Inventory Audit

If your company maintains physical inventory, then you already know how important proper inventory counts are.

Inventory records aren't just essential to inventory control and supply chain management—they're a key part of the financial statements and analytical procedures you use to determine everything from profitability to budgets for new projects and initiatives.

That's why inventory audits play such a key role in effective procurement for any successful company.

Inventory Audits: The Basics

As one of many generally accepted accounting principles, inventory auditing relies on analytical procedures to verify the inventory methods for a given business and ensure both physical inventory counts and financial records are accurate and complete.

Companies rely on inventory audits because they provide a reliable way to protect the company’s financial health (through accuracy of financial statements) and guard against fraud—intentional or otherwise.

Because inventory is classified as a balance sheet account, effective auditing procedures focus on four key aspects: existence, rights, valuation, and completeness.

- **Existence** is the physical presence of inventory.
- **Rights** concern ownership of goods by the company being audited.
- **Valuation** covers correct pricing of goods and any related goodwill impairment.
- **Completeness** of inventory records means all goods that should be recorded are actually included in the records.

Inventory may be kept using either *periodic* or *perpetual* inventory systems.

- **Periodic inventory systems** rely on scheduled physical inventory counts to establish ending inventory balance and the cost of goods sold for the company’s financial records.
- **Perpetual inventory systems** are, as the name implies, continuous. They are more versatile and advanced than periodic systems, but also require more labor in the form of counting procedures and recordkeeping. The advantage with a perpetual system is the immediate availability of physical inventory levels and updated accounting records in real-time.

In many companies, internal inventory controls are established to minimize risk and maximize process efficiency and inventory accuracy.

Examples include restricting physical access to inventory (particularly in public warehouses), separating inventory management and related financial roles, tagging inventory with barcodes, and adding secured intake and outtake protocols.

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Potential Inventory Auditing Challenges

Inventory audit procedures are designed to weed out inefficiencies, errors, fraud, and other issues.

When performing an inventory audit, some of the most common challenges faced by the auditor include:

1. Damaged inventory whose value must be adjusted to reflect its actual value to the company. (*Valuation issues*)
2. Miscounted (intentionally or otherwise) inventory. Overcounted inventory artificially raises reported earnings, while undercounted artificially lowers them. (*Existence and Completeness issues, respectively*)
3. Errors in shipping and receiving of goods can lead to an incorrect end-of-year cutoff total in inventory records. (*Existence issues for overstatements, Completeness issues for understatements*).
4. End-of-year liabilities may not be accurately recorded—or recorded at all—due to vendor invoices not being received or a tactical decision by the company to improve its reported debts. (*Completeness issues*)
5. Consignment inventory issues. Inventory held by the company may be on consignment, or inventory owned by the company itself may be physically out on consignment.

Inventory Audit Best Practices

Performing an inventory audit involves a two-prong approach touching on both physical inventory and accounting records.

It may also include an assessment of the company’s Accounts Payable (AP) and procurement software solutions, as well as their purchasing/inventory workflows, to ensure proper internal controls are present.

Periodic inventory system audits are performed at year-end, while perpetual inventory system audits can be performed at any time, barring unusually high risk exposure.

Evaluating Existing Inventory System

Depending on the type of systems and business processes the company has in place, reviewing the inventory record keeping system can reveal any chokepoints, weak links, or inherent inefficiencies that could compromise inventory accuracy.

For optimal performance, these systems will integrate artificial intelligence and automation to streamline workflows and strengthen accuracy and compliance.

A well-functioning and efficient inventory system will operate like so:

1. Staff requests an item. The request enters approval workflow. Purchase requisition is automatically recorded and linked to subsequent related documents on a cloud-based, centralized server.
2. Available items are dispatched from inventory. If the requested item is not available, a purchase requisition is issued.
3. Purchasing confirms the details of the order and its authorizations. If required, bidding and vendor selection occur, ideally supported by supplier management tools integrated with procurement software to

ensure only approved vendors are used and approved products ordered.

