Inventory and production cycle mainly deals with:

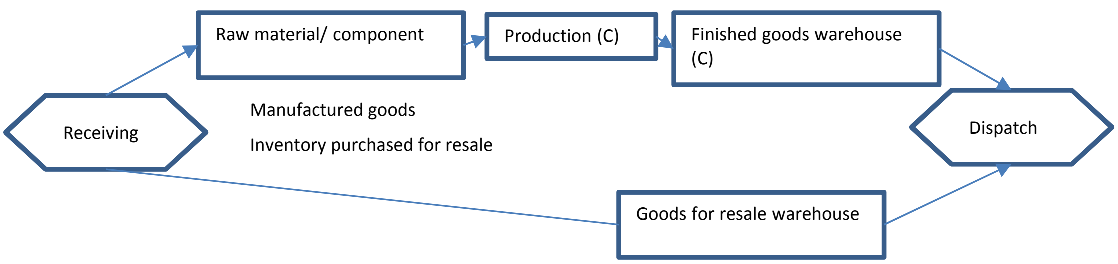
- custody and safekeeping of inventory
- recording of costs where production/manufacturing occurs

Characteristics of the cycle:

- **Heart of the business:** organization is often shaped around what type of inventory it deals with
- **Effects on the FS:** inventory is a major component in the calculation of cost of sales, gross profit and net profit. It plays a prominent role in fair presentation of FS
- **An internal cycle:** no interaction with entities outside the company
- **Physical asset:** extensive internal controls for theft etc. should be in play
- **Inventory fraud:** inventory is important in fair presentation, misstating inventory is an effective way to misstate FS
- **Diversity of inventory:** the accounting system and internal controls should be able to deal with the location, nature, permanence (fresh) and stage of development

Basic requirements for any inventory and production cycle:

- inventory and production cycle must do 3 things:
  - control they physical transfer of inventory
  - protect the inventory from damage, loss, theft etc.
  - plan, control and record costs of manufacture



Documents used in the cycle:

- Goods Received Note
- Materials requisition/materials issue note
- Manufacturing/production schedules
- Job cards
- Production report
- Costing schedule
- Transfer to finished goods note
- Picking slip and delivery notes
- Inventory sheet
- Inventory tag
- Inventory adjustment form

NB: See Jackson & Stent 12/6 - 12/10

Fraud in the cycle

- Fraudulent Financial Reporting
- Misappropriation of assets

Fraudulent Financial Reporting

- inventory presents a very good opportunity for directors to report fraudulently:
- the directors may:
  - include fictitious inventory (existence)
  - understate the write-downs of inventory (valuation)
  - exclude inventory which should be included/ overstate inventory (existence & valuation)
- auditor will conduct physical tests on inventory

Misappropriation of assets

- this mainly amounts to theft
- a lack of division of duties could lead to the theft being hidden easily

Inventory counts: Cycle counts

- frequent comparison and recon of actual assets with theoretical assets
- large companies and companies with a lot of inventory will normally perform cycle counts
- procedures to conduct cycle counts:
  - timing of each count should be planned at the start of the year
  - items to be counted must be identified
  - inventory will be counted using an acceptable method with sound controls
  - the physical count will be compared to the theoretical figure, and discrepancies will be entered onto a sequenced inventory adjustment form
  - discrepancies must be investigated by internal audit & inventory controller
  - adjustment to the records should be made by someone who is independent to the inventory
  - analysis of discrepancies over a period should be conducted to identify any trends

Inventory counts: Year-end inventory count

- companies which operate on the periodic inventory system
- principles to conduct a successful count:
  - planning and preparation
  - design of stationary (documents used)
  - written instructions
  - conducting the count

Computerization in the cycle:

- the systems which interface with the inventory and production cycle will directly affect and be affected by the inventory masterfile

Auditing the cycle:

Financial statement assertions & the Inventory and Production Cycle:

- auditor's main concern is that the asset is fairly presented in the financial statements
- assertions which apply to the inventory account balance: (VERC)
  - **Valuation & Allocation:** inventory is reflected in the FS at appropriate amount
  - **Existence:** all inventory included in account balance actually existed at reporting date
  - **Rights:** the company holds/controls all rights to inventory reflected in FS
  - **Completeness:** all inventory to which the company has rights of ownership is included in FS, all inventory have been recorded
- assertions pertaining to presentation and disclosure:
  - all matters pertaining to balances are **complete**, have been correctly **classified** and **accurately** presented & disclosed in **understandable** manner

Important accounting aspects - IAS2 Inventories

- Inventories consists of:
  - assets held for sale in the ordinary course of business (finished goods)
  - assets held in the process of production (WIP)
  - materials/supplies to be consumed in the production process (raw materials)
- **net realizable value:** estimated selling price less estimated cost of completion & estimated cost to make the sale
- inventory should be presented at the lower of cost and net realizable value, this prevents the asset being presented at a higher amount than what is expected to be realized
- cost of inventories consists of:
  - all costs of purchase including import duties, transaction costs that are not reclaimable (NOT VAT!), transport costs
  - cost of conversion (labor, overheads)
  - cost incurred in bringing inventory to its present location and condition
- excluded from the cost of inventory is:
  - storage costs
  - administrative costs
  - selling costs
- cost of manufactured goods: allocation of overheads to cost of manufactured inv. must:
  - include only fixed costs and variable production overheads
  - based on normal capacity
  - allocated on a systematic basis which is reasonable
  - all other abnormal amounts/wasted material & labor should be excluded
- cost formulae: IAS2 permits 3 cost formulae:
  - specific identification
  - weighted average
  - FIFO
- pricing of imported inventory:
  - exchange rate at which inventory is purchased must be recorded at the transaction date
  - even if exchange rate is different at year-end **no** change is made to value of inventory