footings, and summaries, and the consideration of internal control. Weakness in internal control may cause large losses from excessive stockpiling, obsolescence, inaccurate cost data, and other sources, even though the ending inventory is properly counted and priced.

12–18 The independent auditors utilize the client's backlog of unfilled sales orders in the determination of net realizable value of finished goods and goods-in-process, and in the determination of losses, if any, on firm sales commitments for which no production has yet been undertaken.

12–19 No. Inspection of the warehouse receipts does not constitute sufficient verification. The inventories should be confirmed in writing directly to the auditors by the custodians of the stored goods. If the inventories stored in public warehouses are substantial in relation to other assets, the auditors should also review client records regarding selection and performance of the warehouses, and any available reports on the warehouses' internal control. The auditors also should consider observing substantial inventories stored in public warehouses.
12–20 In the confirmation of bank accounts and bank loans, the reply from the bank may disclose a lien on inventory. Also in examining insurance policies on inventory, the auditors may find a "loss payable clause" to a third party indicating inventories have been pledged. Finally, the client officials should be asked to disclose any lien on inventory as part of the written representations furnished to the auditors.

Questions Requiring Analysis

12–21 Weaknesses in internal control of Nolan Manufacturing Company include the following:

(1) Organization structure is poor. The receiving department should not be under the authority of the purchasing agent.

(2) Copies of purchase orders sent to receiving department should not show quantities. This encourages careless counting.

(3) The receiving department should prepare a receiving report for each shipment received. These documents will permit evaluation of the department's work, indicate proportion of returns, and establish accountability for goods.

(4) Errors by buyers are covered up by the existing system since any deficiency in goods received is not reported by the receiving department to anyone but the buyer.

(5) Goods should be kept in storerooms until required for production, not sent directly to the factory production area.

(6) There is apparently no control over the movement of raw materials into goods-in-process and no record of the quantities of goods-in-process.

(7) The perpetual inventory records (physical units only) for finished goods are apparently not integrated with the accounting records.

(8) The custody of finished goods and the recordkeeping for these goods are assigned to the same employee.
12–22 a. The auditors do not regard the inventory certificate of an outside service company as a satisfactory substitute for their own audit of the inventory. The service company has merely assumed the client's function of taking the physical inventory, pricing it, and making the necessary extensions. To the extent that the service company is competent, the internal control with regard to the inventory has been strengthened. Nevertheless, as with any internal control system, the auditors would investigate the internal control to ascertain that it is operating in a satisfactory manner. The auditors' investigation would necessarily entail an observation of the taking of the inventory and testing the pricing and calculation of the inventory.

b. The inventory certificate of the outside specialists would have no effect upon the audit report. The auditors must determine that the inventory was fairly stated by observing the taking of the inventory and testing the pricing and calculation of the inventory.

On the other hand, if the taking of the inventory was not observed and no audit tests were applied to the computation of the inventory, the auditors would be compelled to disclaim an opinion (or qualify their opinion) on the financial statements as a whole if the amount of the inventory is material.

If it has been impossible for the auditors to observe the taking of the physical inventory, but they have been able to satisfy themselves by the application of other auditing procedures, they should not refer to the inventory in the audit report.

c. The auditors would make no reference to the certificate of the outside specialists in their report. The outside specialists are serving as adjuncts of the company's permanent employees and, as such, are in somewhat the same guise as temporary employees. The outside specialists are not independent in that they do not have third-party interests. The auditors, under certain circumstances, mention in their report the reports of other independent auditors, but this practice does not extend to the certificate of outside specialists who are not independent auditors.

12–23 a. Observation of physical inventory is generally mandatory because it provides strong evidence as to existence and quality of the client's inventories.

b. Observation of physical inventory generally is impossible when the independent auditors were not appointed by the client until after the physical inventory had been taken. There may also be conditions where weather conditions, terrains, or some other circumstances make it impossible for the independent auditors to be present at the site of the client's inventory-taking; but such circumstances should be rare.

c. The auditors' review of the client's control for inventory tags is important because of the danger that fictitious inventory tags might be created by dishonest client personnel after the auditors have completed their observation of the physical inventory.

