Covid-19

Implications for Attendance at Stocktakes for Financial Years ending on or after 31 March 2020

Guidance for Auditors

Issued: 31 March 2020 (Updated Version)
This guidance document is published by ICAS to provide assistance to auditors in relation to assessing the existence and completeness of an audited entity’s inventory during the Covid-19 outbreak in the UK. It is expected that the guidance will have a temporary lifespan and be withdrawn when normal service is deemed to have been restored in the UK and restrictions on the mobility of people removed.

This document gives general guidance only and should not be relied on as appropriate or comprehensive with regard to any particular set of circumstances. It is recommended that users consider seeking further legal or other professional advice in relation to any specific circumstances. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the authors or the publisher. All enquiries should be addressed in the first instance to James Barbour, ICAS Director, Policy Leadership: jbarbour@icas.com
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Introduction

1.1 The spread of Covid-19 has escalated considerably across the UK in recent days. This has led to the measures announced by the UK Prime Minister and First Minister of Scotland on 23 March 2020. The measures impose restrictions on the mobility of UK citizens and state that travelling to and from work is only permitted where this is absolutely necessary and where the work cannot be done from home. This will obviously have major implications for many businesses and indeed for auditors.

1.2 The Financial Reporting Council (FRC) issued guidance for auditors on 16 March 2020 and a bulletin on 26 March 2020. Given the fluidity of the current situation it is likely that further guidance will be issued in due course. Members are therefore advised to sign up to news alerts from the FRC and to check their website on a daily basis. This updated version of the ICAS guidance contains additional content at paragraphs 1.4, 1.5 and 4.7 to provide increased clarity to the earlier version published on 26 March 2020.

1.3 One issue that is focussing minds in the audit profession at the moment is attendance at stocktake. The implications of not being able to obtain sufficient and appropriate audit evidence on inventory can have an impact on the audit opinion, not just on the current year’s financial statements but also those of future years. ICAS has therefore issued this guidance to assist auditors in assessing whether, in light of their potential non-attendance at a stocktake, the use of alternative procedures would enable them to have sufficient and appropriate evidence in relation to the assertions of existence, condition and completeness of inventory.

1.4 It should be noted that the requirements of ISA (UK) 501 (June 2016) ‘Audit Evidence—Specific Considerations for Selected Items’ are not ‘suspended’ but rather that this is additional guidance to help auditors to comply. The auditor has to work through the requirements of ISA (UK) 501 and appropriately document their approach and evidence obtained, on the audit file.

1.5 Ultimately, before issuing their audit opinion the auditor has to assess whether they have obtained sufficient and appropriate audit evidence. During the current Coronavirus outbreak a limitation in scope in relation to inventory might be a more likely occurrence because:

(a) stocktakes may not happen;
(b) even if they do, auditors may not be able to attend in person or make remote observation work to a satisfactory level; and
(c) alternative procedures may not be possible.

Each situation, of course, has to be assessed on a case by case basis.

Stocktake Attendance - Requirements of International Standards on Auditing (ISAs) (UK)

2.1 The International Standards on Auditing (ISAs) (UK) can be viewed at: https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/current-auditing-standards

The most relevant ISAs (UK) in terms on stocktake attendance, are ISA (UK) 501 (June 2016) ‘Audit Evidence—Specific Considerations for Selected Items’, and ISA (UK) 705 Modifications to the Opinion in the Independent Auditor’s Report (June 2016).

2.2 ISA (UK) 501 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:

(a) Attendance at physical inventory counting, unless impracticable, 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; and

(b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.”
2.3 It then specifies that if the stocktake takes place at a date other than the entity’s financial year end the auditor shall, in addition to the procedures required in paragraph 2.2. above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

2.4 If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions. In circumstances where attendance at physical inventory counting is impracticable, the auditor is required to perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with ISA (UK) 705 (Revised June 2016).

2.5 The application material to ISA 501 provides guidance on the above requirements. In particular reference should be made to paragraphs A1 to A14. Paragraphs A9 to A11 deal with physical inventory counting conducted other than at the date of the financial statements and A12 to A14 deal with situations where attendance at physical inventory counting is impracticable.

2.6 The application material recognises that in certain situations where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory. The use of “for example” highlights that the alternative procedures mentioned are not necessarily exhaustive.

