GN on Audit of Inventories

- Notes for CA Final

Roopali Kadam

Contents

Guidance Note on Audit of Inventories

⇒ The following is the text of the GN on *Audit of Inventories*
  → issued by the Auditing Practices Committee (APC) of the Council of the ICAI.

⇒ This GN should be read in conjunction with the Statements on SAP issued by the Institute.

P1.

⇒ Para 2.1 of the "Preface to the Statements on SAP" issued by the ICAI states that
  → the "main function of the APC is
    - to review the existing auditing practices in India and
    - to develop Statements on SAPs so that these may be issued by the Council of the Institute."

⇒ Para 2.4 of the Preface states that the "APC will issue GN on the issues arising from the "SAPs wherever necessary."

P2.

⇒ The APC has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee.

⇒ It is intended to issue, in due course of time, Engagement Standards or GNs, as appropriate, on the matters covered by such Statements which would then stand withdrawn.

⇒ Accordingly, with the issuance of this GN on Audit of Inventories, Ch. 5 of the SAPs, titled "Inventories", shall stand withdrawn. In due course of time, the entire SAPs shall be withdrawn.

INTRODUCTION

P3.

⇒ **Inventories** are **tangible** property
  → held for sale in the ordinary course of business, or
  → in the process of production for such sale, or
  → for consumption in the production of goods or services for sale,
    - including
      ♦ maintenance supplies and consumable
      ♦ stores and spare parts meant for replacement in the normal course.

[Foot note: Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.]

⇒ Inventories normally comprise
- → raw materials including components,
- → work-in-process,
- → finished goods including
  - by-products,
  - maintenance supplies,
  - stores and spare parts, and
  - loose tools.

[Foot Note: The audit procedures relating to shares, debentures and other securities held as stock-in-trade (i.e. for sale in the ordinary course of business) are similar to those followed for audit of investment, Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.]

P4.

⇒ Inventories normally constitute a **significant portion-of the total assets**,
- → particularly in the case of
  - manufacturing and
  - trading entities as well as
  - some service rendering entities.

⇒ Audit of inventories therefore assumes special importance.

P5. The following **features of inventories** have an impact on the related audit procedures:

(i) By their very **nature**, inventories normally **turnover rapidly**.

(ii)

⇒ Inventories are susceptible to
- → **obsolescence** and
- → **spoilage**.

⇒ Further,
- → some of the items of inventory may be **slow-moving**
- → while others may follow a **seasonal pattern** of movement.

(iii) Inventories are

⇒ normally **movable** in nature,

⇒ although there may be some instances of **immovable** inventories also,

⇒ e.g. in the case of an entity dealing in real-estate.

(iv)

⇒ All the items of inventory may **not be located at one place** but

⇒ may be held at different locations such as
- → factories and warehouses, or
- → with third parties such as selling agents.

(v)

⇒ The **individual items** of inventory may **not** be **significant in value**,

⇒ but **taken together**, they normally constitute a **significant proportion of total assets and current assets** of manufacturing, trading and certain service entities.

(vi)

⇒ **Physical condition** (e.g. stage of completion of work-in-process in certain industries) and