12–24 The following procedures should be undertaken:

a. The oral evidence that the motors are on consignment should be substantiated by a review of the client's records of consigned inventory, examination of contracts and correspondence with consignors, and confirmation of consigned stocks by direct communication with consignors.

b. The location of the machine in the receiving department, together with the presence of the "REWORK" tag, suggests that the machine had been shipped to a customer but rejected and
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returned. The auditors should examine the receiving report for the machine, the accounts receivable confirmation from the customer, and records of the client's quality control department, to ascertain who has title to the machine. If the customer has title, the machine should not be included in inventory, and a liability for rework costs should be established. If the client has title, the customer's account should be credited for the sales return and the machine should be included in the client's inventory at estimated realizable value.

c. The "Material Inspection and Receiving Report" signed by the Navy Source Inspector is evidence that title to the machine passed to the U.S. Naval Base on November 30. Accordingly, the auditors should ascertain that the sales value of the machine is included in accounts receivable, and that the cost of the machine is not in the inventory.

d. The location of the storeroom and the dusty condition of the goods suggest that the items may be obsolete, or at least slow moving. The auditors should inspect perpetual inventory records for usage of the materials, and should inquire of production personnel whether the materials are currently useful in production. The materials may have to be valued at scrap value.

12–25 Auditing procedures that the auditors would employ to determine whether slow-moving or obsolete items are included in the inventory are the following:

1. During the observation of physical inventory, make note of any dusty or rusted items, or other items in obviously poor condition. In addition, investigate any inventory stored in out-of-the-way locations.

2. If the client maintains reliable perpetual inventory records, review them for raw materials that have not been requisitioned and for finished goods that have not been shipped for extended periods.

3. Compare the raw materials physical inventory listings with bills of material for products currently in production or on order.

4. Compare the backlog of unfilled sales orders at the audit date to the finished goods inventory list.

5. Review catalogs and other sales department publications for finished goods currently being advertised and offered for sale.

6. Be alert for any incomplete jobs that are dormant in the review of goods-in-process inventory records.

7. Examine post-audit date sales orders and materials requisitions to determine what finished goods and raw materials were active in the subsequent period.

8. Inquire of the client management as to any recent survey for obsolete or slow-moving inventory.

9. Compare the beginning and ending inventory listings are compared for items showing little if any quantity changes.

10. Compute the turnover of inventory by product line and compare it to that of prior periods for an indication of an adverse trend.
(11) Perform other analytical procedures, such as comparing the trend of gross profit by product line.

12–26 Since Reed Company obtained its entire merchandise inventory from the president of the company in a related party transaction, the auditors should consider the cost of the merchandise to the president in his operation of a similar business as a sole proprietor. In this related party transaction, the auditors must look beyond form—a total cost of $100,000 for the original stock of merchandise—to substance. Substantively, the merchandise of Reed Company should not be valued at excessive amounts, that is, amounts beyond what it could be acquired for directly from vendors. Any excess amount charged by the president to Reed Company represents unamortized discount on the notes payable. The entire transaction should be fully disclosed in a note to the financial statements of Reed Company.

12–27

a. To establish proper inventory cutoff, the auditors use the shipping and receiving information obtained at the physical inventory and:

(1) Examine sales transactions and supporting documentation for a period before the physical inventory and determine that goods shipped before the physical inventory have been included in sales and cost of sales, and that goods included in inventory are not included in sales and cost of sales.

(2) Select receiving reports for goods received before the physical inventory and determine that all goods received before the inventory have been included in inventory and liabilities.

(3) Review supporting documentation for goods not included in the physical count but included in the general ledger inventory control account (e.g., inventory in transit) and determine that the goods are properly included in inventory.

(4) Examine purchase and sales transactions and detailed supporting documents for the period after the physical inventory to determine that they have been reflected in the proper period.

