Verification of Assets & Liabilities

Auditing- Unit IV

III BBA

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Verification and Valuation of Stock in Trade/ Inventory

Stock in Trade: it refers to stock of goods which have to be ultimately converted into cash.

In case of Manufacturing concerns, stock in trade includes:

- Stock of raw materials
- Stock of work-in-progress
- Stock of finished goods
- Scrap or by- products
- Stores and spare parts

In case of Trading concerns, stock in trade includes only finished goods.

Importance of verification and valuation of stock in trade

- Stock in trade usually constitutes the single largest current asset of an enterprise, involving considerable amount.
- The values of stock in trade exert considerable influence over profit or loss of the business.
- Stock in trade directly affects the financial position of the enterprise.
- There are many recognised bases and methods of valuation of stock in trade.
- The verification of the quality, condition and value of the stock in trade is a difficult task.
- Stock in trade is more susceptible to errors and manipulations in stock taking and valuation, like, incorrect calculations, prices or ommissions.

Objectives of Verification & Valuation of Stock in Trade:

- To ensure that as far as possible, the amount of stock in trade is really represented by the physical stock of goods.
- To ensure that reasonable care has been taken in determining the physical quantities and the condition of stock in trade.
- To ensure that the client owns the goods and that any hypothecations, liens, or pledges of the stock in trade are disclosed in financial statements.
- To ensure that the stock in trade has been fairly and consistently priced in accordance with the accepted accounting principles

Verification of Stock in Trade: points to be borne in mind by an auditor while verifying the stock in trade:

1. The auditor should examine the system of internal check regarding stock taking and find out whether it is efficient to prevent any manipulation.
2. He should obtain copies of physical layouts of all plants giving the names and descriptions of all departments where stocks are held, names of persons in charge of operations.
3. He should obtain details as to quantity and value of stock with each department at the time of last stock –taking for comparison with the current year's data.
4. He should secure a copy of the stock-taking instructions issued to the staff engaged in stock-taking.
5. He should satisfy himself that proper and adequate records of stock have been maintained by the client, and such cut-off arrangements are made that goods sold but not despatched are excluded from stock, and in case of physical stock taking being at the date other than the balance sheet date, movement of stock in and out of the establishment are properly added or deducted as required.

6. He should ascertain whether the personnel deployed for stock taking are reasonably competent, have enough time to devote to the work of stock-taking and are not concerned with the custody or release of stocks.
7. He should ascertain whether the method prescribed in the management's instructions regarding counting, weighing and measuring of stock are duly adhered to.
8. He should see that goods which are not related to the client's business and those held by the client on others' behalf are excluded from stock.
9. He should see that goods sold on or prior to the closing date are not included in the stock.
10. He should see that items of capital nature like furniture and fittings are excluded from stock.
11. He should test check the physical existence of at least 5% of the items to ascertain whether the stock records do correctly represent the stock in hand.

12. He should inspect the original verification sheets to ascertain whether they cover all the items of stocks and trace a selected number of items, particularly the more valuable ones to the finished stock.
13. He should see that stocks lying with third parties, such as fabricators or consignees are included in the stock sheets.
14. He should scrutinise and compare both the original and fair copies of stock sheets.
15. The auditor should attend the stock-taking at least for a pert of the time, and see if the staff deployed for it discharging their duties efficiently.
16. He should work out the ratio between gross profit and sales of the current year, and compare it with that of the previous two or three years. Any material difference between the two should be properly investigated.

17. He should review and be familiar with the procedure and arrangements of the maintenance of stock records and find out the discrepancy if any.
18. He should compare the stock sheet of the current year with that of the previous year, and see whether there is a considerable difference in the closing stock of the two years. If there is a considerable difference in the closing stock of the two years, he should enquire into the matter.
19. He should check the calculations, additions and castings in the stock sheets and see whether they are correct.
20. He should see whether the work of preparing stock sheets is supervised by a responsible official of the concern, and see whether the stock sheets are signed by a responsible official and a certificate is appended to the stock sheet.

21. He should check the stock sheets. If he finds any alteration in the stock sheets, he should insist upon the initials against such alterations. If he finds any variation between the stock sheet and the stock records, such as bin cards and the stores ledger, and there is any discrepancy, he should enquire into it.
22. If a record is maintained for the purchases and the sales in quality, the auditor should check the purchases and sales and compare the balance with the stock in hand as shown in the stock sheets.
23. He should see that the goods which have been sold, but not delivered to the buyer by the stock-taking date are not included in the stock in hand.
24. He should see that the goods which have been purchased and the relative invoices of which have been entered in the purchases book are included in the closing stock.
25. He should see that the stock sheets are initiated by all persons connected with their preparation.

26. He should verify the stock with the consignee with the help of the certificate received from the consignee.
27. He should verify whether all goods taken in the stock sheets are passed through the purchases books.
28. He should particularly guard himself against the following errors which often creep into the physical verification of stock in trade:
    a) Name, size or part number on the count tags may be entered improperly.
    b) There may be a mistake in identifying the stage of completion of a particular product.
    c) Unit of measurement may be wrongly listed on the tags
    d) Some items of the stock may escape counting, and some counted items may not be recorded in verification sheets.
    e) Discrepancies in stock may not be corrected through adjustments in the stock records.

Valuation of Stock in Trade:

1. He should enquire into the basis of valuation and see that the stocks have been currently valued on the basis of valuation adopted.
2. He should see that the basis of valuation has been consistently adopted from year to year to facilitate comparison of profits of different years. Any change in the basis of valuation should be enquired into.
3. As stock in trade is floating asset meant for resale, the auditor should see whether the stock in trade is valued at cost price or market price, w.e.l.
4. He should check the values of a few items in the stock sheets with their corresponding invoices prices and current selling prices.
5. He should test check the extensions i.e., he should see that the extensions are correct.

6. He should ascertain whether the totals of the stock sheets are correct.
7. He should verify whether slow- moving, obsolete and damaged goods have been listed separately and are properly valued. He should see that suitable adjustments are made against them.
8. He should compare the percentage of gross profit to sales of the current year with that of the previous year and investigate into any material difference i.e., increase or decrease in the percentage of profit.
9. He should find out whether the calculations, additions and castings in the stock sheets are correct.
10. He should see that the stock sheets are signed by a responsible official.
11. He should see that the goods with the consignees or with the customers are valued at cost price and not selling price.

Auditor’s Position or Duty in regard to Verification and Valuation of Stock-in-Trade

As per the Kingston Cotton Mill’s case, England, 1896

a) It is no part of an auditor’s duty to take stock, and he must rely on other people for the details of the stock in hand.

b) The auditor is not a valuer, and for materials necessary to enable him to ensure that the stock appears at its proper value in the balance sheet.

c) He is not an insurer, and his duty does not extend beyond exercising reasonable care and skill in the tasks performed by him, the standard of such care and skill depends on the facts and circumstances of each case.

- He should satisfy himself with regard to the procedures and methods followed in verification of stock by the management, and test the competence with which these procedures are carried out.
- He should examine the internal control programme for verification of stock.
- If possible, the auditor can observe the physical stock taking by the client, and carry out a test check of the work performed at irregular intervals.
- He should compare the original or rough stock sheets with the fair and final stock sheets, and compare the same with the stock records to ascertain the correct position of stock in trade.
- He should satisfy himself that the system of stock valuation is proper and consistent.