2.7 In situations where it is not possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures, ISA (UK) 705 (Revised June 2016) requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation. Reference should be made to section 6 below.

3 Prohibition on access

3.1 This is a matter that the auditor should discuss with the audited entity prior to the date of the stocktake. Due to the mobility restrictions that are now in place many businesses will not be undertaking year-end stocktakes. The auditor needs to understand what the audited entity’s plan is to determine stock quantities and subsequently its stock valuation for the year-end financial statements. This may involve having a stocktake at some future date when it is safer to do so.

3.2 Where the audited entity is a business of a nature that is allowed to continue trading in the current circumstances (e.g. food producer), and is holding a stocktake, then firstly the auditor has to ascertain whether they would be allowed to attend such a count and indeed whether there would be any health and safety issues for audit staff if they were to be in attendance.

3.3 As this situation develops, as well as prohibitions being placed on audit firms attending an audited entity’s premises, such workplaces may be required to close. Therefore, the likelihood is that there will be far fewer stocktakes taking place in the coming months.

4 Alternative Procedures – matters for consideration

4.1 ISA 501 highlights that the auditor may be able to perform alternative procedures to obtain sufficient and appropriate audit evidence. The following paragraphs highlight matters for the auditor to consider and suggests potential alternative procedures that the auditor could employ that might allow them to achieve this objective. These of course are very much circumstances specific, and the auditor will need to exercise professional judgement as to their practicability.

4.2 Consideration needs to be given to matters such as:
  - the nature of the inventory, is it material, what is the inherent risk associated with the inventory in question?
  - does the audited entity have a perpetual inventory system?
• what is the firm’s experience of attending previous stocktakes at the audited entity – have they been well organised e.g. different types of stock clearly separated and clear instructions given to counters and adequate checks in place, and ultimately have the counts been accurate? Have many errors requiring adjustments been identified in past stocktakes?
• does the company have good controls in place over stock? Will this year’s stocktake (if it goes ahead) be undertaken in the usual manner and by staff who have knowledge of the stocktaking process and the items being counted?
• does the company have appropriate controls in place to identify obsolete, damaged or slow-moving inventory? Are there any perishable items that may need to be written off?
• does the company undertake regular monthly/quarterly stock takes? If so, are there many adjustments to the stock records? Is there a history of stock loss, e.g. through theft?
• is there any stock held on behalf of third parties and is this clearly separated?
• is there any audited entity stock held at other premises?
• where the audited entity has an internal audit function, consideration should be given as to what extent the auditor would need to assess the expertise and independence of those third parties.

If the Stocktake is being held at the year-end date

4.3 Consideration should be given as to whether appropriate use of technology, e.g. use of web or mobile-based video-conferencing technologies could help in the circumstances, e.g. could the stocktake be streamed live via video to the audit firm and tests be led by commands from the audit team to seek to provide evidence of existence, and completeness of inventory. If so, then the auditor should prepare a memorandum substantiating the impracticability and unreasonableness of observing the count in person, given the Covid-19 situation. Additionally, the auditor should consider at the beginning of the count, confirming the GPS coordinates of the location of the count. The auditor should also be aware of the individuals who are performing the count (do they have appropriate qualifications, their level of familiarity with the inventory being counted, etc). This approach would provide an opportunity to observe the count as it is in progress. It would need to be discussed with the audited entity in advance and would need to take account of their planned procedures for the stocktake. If the streaming was also recorded it could be held on the audit file for future reference. This approach also involves having confidence in the integrity of the individuals concerned. Additionally, could drones be used in conjunction with other procedures?

The more knowledge that the auditor has of the audited entity concerned and the types of inventory that it holds, the more likely that attendance by video-conferencing will assist the auditor in obtaining sufficient and appropriate evidence.

4.4 Attendance at a stocktake is not only useful from a verification perspective, it also facilitates the auditor being able to look around the audited entity’s premises to see if anything doesn’t look right, evidence the condition of premises, etc. Use of live video might also enable a 360-degree tour of the premises of sorts, on the day of the stocktake. The auditor should consider asking to be introduced to other individuals in the warehouse, e.g. ask the inventory counter to walk the auditor through different parts of the warehouse (look for markers so that when the auditor performs their random sample for floor to sheet testing, they can have the individual return to these locations). The auditor should enquire about different types of inventory (e.g. those in boxes vs. bins), and ask to be shown consigned inventory, as well as some of the security measures in the warehouse (e.g. locked doors). The auditor should look for boxes that may be left to the side and ask the counter to open – do they appear to contain unusable or obsolete inventory? If inventory items include expiration dates, the auditor should ask the counter to verify dates of expiration. The auditor should also perform cut-off procedures by asking to see the loading zone and evaluate whether the inventory has been properly included or excluded from the entity’s inventory listing.