(5) Review records of returned goods and claims against suppliers and related memoranda for periods before and after the cutoff date to determine that returns and claims against suppliers made after the cutoff date have been entered in the appropriate period.

b. When the auditors arrive for the observation, they will inspect the premises to determine whether:

(1) The arrangement of inventory is such that an accurate count is possible.

(2) Scrap, obsolete, and damaged goods are adequately identified and segregated.

(3) Inventory owned by other companies are adequately identified and segregated.

(4) Inventories appear to be adequately safeguarded against access by unauthorized persons and protected against deterioration.

12–28 The audit procedures to be applied to determine that standard costs and related variance accounts applicable to materials are acceptable and have not distorted the financial statements would include the following:

(1) Consider the internal control, determine appropriate tests of controls, and assess control risk.

(2) Test the arithmetic computations of the standard cost records.
(3) Determine that the data on the standard cost records are reasonably current. Out-of-date standards may result in abnormal variances.

(4) Ascertained the accuracy of the specifications on the standard cost records by comparison with engineering specifications or other independent sources. Determine that the procedure for establishing standard material cost gives consideration to spoilage, scrap loss, and by-products of the process.

(5) Determine that, in establishing standard material prices, consideration was given to the following factors: normal quality, normal quantity, normal sources, and delivery by normal carrier. The treatment in the accounts of discounts, whether excluded or included in the standard costs, should be investigated for consistency.

(6) The accounting system for recording standard costs should be reviewed for reasonableness, and tests should be applied to determine that the system is functioning effectively. Source documents (vendors' invoices, requisitions, production reports, and other internally generated accounting evidence) should be examined and related to the transactions flowing through the cost system. In this connection, reference should be made to the standard cost records to determine that standard cost data flowing through the accounting system are being accurately compiled.

(7) Review the material price variance and material usage variance accounts for overall reasonableness. The variance accounts should also be reviewed for excessive variations in the month-to-month charges, and satisfactory explanations should be obtained where necessary.

(8) The impact of the variances on the financial statements should be considered. If the variances are of amounts so substantial that placing them in the income statement would distort current operating results and inventory valuation, then consideration should be given to allocating them on a pro rata basis to cost of goods sold and inventories.

Objective Questions

12–29 Multiple Choice Questions

a. (3) Inventory need not be on hand at year-end. For example, purchases in transit on which title has passed to the client should also be included.

b. (3) The shipping department, not the receiving department, is responsible for preparation of a shipping document.

c. (1) A bill of lading acknowledges the receipt of goods and sets forth provisions of the transportation agreement.

d. (1) Direct labor, raw materials, and factor overhead are all included in inventory costs of a manufacturing company.

e. (1) The Cost Accounting Standards Board was established by Congress to narrow the options in cost accounting that are available under generally accepted accounting principles.
f. (1) Of the choices, existence is most directly related to overstated inventory because inclusion of inventory items that do not exist in inventory totals results in an overstated inventory.

g. (1) The professional standards allow auditors to use physical counts prior to year-end when a client has well-kept perpetual (computerized or noncomputerized) inventory records.

h. (1) Analytical procedures will be facilitated when a client uses a standard cost system that produces variance reports. Such reports will allow the auditors to identify significant deviations from expected values.

i. (1) Since the internal control is described as being weak, the CPAs will generally insist upon a physical count at year-end.

j. (2) The best procedure for the discovery of damaged goods is an examination of the condition of the inventory during the auditors' observation of the physical inventory.

k. (1) Mullins may issue an unqualified opinion as long as she is satisfied that the client's procedures are adequate to provide a reliable inventory balance.

l. (2) The primary objective of the CPAs' observation of inventories is to provide sufficient competent evidence as to the existence of the inventory and the controls over the inventory-taking process.