⇒ **existence** of certain items of inventories

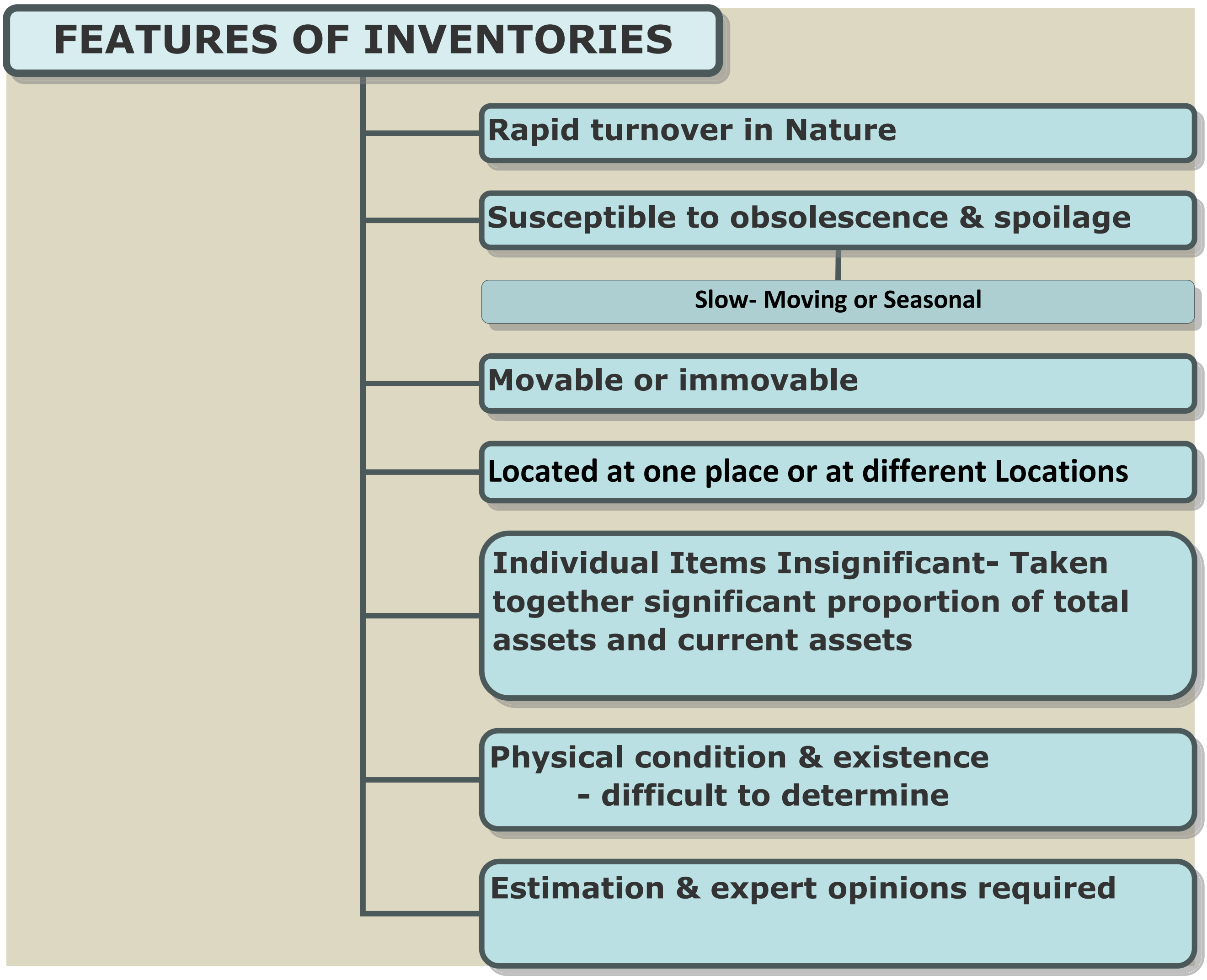
may be **difficult to determine.**

(vii) Valuation of inventories may involve

⇒ varying degrees of **estimation**.,

⇒ including **expert opinions**,

⇒ e.g., in the case of jewellery.



INTERNAL CONTROL EVALUATION

P6.

⇒ The auditor should study and evaluate the system of internal control relating to inventories, to determine the nature, timing and extent of his other audit procedures.

⇒ He should particularly review the following aspects of **internal control** relating to inventories[4]:

[The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the ICAI in 1976 which contains, inter alia, an illustrative discussion on controls in relation to inventories.]

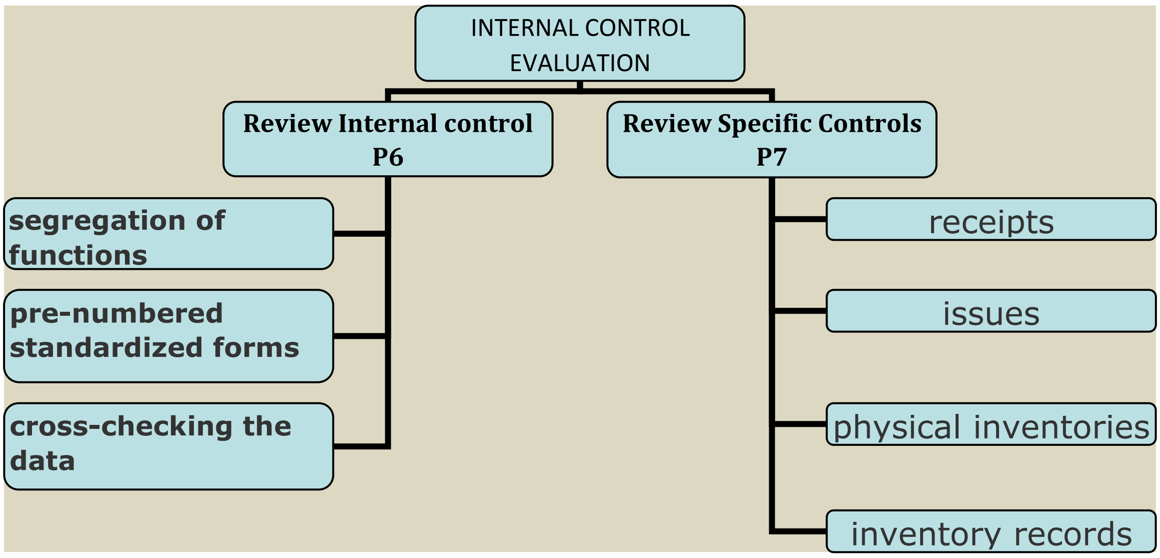
(a) The **control procedures** should provide for **segregation of** such **functions**
- → whose combination may permit the **commitment or concealment of fraud or error**;
- → for example, persons undertaking physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.