Consideration should also be given to incorporating elements of unpredictability throughout the inventory count, e.g. asking the counter to open boxes or bins at random to check whether boxes are empty and whether their contents are as expected, e.g. do they contain scrap material? The auditor should also give consideration to selecting additional floor to sheet items to be counted and might want to expand the number of test counts performed. Where applicable,
consideration should also be given to getting sight of appropriate serial numbers, e.g. large production parts.

4.5 Stocktake attendance also provides auditors with the opportunity to converse with other key people at the audited entity, people who may be more readily open in their comments, so the auditor could arrange a conference call with the store’s manager/stock room staff (without management present of course) to understand their stock control policy, other internal controls, etc. Again, all of these discussions should be documented.

4.6 Given the current mobility restrictions in place in the UK it has to be recognised that some audited entities may not undertake a year-end stocktake. Therefore, virtual attendance will not be an option in such circumstances.

4.7 Even if the above possibilities for alternative ways to remotely attend a stocktake are feasible, it may still be determined by the auditor that the inherent risk and/or materiality of the stock amounts are so significant that remote observation is not appropriate. In these situations, if there are no suitable alternative procedures, it is likely there will be a limitation of scope in the audit opinion.

**Where the Stocktake is held at a date after the year-end**

4.8 Unless there is a pressing need for audited financial statements in early course, the stocktake (or potentially a sample stocktake) could be held at a suitable and safer time after the year-end and tests carried out to check movements in and out of stock since the year-end to try and provide evidence as to the stock that was held (existence and completeness) at the year-end date. This would also provide evidence with regards to the company’s systems and whether they can be relied upon (assuming no change since year end). This could be coupled with tests over the effectiveness of the controls provided the same controls would have been in operation at the year-end date.

4.9 Cut-off tests could then be performed using goods inwards/despatch notes and quantities checked to after date sales invoices. This could be combined with the analytical procedures work described below. Does the audited entity have good cut-off procedures in place? If so, this will provide greater confidence in the ability to utilise this approach.

4.10 Use of analytical review to assess the reasonableness of the stock figure included in the accounts – including computation and assessment of relevant ratios such as gross profit, inventory days, stock/turnover, etc. Please note that this alone would not be sufficient.

4.11 Ultimately, an assessment then has to be made by the auditor, exercising professional judgement as to whether they have obtained sufficient and appropriate audit evidence. The auditor also has to ensure that all matters considered and implemented are appropriately documented to allow understanding of the thought process that was followed in their determination. If the auditor concludes that they have obtained sufficient and appropriate audit evidence, then there is no need to qualify the audit opinion on the basis of a limitation of scope with regards to inventory.

5 Extension of Accounting Period

5.1 An audited entity could consider taking advantage of the ability to extend their accounting period. This is covered in section 392 of the Companies Act 2006 which allows this period to be extended (please note the accounting period cannot exceed 18 months) provided this has not been done in the previous 5 years. Certain conditions apply, so the audited entity’s directors should check these before pursuing this approach.

6 Inability of Auditor to Obtain Sufficient and Appropriate Evidence

6.1 ISA (UK) 705, Modifications to the opinion in the auditor’s report, (Revised June 2016), notes that an inability of the auditor to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures.
6.2 However, in circumstances where the auditor is not able to obtain sufficient and appropriate audit evidence in relation to the existence and completeness of inventory, whether by procedures performed at the stocktake or by alternative procedures, there would be a limitation of scope.

6.3 If the inventory is material then there would be a need to qualify the audit opinion on the basis of a limitation of scope. In certain circumstances the auditor may need to issue a disclaimer of opinion if they conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

6.4 Where the auditor is to issue a limitation of scope opinion, reference should be made to illustration 3 in ISA (UK) 705. This provides an example of a limitation of scope audit qualification, but this does not relate to an inventory related scenario. Therefore, this would need to be reworded appropriately but does illustrate how the concept should be applied.