12–30 Adapted AICPA Task-Based Simulation

Solution

<table>
<thead>
<tr>
<th>Description of Audit Procedures Performed</th>
<th>Type of Audit Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. During the physical inventory count, the auditor asked the client to open various boxes of inventory items so she was able to assess the quality of the item.</td>
<td>Inspection of tangible assets</td>
</tr>
<tr>
<td>b. During a site visit to a construction site, the auditor determined that all employees were wearing proper safety equipment.</td>
<td>Observation</td>
</tr>
<tr>
<td>c. The auditor asked the warehouse manager about whether certain inventory items were becoming obsolete.</td>
<td>Inquiry</td>
</tr>
<tr>
<td>d. The auditor obtained a purchase order from the purchase order file and compared it to the authorized supplier list to determine that the related goods had been purchased from an approved supplier.</td>
<td>Reperformance</td>
</tr>
<tr>
<td>e. The auditor calculated the accounts receivable turnover for the year.</td>
<td>Analytical procedure</td>
</tr>
<tr>
<td>f. The auditor obtained a copy of the company’s accounting manual and read the section on inventory to prepare for the physical inventory observation.</td>
<td>Inspection of records or documents</td>
</tr>
</tbody>
</table>
The auditing firm’s computer assisted audit specialist obtained an electronic inventory file from the company and checked the accuracy of the extensions and footings.

12–31 Task-Based Simulation

a. (3) Answer (3) is correct because a larger percentage of sales in the last month is likely to result in a lower ending inventory, thus increasing the inventory turnover ratio since the denominator of the fraction becomes smaller.

b. (5) Answer (5) is correct because the only reason net income increased was the decreases in the provision for income taxes.

c. (6) Answer (6) is correct because inability to pass on costs will decrease the profit percentage.

d. AU 501 addresses inventory, including the counting of inventory.

12–32 Adapted AICPA Task-Based Simulation

a. Yes. Strong internal control may create a situation in which the count may be taken prior to year-end and updated as necessary.

b. No. Ordinarily, locations may be sampled.

c. No. Although enough counts must be recorded to allow a reviewer to in essence determine whether a proper count has been taken, not every count need be recorded.

d. No. Both existence and completeness are addressed.

e. Yes. Raw materials are also included.

f. No. Inventory should be valued at the lower of cost or market, not standard cost.

g. Yes. Inventory “consigned in” is owned by the company that supplied the goods.

h. No. Williams Inc. must perform the count.

i. No. The auditor may sample items.

j. No. The client should not know every test count taken, thus reducing the possibility of manipulation of items not counted.

12–33 Multiple Choice Questions

a. (1) Valuation.

b. (4) Existence.

c. (1) Valuation.

d. (2)Completeness.

e. (4) Valuation.
Problems

12–34 SOLUTION: Inventory Misstatements (Estimated time: 20 minutes)

<table>
<thead>
<tr>
<th>Misstatement</th>
<th>Error or Fraud</th>
<th>Control</th>
<th>Substantive Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Error</td>
<td>Development of adequate inventory-taking procedures and adequate supervision of physical inventory.</td>
<td>Observation of inventory.</td>
</tr>
<tr>
<td>b.</td>
<td>Fraud</td>
<td>Use of prenumbered receiving reports and controls to insure adequate cutoff of purchases and payables.</td>
<td>Observation of inventory and collection of cutoff information that is traced to accounting records.</td>
</tr>
<tr>
<td>c.</td>
<td>Fraud</td>
<td>Effective audit committee and internal audit department to monitor management’s override of internal controls.</td>
<td>Price tests of a sample of inventory items.</td>
</tr>
</tbody>
</table>

12–35 SOLUTION: Williams Pharmaceutical Company (Estimated time: 25 minutes)

a. Williams faces a number of business risks including (only three required):

(1) Violations of FDA regulations (or equivalent regulations in other countries) regarding production or storing of inventory.
(2) Development of products by competitors that compete with the company’s products or make them obsolete.
(3) Loss of inventory due to theft.
(4) Defects in the production process that cause ineffective or dangerous products to be produced.
(5) Violations of the company’s patents by competing companies.