(b) The stores procedures should provide for the use of **pre-numbered standardized forms**.

(c) There should be a system of **cross-checking** the data generated by **different operating departments**.

P7. The auditor should also **review specific controls** over

⇒ receipts,
⇒ issues,
⇒ physical inventories, and
⇒ inventory records.



VERIFICATION

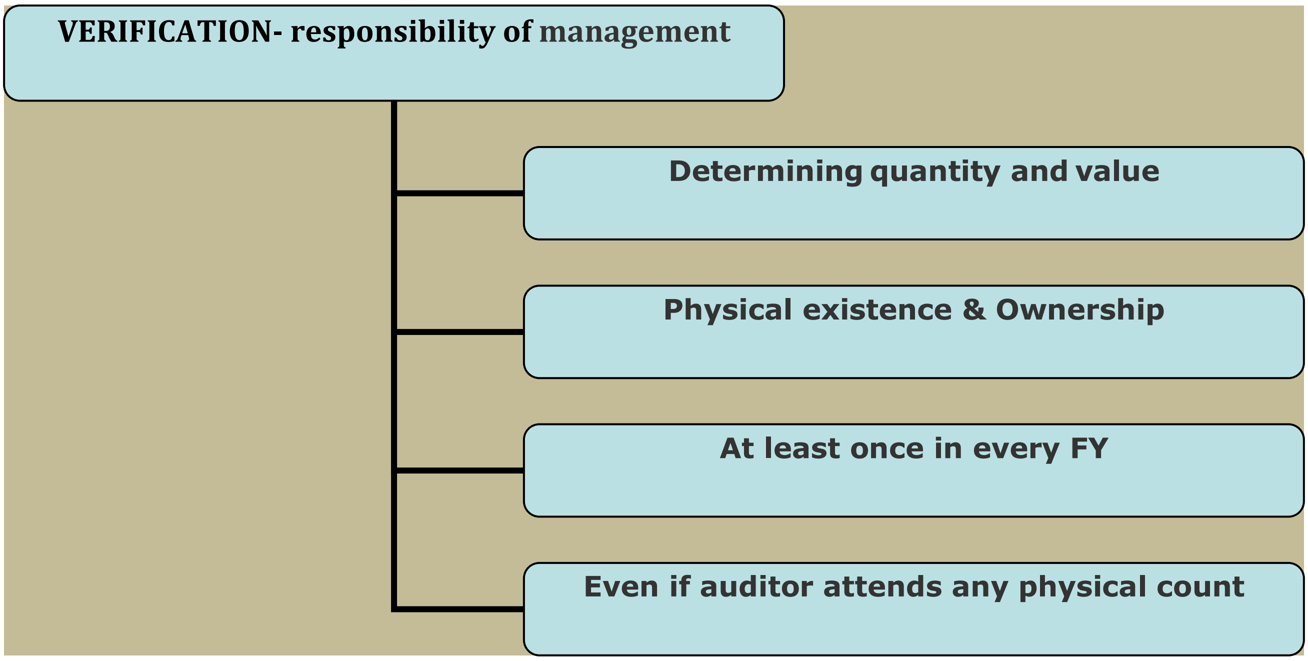
P8.

⇒ As in the case of other assets, the **responsibility** for properly **determining** the
  → **quantity and**
  → **value**
  of inventories rests with the **management** entity.

⇒ It is therefore the responsibility of the management of the entity to **ensure** that the inventories included in the financial information are
  → **Physically in existence** and
  → represent all inventories **owned by the entity**.

⇒ The management satisfies this responsibility
  → by carrying out appropriate procedures which will normally include
  → **verification** of all items of inventory **at least once in every FY.**

⇒ This **responsibility** is **not reduced** even where the **auditor attends any physical count** of inventories in order to obtain audit evidence.



P9.

⇒ In any auditing situation,
  → the **auditor** employs **appropriate procedures**
  → to obtain **reasonable assurance** about various assertions (see SA 500, Audit Evidence).

⇒ In carrying out an audit of inventories,
  → the auditor is particularly concerned with obtaining **sufficient appropriate audit evidence**
  → to corroborate the **management's assertions** regarding the following:

- **Existence**-

→ that all recorded inventories **exist** as **at the year-end**.