4. Purchase order is digitally distributed. The copy sent to Receiving has its quantities obscured to ensure a manual inventory count when item is received.
5. Goods are received and evaluated. Exceptions are recorded and automatically connected to related documentation. Defective items are returned, while acceptable items are transferred to the warehouse for distribution to recipient.
   Note: Receiving and Inventory areas are physically separated to support complete documentation and minimize errors and fraud.
6. Transferred goods are once again compared to original documents. A signed copy of the receiving report is digitally added to the server and automatically connected to the transaction and inventory records for the order.
7. Invoice is received, reviewed, and verified. Records are automatically updated.
8. All documentation and workflows related to the order, including the invoice, are reviewed by AP.
9. AP issues a voucher for payment. The voucher travels through the approval workflow. Purchase is recorded in the voucher register, which is automatically summarized and forwarded to general accounting at predetermined intervals to allow for review and recording in the general ledger. Records are updated automatically.
10. Approved vouchers and all related documentation are reviewed from the server by cash disbursements staff for payment automatically to ensure timely payment.
11. Payment is issued to vendor and records updated.

If your inventory management system can’t meet these standards, you might need to make some upgrades and adjustments to strengthen your compliance and protect against needless risk.

Performing an Inventory Audit

After reviewing *how* inventory is managed, observing and evaluating an actual physical inventory count and related accounting procedures completes the inventory audit.

A simple audit checklist ensures a complete, accurate, and transparent audit.

- Perform analytical procedures, comparing expected values for gross margin and inventory turnover with values from previous years, as well as unit costs, age of inventory, etc.
- Trace a sample transaction through the inventory/procurement/AP workflows to verify accuracy and completeness.
- Examine workflows and accounting records (including voucher register, disbursements journal, and general ledger), as well as inventory cost figures if the company manufactures goods.
- Verify Last In, First Out (LIFO) or First In, First Out (FIFO) inventory management as appropriate.
- Evaluate cut-off procedures in a period extending from four days before year end to four days after year end to verify accuracy of transaction records.
- Investigate inventory and accounting records for necessary adjustments for obsolete and damaged inventory as well as unrecorded liabilities.
- Review inventory that is out on consignment and goods held on consignment. Adjust records as necessary in the event of consignments recorded as receivables or irregularities in cash disbursements.
- Prepare for a physical inventory count. Review internal controls, workflows, and business processes. Select a statistical sampling of items to test on the actual day of the count. Ensure any relevant policies are up to date and enforced, including (for example):
    - Suspension of shipping and receiving during the audit

    - Use of two-person counting teams
    - Proper barcoding and tagging procedures
    - Separation of consignment goods
    - Creation of a master count sheet accessible only to management
    - Schedule additional review by specialists as necessary to verify inventory quality. For example, food products, jewelry and precious metals, and advanced technological items may require onsite or lab examination to verify their authenticity.
- Observe a physical inventory count. During the physical count, ensure you:
    - Monitor compliance with established inventory policies and procedures, as well as workflow efficiency and accuracy.
    - Review the quality, condition, and age of goods counted to detect obsolescence and impairment (if any).
    - Take test counts and record any necessary adjustments.
    - Record barcode/tag and shipping documents for the last three transactions to ensure no additional items are added to inventory after the audit.
- Repeat analytical procedures to verify final total of cost of inventory and accuracy of pricing.
    - Ensure items included in test counts match listed quantities and price.
    - Adjust inventory to net realizable value as appropriate.
    - Verify gross margin, unit cost, and other values calculated before the audit.
    - Monitor sales of inventory following the audit to determine if it is sold for more or less than cost.

Is Your Company's Inventory Audit-Ready?

No matter how big or small your business, managing the ins and outs of inventory can be challenging.

But by reviewing your inventory processes, implementing helpful tech tools, and making smart use of internal and external inventory auditing, you can keep your workflows moving smoothly, ensure your financial records are accurate, and your bottom line is healthy and growing.

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