b. (1) This risk results in a current period inherent risk. Violations of FDA regulations regarding production or storing of inventory may cause a misstatement if the violations cause products in the inventory to be unsalable. In this situation, inventory items may be overvalued.
(2) This risk results in a current period inherent risk. If a competitor’s products cause Williams’ products to become obsolete, the products may be overstated and may need to be written down to net realizable value.
(3) This risk results in a current period inherent risk. Inventory theft will cause the financial statements to be misstated if it is not reflected in the accounting records. Therefore, this risk may or may not result in material misstatement depending on whether Williams has adjusted its inventory to actual quantities on hand.
(4) This risk results in a current period inherent risk. Defects in manufacturing may cause inventory to be overvalued because it is unsalable.
(5) This risk probably does not result in a current period inherent risk. Violations of the company’s patents usually would not result in a misstatement of inventory unless the effects are so great as to affect the value of the inventory on hand.

c. (1) To prevent violations of FDA regulations, management must develop production...
processing and inventory controls that ensure compliance with government regulations. These controls include physical controls over inventory and detailed records on production batches. In addition, Williams’ management should establish ongoing monitoring procedures to ensure compliance with the regulations.

(2) Controls that management may establish over competition include controls over research and development costs, and risk assessment directed at monitoring competition and designing responses to the development of competitive products.

(3) To prevent inventory theft, management should establish effective physical controls over the inventory and monitor compliance with those procedures. Radio frequency identification (RFID) technology is often used in this industry because of the typical high value of the products. With RFID tags embedded in the boxes, the company can monitor the inventory on a real-time basis. Alarms can be used to alert personnel when product is being inappropriately removed from the premises.

(4) To prevent defects in manufacturing, management must establish quality controls over manufacturing processes and monitor compliance with those controls.

(5) This risk would generally not result in a financial reporting risk.

12–36 SOLUTION: Potential Misstatements (Estimated time: 20 minutes)

<table>
<thead>
<tr>
<th>Misstatement</th>
<th>Audit Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>1. Observation of inventory at selected locations without prenotification of the locations selected. &lt;br&gt;2. Analytical procedures comparing ratios (e.g., gross margins) at locations observed to locations not observed.</td>
</tr>
<tr>
<td>b.</td>
<td>1. Tests of the accumulation of manufacturing costs and assignment of costs to selected inventory items. &lt;br&gt;2. Analytical procedures involving the comparison of recorded costs of inventory items to costs assigned in prior periods.</td>
</tr>
<tr>
<td>c.</td>
<td>1. Review of inventory turnover of selected inventory items. &lt;br&gt;2. Inquiry of sales personnel about sales of particular inventory items.</td>
</tr>
<tr>
<td>d.</td>
<td>1. Review of trends in sales returns. &lt;br&gt;2. Inquiry of production and quality control personnel.</td>
</tr>
</tbody>
</table>

12–37 SOLUTION: Internal Control, Tests of Controls, and Substantive Procedures (Estimated time: 25 minutes)

a. (1) Written inventory-taking instructions help ensure that everyone involved in the physical inventory understands the procedure. The instructions make it more likely that an accurate and complete record of amount and quality of inventory on hand will be obtained.

(2) Identification of damaged goods is required for fair presentation of the inventory account, since such items should be valued at net realizable value.

(3) Perpetual inventory records provide essential information to make decisions regarding purchasing, sales, and production planning. The records serve to discourage waste and theft, since storekeepers are held responsible for shortages.
revealed by physical counts. They also reduce the probability of errors or fraud in
the Inventory and Cost of Goods Sold accounts.

b. (1) The existence of written inventory-taking procedures is verified by examination of
the instructions. The auditors also make suggestions for improvements when they
discover deficiencies in the instructions.

(2) Inquiry of client personnel or review of the client's inventory policies could be used
to test the existence of a requirement for the identification of damaged merchandise.
The auditors should be alert for damaged merchandise during their inventory
observation to test the effectiveness with which client personnel are complying with
the policy.

(3) The existence of perpetual records is tested by inspection of the records and inquiry
regarding the client's procedures.

c. (1) When written instructions are not prepared for the client's physical inventory, the
auditors might decide to increase the intensity of their observation procedures. More
auditors might be assigned to the inventory observation, and the extent of the test
counts of inventory items could be increased. The auditors should be more alert for
problems, such as failure to adequately control inventory tags or double counting of
inventory items.