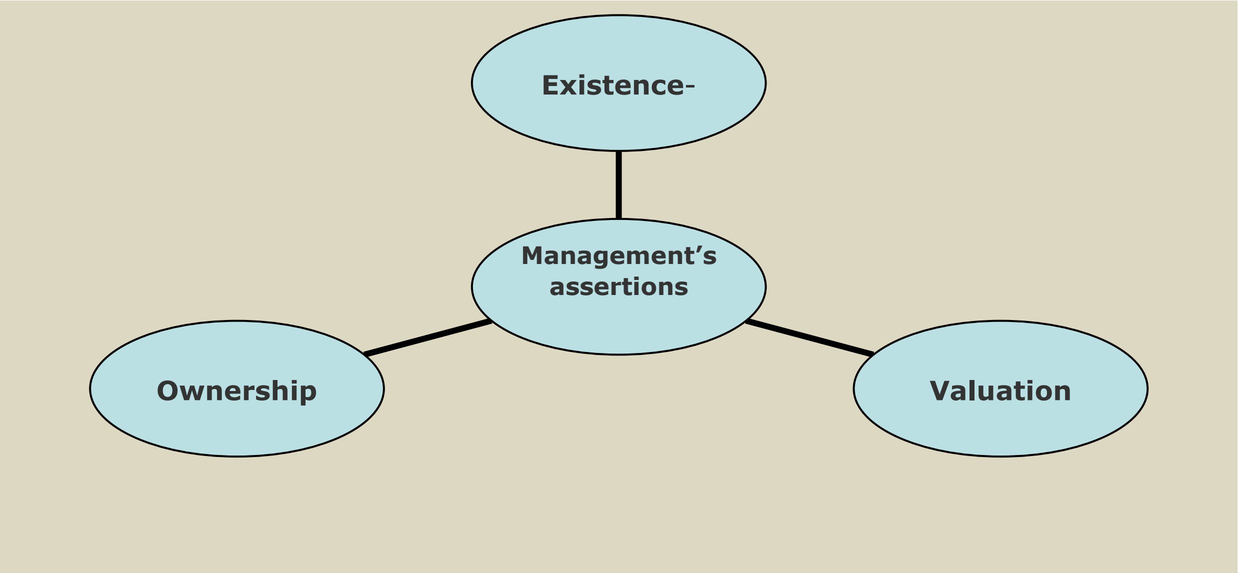
- **Ownership**-

→ that all inventories **owned** by the entity **are recorded** and
→ that all **recorded** inventories **are owned** by the entity.

- **Valuation**-

→ that the stated **basis of valuation** of inventories is
  - ♦ **appropriate** and
  - ♦ **properly applied**, and

→ that the **condition** of inventories is **recognised** in their valuation.



Verification of inventories may be carried out by employing the following **procedures**:

(a) examination of **records**;
(b) attendance at **stock-taking**;
(c) obtaining **confirmations** from third parties;
(d) examination of **valuation** and **disclosure**; and
(e) **analytical review procedures.**

The nature, timing and extent of audit procedures to be performed is, however, a matter of **professional judgement** of the auditor.

Examination of Records

P10.

⇒ The entities usually maintain **detailed stock records** in the form of stores/stock ledgers showing in respect of each major item the receipts, issues and balances.

⇒ The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

P11.

⇒ The auditor may come across cases where the entity does **not maintain detailed stock records other than the basic records** relating to purchases and sales.

⇒ In such situations, the auditor would have to suitably extend the extent of application of the audit procedures discussed in paragraphs 12-22 and 30.

Attendance at Stock-taking

P12.

⇒ **Physical verification** of inventories is the **responsibility** of the **management** of the entity.

⇒ However, where the inventories are **material** and
  - → the auditor is placing **reliance** upon the **physical count** by the management,
  - → it may be appropriate for the auditor to **attend the stock-taking**.

⇒ The extent of auditor's attendance at stock-taking would depend upon
  - → his **assessment** of the **efficacy** of relevant **internal control procedures**, and
  - → the **results**
    - of his examination of the **stock records** maintained by the entity and
    - of the **analytical review procedures.**

P13. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity.

P14.

⇒ There are two principal methods of stock-taking:
- **periodic stock-taking** and
- **continuous stock-taking**.

⇒ Under the first method,
→ physical verification of inventories is carried out at a **single point of time,** usually
- at the year-end or
- at a selected date before or shortly after the year-end.

⇒ Under the second method,
→ physical verification is carried out **throughout the year**,
→ with different items of inventory being physically verified at different points of time.

⇒ However, the verification programme is normally so designed that each material item is physically verified
→ at least once in a year and
→ more often in appropriate cases.

⇒ The **continuous stock-taking method** is **effective** when a **perpetual inventory system of record-keeping** is also in existence.

⇒ Some entities use
→ **continuous** stock-taking methods **for certain stocks** and
→ carry out a **full count** of **other** stocks at a selected date.

P15.

⇒ The auditor is expected to **examine** the **adequacy** of the **methods** and **procedures** of **physical verification** followed by the entity.