(2) If the client does not require the identification of damaged goods, the auditors should
be especially alert for damaged goods during their observation of the physical
inventory. They might also make more extensive inquiries of storekeeping personnel
regarding the condition of inventory items.

(3) The lack of a perpetual inventory system would generally require that the auditors
observe the client's physical inventory at, or near, the balance sheet date. The
auditors' inventory observation procedures might also be intensified.

12–38 SOLUTION: Zorostria (Estimated time: 15 minutes)

a. The auditors must control all inventories until they have been counted to be certain that
artwork is not transferred from one store to another store and is included in inventory more
than once. The locations of the stores being in three different countries raises issues as to
observing the count of the artwork. The auditors will have to determine whether all locations
must be observed by considering the risks of material misstatement.

b. The valuation of the inventory is a difficult issue. While it may be possible to determine
whether the cost of the items has been properly recorded, whether that cost is in excess of
market value is necessary.

c. (1) Whether the sale is valid depends upon its terms. Shipments made FOB shipping
point on December 31 represent valid sales, while those made FOB destination do
not become sales until the goods are received by the purchaser.

(2) The auditors must determine that it is a valid sale to a legitimate customer. This may
be done through confirmation and/or by examination of documentation relating to the
sale (e.g., customer’s purchase order).
12–39 SOLUTION: Raye and Coye, CPAs  (Estimated time: 25 minutes)

The following inventory observation problems might be anticipated in audits of the three new clients:

1. The size of the ranch and the movements of the large number of cattle during their grazing make observation of a complete physical inventory very difficult. The auditors might consider requesting the client to rent a helicopter for the auditors to use in taking low-level photographs of the various clusters in each photograph, and to obtain an accurate estimate of the number of head of cattle in inventory. Lacking the aerial photography, the auditors would have to request the client to round up the cattle and run them through a chute for counting.

2. The gondola freight cars would contain pig iron bars in several layers. Therefore, to make certain that the lower layers of the gondola cars did contain pig iron rather than lumber, for example, the auditors would have to request the client to move enough of the pig iron from the car to permit observation of portions of each layer of pig iron. A representative sample of the pig iron bars would have to be weighed or measured, depending upon the unit of count, so that the total load of the gondola car could be estimated. If the weight is the unit of measure of the pig iron, the loaded gondola car might be weighed and the weight of the empty car, furnished by the railroad, subtracted to obtain an estimate of the weight of the entire carload of pig iron.

3. The cutoff of production, purchases, and sales is the principal problem when a client operates around the clock. Presumably, the client will employ a professional inventory service to take the physical inventory, since production is continuing. The client and the auditors would have to agree upon a set hour for the cutoff, instead of just the balance sheet date.

12–40 SOLUTION: Blue Distributing Corporation  (Estimated time: 35 minutes)

Substantive procedures that would document management’s completeness assertion as it relates to inventory quantities would be:

1. Observing physical inventory counts.
2. Analytical procedures examining the relationship of inventory balances to purchase, production, and sales activities.
3. Inspecting shipping and receiving documentation for proper amounts and dates to verify proper cutoff procedures.
4. Obtaining confirmation of inventories at locations outside the entity.
5. Tracing test counts recorded during the physical inventory observation to the inventory listing.
6. Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
7. Recomputing the inventory calculations for clerical accuracy.
8. Reconciling physical counts to perpetual records and general ledger balances and investigating significant differences.
### In-Class Team Case

12–41 SOLUTION: Hovington, CPA (Estimated time: 15 minutes)

<table>
<thead>
<tr>
<th>Item</th>
<th>Financial Statement Assertion</th>
<th>Specific Audit Objective</th>
<th>Audit Procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>D</td>
<td>Legal title to inventories relates to whether the client owns and, therefore, has rights to the inventories. An appropriate audit procedure would be to sample from the recorded items and examine related vendors' invoices, contracts, etc. to determine that the client owns the goods.</td>
<td>I</td>
</tr>
<tr>
<td>(2)</td>
<td>A</td>
<td>The completeness assertion addresses whether all assets (here inventory) have been included in the financial statements. Sampling from the inventory items to the count sheet to determine that all items have been included will be the most effective procedure.</td>
<td>H</td>
</tr>
<tr>
<td>(3)</td>
<td>E</td>
<td>The valuation or allocation assertion addresses whether the assets have been included in the financial statements at the appropriate amount. Inventories should be valued at the lower of cost or market. An examination of current vendors' price lists will provide evidence about the current value of inventory items.</td>
<td>F</td>
</tr>
<tr>
<td>(4)</td>
<td>E</td>
<td>The valuation or allocation assertion addresses whether the asset has been included in the financial statements at the appropriate amount. One step in determining the proper amount is to calculate the cost of the inventories. Selecting a sample of recorded items and examining supporting vendors' invoices and contracts will help to meet this objective. Note that answer K is incorrect because no direct manufacturing labor should be capitalized, given that a department store does not manufacture inventories.</td>
<td>I</td>
</tr>
<tr>
<td>(5)</td>
<td>C</td>
<td>The presentation and disclosure assertion addresses whether particular components of the financial statements are properly classified, described, and disclosed. Here, inventories should be reported by category and the bases of valuation should be disclosed in the notes to the financial statements. A review of drafts of the financial statements will allow the auditors to determine whether presentation and disclosure are appropriate.</td>
<td>G</td>
</tr>
</tbody>
</table>

### Ethics Case

12–42 a. If an employee or partner accepts more than a token gift from a client the appearance of independence may be lacking. Accordingly, a judgment must be made as to whether this discount is considered more than “token.” From the client’s perspective it almost certainly is token, but from the perspective of the individual CPA the problem is more complex. Although we are not aware of research addressing the issue, our experience is that such
discounts have historically been commonly accepted. While we question accepting such discounts, we do not believe that they necessarily would impair the independence.

b. First, relating to the discount, if one believes that it affects either actual independence or the appearance of independence, a very major difficulty is encountered. Indeed, if one is concerned about this matter, and if members of the audit team received such a discount in the past, the audit may be viewed as having been performed by non-independent accountants. Yet, as indicated above, we question whether such a discount would impair independence.

A more subtle issue is that related to inventory. Tests of controls have revealed a system that seems “strong,” yet the controller simply withdrew shirts from inventory—apparently with no documentation of the transaction. The information is limited, but it causes one to question whether recorded quantities of inventory do in fact exist and the control over them. Several possible courses of action exist here:

(1) Ignore the issue. The auditor might assume this is an infrequent occurrence that could not lead to a material misstatement. Yet, if shirts can be taken from inventory this simply a material misstatement may indeed be possible. The approach of ignoring the problem would seem risky at best.

(2) Talk to the controller about the issue. This would have to be done professionally and diplomatically. The auditor would need to attempt to determine whether this possible weakness might lead to a material misstatement.

(3) Bring the matter to the attention of the in-charge senior and seek guidance. In a situation such as this, asking for advice from the in-charge senior seems a good choice.

Research and Discussion Case

12–43 SOLUTION: Western Trading Company (Estimated time: 45 minutes)

a. Statement on Auditing Standards No. 1, Section 560.05 states that:

The second type (of subsequent event) consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.

Since the decline in market value of the commodities occurred subsequent to the client's year-end, the auditors appear not to be justified in issuing a qualified opinion.

The alternatives available to the auditors are to: (1) issue an unqualified opinion if the decline in value of the inventory is adequately disclosed in a note to the financial statements, or (2) issue an unqualified opinion regardless of whether the decline in value is adequately disclosed.

b. We believe that the auditors should issue an unqualified opinion only if the client agrees to disclose the decline in value in a note to the financial statements. As stated in Statement of Financial Accounting Standards No. 5 (Current Text section C59.112):

After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired...after the date of the financial statements...Disclosure of those
kinds of losses...may be necessary...to keep the financial statements from being misleading.