⇒ Before commencement of verification,
→ the **management** should issue appropriate **instructions** to **stock-taking personnel**.
→ Such instructions should **cover all phases** of physical verification and preferably be **in writing**.
→ It would be useful if the instructions are **formulated** by the entity **in consultation with the auditor**.
→ The auditor should **examine** these instructions to **assess** their **efficacy**.
→ An illustrative set of instructions which may be useful in most cases is given in Appendix I to this Guidance Note.

P16.

⇒ Where the **auditor is present** at the time of stock-taking,
  → he should **observe** the **procedure** of physical verification adopted by the stock-taking personnel
  → to ensure that the **instructions** issued in this behalf are being **actually followed**.

⇒ The auditor should also **perform test-counts** to **satisfy himself** about the **effectiveness** of the count procedures.

⇒ In carrying out the test counts, the auditor should give **particular consideration** to those **stocks** which have a **high value**
  → either individually or
  → as a category of stocks.

⇒ Proper **attention** should also be paid to the **physical condition** of inventories

P17.

⇒ Ideally, there should be **no movement of stocks** when the **physical verification** is being **carried out**.

⇒ On occasions, however, it may be **necessary** for the entity **to continue** the **production, receiving, or despatch operations** during physical verification.

⇒ In such circumstances, it is essential that the entity has the procedures to **identify and record such movements**.

⇒ The auditor should **review** the **procedures** adopted by the entity to account **for the movement** of inventories from one location to another within the entity during stock-taking (e.g. issues from stores to production departments).

P18.

⇒ The auditor should also examine whether the entity has instituted appropriate **'cut-off procedures'** to ensure that:-
  (a) **goods purchased but not received** have been **included** in the inventories and the **liability** has been **provided** for;
  (b) **goods sold but not despatched** have been **excluded** from the inventories and **credit** has been taken **for the sales.**

⇒ The auditor may
  → examine a **sample of documents evidencing the movement** of stocks into and out of stores,
  → including documents pertaining to periods **shortly before** and **shortly after** the **cut-off date**, and
  → check whether the stocks represented by those documents were **included or excluded, as appropriate**, during the stock-taking.

P19.

⇒ The auditor should **review** the **original** physical verification **sheets** and **trace** selected items - including the more valuable ones - **into the final inventories.**

⇒ He should also **compare** the **final inventories with stock records** and other corroborative evidence, e.g., stock statements submitted to banks.

P20. The auditor should examine whether the **discrepancies noticed** on physical verification have been **investigated** and **properly accounted** for.

P21. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed in paragraphs 16-20 above, pay greater attention to ascertaining whether the management:

(a) maintains **adequate** stock **records** that are kept **up-to-date**;

(b) has **satisfactory procedures** for physical verification of inventories, so that in the normal circumstances the programme of physical verification will **cover all material items** of inventories **at least once during the year**; and

(c) **investigates** and **corrects** all **material differences** between the **book records** and the **physical counts**.

P22. The auditor should determine whether the **procedures** for **identifying**

⇒ defective,

⇒ damaged,

⇒ obsolete,

⇒ excess and

⇒ slow-moving

items of inventory are **well-designed** and **operate properly.**

Confirmations from Third Parties

P23.

⇒ Where significant stocks of the entity are held by third parties,
  → the auditor should examine that the third parties are not such with whom it is **not proper** that the stocks of the entity are held.

⇒ The auditor should also **directly obtain** from the third parties **written** confirmation of the stocks held.

⇒ **Arrangements** should be made **with** the **entity** for **sending requests** for confirmation to such third parties.

⇒ A proforma letter of request for confirmation to be used in such cases is given in Appendix II to this Guidance Note.

⇒ Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is **holding significant amount of stocks**.

⇒ Appendix III to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

Examination of Valuation and Disclosure

P24. The auditor's objective concerning valuation is to obtain evidence that **amount** at which inventories have been valued is **computed** on an **appropriate basis.**

P25.

⇒ The auditor should satisfy himself that the valuation of inventories
  → is in accordance with the normally accepted accounting principles and
  → is on the **same basis as in the preceding year**.

⇒ The generally accepted accounting principles, involved in the valuation of most types of inventories are dealt with in **AS 2, "Valuation of Inventories"** issued by the Council of the ICAI.

[It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1989 uses the words "normally accepted accounting principles".]

P26.

⇒ The auditor should examine the **methods of applying the basis** of inventory valuation.

⇒ Thus, with regard to **determination of cost**, the auditor should examine, inter alia,
  → the stock sheets,
  → records of physical verification,
  → invoices,
  → costing records and
  → other relevant documents and
  → also examine and test the treatment of overhead expenses as a part of cost of inventories.

P27.

⇒ Wherever **feasible**, and particularly where **only a single or a few major products** are **produced**,
  → the auditor may **call for a reconciliation** of
    - the **total cost of production** for the year as determined by the **cost records** with
    - the **total expenses** as per the **financial books** and
  → **review** this **reconciliation**.

⇒ Where **standard costs** are used or where **overheads** are charged at **standard rates or percentages**,
  → he may **examine the variances from actuals** and, where these are **significant**, ensure that **appropriate adjustment** is made to the inventories.

P28.

⇒ The auditor should examine the **evidence** supporting the **assessment** of **net realizable value**.

⇒ In this regard, the auditor should particularly examine whether **appropriate allowance** has been **made** for
  → defective,
  → damaged and obsolete and
  → slow-moving
  inventories in determining the net realizable value.

P29.

⇒ The auditor should satisfy himself that the **inventories** have been **disclosed properly in the financial statements**.

⇒ Where the relevant **statute** lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Analytical Review Procedures

P30.

⇒ In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories:

(i) **reconciliation of quantities** of opening stocks, purchases, production, sales and closing stocks;

(ii) **comparison** of **closing** stock **quantities** and **amounts** with those of the **previous year**;

(iii) **comparison** of the **relationship** of **current** year stock **quantities** and **amounts** with the **current** year **sales and purchases**, with the **corresponding figures for the previous year**;

(iv) **comparison** of the **composition** of the **closing** stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the **corresponding figures for the previous year;**

(v) **comparison** of **current** year **gross profit ratio** with the gross profit ratio for the **previous** year;

vi) **comparison** of **actual** stock, purchase and sales figures with the corresponding **budgeted** figures, if available;

vii) **comparison** of **yield** with the corresponding figure for the **previous** year;

(viii) **comparison** of **significant ratios relating to inventories** with the similar ratios for **other firms in the same industry**, if available;

(ix) **comparison** of **significant ratios** relating to inventories with the **industry norms**, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of **professional judgement** of the auditor.

SPECIAL CONSIDERATIONS IN CASE OF WORK-IN-PROCESS

P31.

⇒ In general, the audit procedures regarding **work-in-process** are similar to those used for raw materials and finished goods.

⇒ However, the auditor has to **carefully assess** the **stage of completion** of the work-in-process for assessing the **appropriateness of its valuation**.

⇒ For this purpose, the auditor may
- → examine the **production/costing records** (e.g. cost sheets),
- → **hold discussions** with the personnel concerned, and
- → obtain **expert opinion**, where necessary.

P32.

⇒ In certain cases, due to the nature of the product and the manufacturing process involved, **physical verification** of **work-in-process** may be **impracticable**.

⇒ In such cases, the auditor should lay **greater emphasis** on **ascertaining** whether the **system**, from which the **work-in-process is ascertained, is reliable.**

⇒ It may also be useful for the auditor to **examine** the **subsequent records of production/sales.**

MANAGEMENT REPRESENTATIONS

P33.

⇒ The auditor should obtain **from** the **management** of the entity
- → a **written** statement describing in **detail** the
  - **location** of inventories,
  - **methods and procedures** of
    - ♦ physical verification and
    - ♦ valuation of inventories,

⇒ While such a **representation letter** serves as a **formal acknowledgment** of the **management's responsibilities** with regard to inventories, it **does not relieve** the **auditor** of his **responsibility for performing audit procedures** to obtain sufficient appropriate audit evidence **to form the basis** for the **expression** of his **opinion** on the financial information.

⇒ A sample management representation letter regarding inventories is given in Appendix IV to this Guidance Note.

⇒ It may be mentioned that the representations made in the letter can alternatively be included in a **composite** representation letter usually issued by the management to the auditor.

DOCUMENTATION

P34.

⇒ The auditor should **maintain adequate working papers** regarding audit of inventories.

⇒ He should maintain on his audit file
- → a **summary** of **each inventory** as also
- → the **details** regarding the **extent of his verification**.

⇒ The **management representation letter** concerning inventories should also be maintained on the audit file.

APPENDIX I

ILLUSTRATIVE SET OF INSTRUCTIONS TO BE ISSUED BY THE CLIENT TO ITS STAFF RESPONSIBLE FOR STOCK-TAKING

(Ref. Paragraph 15)

This appendix contains an illustrative set of instructions which may be issued by the client to the staff responsible for stock-taking. The appendix also lists special instructions in respect of stocks held by others and work-in-process.

⇒ The annual physical examination of inventories of the entity is to be carried out **on 31st March**.

⇒ The work will commence **at 8.00 a.m**. on 31st March, and there will be **no movement** of inventories **during their physical examination.**

1. Mr. AB will be in **overall charge** of the physical counting.
2. Messrs....., **Auditors**,
   - will depute their staff to **observe** the work performed by us.
   - It should be remembered that they are **not responsible** for any part of the stock-taking.
3.
   - You are responsible for the physical counting of all stocks in (state here the **exact area** for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.).
   - You are **not concerned** with similar items of stock which may be **stored at other locations**.

How to proceed with the work

4.

- At 8 a.m. you should present yourself in the office of Mr. AB
  - where you will be **handed over a bunch of inventory tags**.
- You should ensure that you have in your possession a sufficient number for your needs.
- You should also have in your possession
  - a **pen,**
  - **blank papers,**
  - **a measuring tape,** ...
  - (state here any other instrument which is required for measurement, counting, weighing etc.).
- Please ensure that for all items in your area for which weighing or measuring is required, the **necessary apparatus is available.**

Procedure for tagging

5.1

- You should **place a tag** on each pile, box, bin, etc.,
  - which is **counted by you**
  - **after recording** the
    - quantity,
    - description,
    - part number,
    - condition of the stocks to the extent known (e.g., damaged stocks),
    - etc., on the tag.
- You should proceed in proper order so as to ensure that no items are omitted.
- When the work of counting is completed you should **hand over the remaining tags including soiled and damaged tags to Mr. PQ**.

5.2

- All items are required to be **measured, weighed or counted** in order to ascertain the **exact quantity on hand**.
- However, in respect of small items of **insignificant value**,
  - such as bolts, nuts
  - (state here any other items known to be of small value),
    - the quantities on hand may be **estimated without actual counting** etc.
    - In the latter case **please state "estimated**" on the tag.

5.3

- Please ensure that **proper identification** is made
  - by part number, description, etc., and
  - that in the case of **work-in-process** the **last operation performed** is clearly **specified** in accordance with the schedule attached to this Memorandum.
- **No movement** of any stock from one location to another should take place during the period of stock checking.

5.4

- Where
  - bin cards are kept on the bins or
  - job tickets are attached to items in process,
    - you should **not merely copy the quantities** shown on those documents to the tag
    - **without verification**.
- All **alterations** made **to the tags** should be **initialled** and
  - **quantities** should be **recorded in ink**.

5.5

Mr. PQ is responsible for the **control over tags in use**.
For this purpose,
he should **prepare a schedule in the attached Form**.

5.6

- After obtaining the **permission of the auditors**,
  [Foot Note: It is presumed that the auditors or their representatives are present at the time of stock-taking.]
- **instructions will be issued for the removal of the tags** and
- a **suitable person** should be sent around in each department
  - to **detach the detachable portion** of the tags,
  - leaving the counterpart in the proper position.
- When they are **collected**,
  - All such tags should be **brought back to a central location**,
  - placed in **serial order**
  - **tallied with** the **schedule** prepared by Mr. PQ.
- After this has been done,
  - the **tags will be released** to the **Accounts Department** which is concerned with the preparation of the inventory.
- Later on, when the **inventory** has been **prepared**,
  - a **check** should be possible to see whether **all the tags have been listed**.

5.7

- After the work of **counting** has been **completed**,
    - ♦ Mr. AB who is in **overall charge** of stock-taking,
    - ♦ will make a **visit to each area**
        - ∗ in order to ascertain that **all** bins, boxes, etc. **bear a tag** and
        - ∗ make a **check** of the **quantities shown therein**.
- At this point, the **auditors** will carry out **further observation** make such **test checks** as they consider necessary.

5.8

- The **counterparts** of the tags **should be left on** the relevant bins or piles for a period of **at least one month** and
- the **quantity shown** on the counterparts of the tag should be **used as the opening balance** of the bin card for the subsequent period.

Procedure for preparing stock sheets

6.1

Separate listings under the following **broad heads** should be prepared:

- Raw materials including components
- Work-in-process
- Finished goods including by-products
- Maintenance supplies and stores and spare parts
- Loose tools

    - ➢ Defective,
    - ➢ damaged,
    - ➢ obsolete,
    - ➢ excess or
    - ➢ slow-moving stocks

should be listed separately under each of the above categories.

6.2 It should be **examined** that the

⇒ stock cards,

⇒ bin cards,

⇒ tags or

⇒ other stock records

are **posted up-to-date** so that items can be **traced** and **verified** in these records, **simultaneously with** the **physical checking** of stocks.

6.3 A **list of excesses and shortages** should be drawn up at the time of physical stock-taking.

6.4 Stocks **belonging to third parties** and remaining **in custody** of the entity should be **separately identified** from the entity's own stock.
A separate listing should be prepared for all such items of stocks.

6.5 Defective, damaged, obsolete, excess or slow-moving stocks should be **kept separate from other items**.

6.6 **Counters and checkers** should **sign or initial** the stock sheets for the work done by them.

Stocks held by others

7.1 The following steps be taken for stocks belonging to the entity but held by others:

(i) A **separate listing** for such stocks be prepared.

(ii) A **letter** should be sent to such persons to **confirm** the stocks held by them **directly to the auditor**.

(iii) An **authority to inspect** stocks held by third parties should be given to the auditor where the same is **considered necessary** by the auditor.

(iv) An **independent record** for such goods be kept by the entity.

7.2 The above steps should also be taken for <u>**stocks given on loan or received on loan.**</u>

Work-in-Process

8.1 With regard to work-in-process, the following **instructions** be given **to** the **staff members** concerned.

(i) A **separate listing** for work-in-process be prepared.

(ii) The **internal records** kept by the entity be written **up-to-date**.

(iii) If the **amount** of work-in-process is **determinable from production records**, the same be kept **up-to-date**.

(iv) A **list of opening work-in-process** be kept ready at the time of stock taking.

APPENDIX II

ILLUSTRATIVE LETTER OF CONFIRMATION - INVENTORIES HELD BY OTHERS

[Ref. Paragraph 23]

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

For audit purposes, kindly **furnish directly to our auditors** (name and address of the auditors) **details** concerning our inventories held by you for [state here the **purpose of holding** of inventories by the third party] **as of the close of business on** ......

According to **our records**, you held the following inventories as of that date:

Description	**Quantity**
......	......
......	......

In case you identify certain items of inventories as **defective or damaged,** the **details** thereof may be furnished **separately**, indicating the **quantities** and giving a **general description of the condition** of such items. Also**, please confirm** that our inventories held by you are **free of any charge or encumbrance.**

A **stamped envelope addressed to our auditors** is enclosed for your convenience.

Yours faithfully,

(Signature of responsible
official of the entity)

APPENDIX III

ILLUSTRATIVE LETTER OF CONFIRMATION - INVENTORIES HELD BY THE ENTITY ON BEHALF OF OTHERS
[Ref. Paragrapf 23]

[Letterhead of the entity]

[Date]

[Name and address of the owner of inventories]

Dear Sir,

For audit purposes, kindly **furnish directly to our auditors** (name and address of the auditors), **details** concerning your inventories held by us for [state here the **purpose of holding** of inventories by the entity] **as of the close of business on** __________.

According to our records, we held the following inventories as of that date:

Description	Quantity
......	......
......	......

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible
official of the entity)

APPENDIX IV

REPRESENTATION LETTER FOR INVENTORIES
[Ref. Paragraph 33]

The following is a sample representation letter for inventories. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X limited as of ..., 19XX, and for the year then ended, we make, to the best of our knowledge and belief, the following representations concerning inventories.

1. **Inventories at the year-end consisted** of the following:

Raw Materials (including components)	Rs. _________
Work-in-Process	Rs. _________
Finished Goods (including by-products)	Rs. _________
Maintenance supplies and Stores and Spare Parts	Rs. _________
Loose Tools	Rs. _________
Others (specify each major head separately)	Rs. _________
Total	Rs. _________

2. All **quantities** were **determined** by actual physical count or weight or measurement that was taken **under our supervision** and in accordance with **written instructions**, on …… (date/s of physical verification), except as follows:

……………………………………

………………………………………

[Where physical verification of inventories is **carried out at a date other than the closing date**, this paragraph may be modified as below:

⇒ Inventories recorded in the books as at....(**date of balance sheet) aggregating** to Rs .....
  → are based upon the physical inventories taken as at ... (**date of physical verification)**
  → by actual count, weight or measurement.

⇒ The **material discrepancies** noticed on physical verification of stocks as compared to book records have been **properly dealt** with in the books of account and
  → **subsequent transactions** recorded in the accounts **fairly reflect** the **changes** in the inventories **up to** ……(**balance sheet date**).]

3. Except as set out below, all goods included in the inventory are the **property of the entity** and are **not** subject to any **charge**, and none of the goods are held as **consignee** for others or as **bailee**:

....

....

4. All inventories **owned** by the entity, **wherever located**, have been **recorded**, including goods sent on consignment.

5. Inventories do **not include** goods **sold** to customers **for which delivery** is **yet to be made**.

6. Inventories have been **valued on the following basis/bases**:

Raw Materials (including components)
Work-in-process
Finished goods (including by-product)
Maintenance supplies and Stores and Spare Parts
Loose Tools
Others (specify each major head separately)

(In describing the basis/bases of valuation, the **method** of ascertaining the **cost** (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which **overheads** have been **included** in the cost should also be stated.)

7. The following **provisions** have been made in respect of excess, slow-moving, damaged, or obsolete inventories and these, in our view, are **adequate**.

.....

......

8. **No** item of inventories has a **net realizable value** in the ordinary course of business which is **less** than the amount at which it is included in inventories.

9. The **basis/bases of valuation** is/are the **same** as that/those used in the **previous year**, except as set out below:

Class of Inventory	Basis of Valuation This year	 Last year	Effect of change in Basis of Valuation
...	....	.....	...
...	....	.....	...

Yours faithfully,

[Signature of responsible official of the entity]