
Aspects concerning the internal audit of inventories

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Abstract

The audit of inventories represents a challenge for the staff involved in audit missions especially considering the risks encountered. In the first section of this article a synthesis of the main aspects related to the internal audit procedures reported in the literature is presented. In the second part some aspects related to the internal audit procedures which should be used for the mission of inventories auditing, accompanied also by an exemplification of the audit objectives specific to each procedure are presented.

Keywords: Inventory losses, fraud risk, audit procedures, non-deductible expenses.

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Introduction

Inventories are for many entities assets which present a significant balance in the financial statements (as weight from the total assets) or which have a very big rollover, especially with respect to the companies which have as profile the production or sale of goods.

The financial audit of inventories is a very complex activity due to the fact that, most of the times, the procedures related to the internal control of inventories present numerous deficiencies, these types of categories being subject to an increased risk of fraud (abstraction). Due to this reason, all companies need a physical control of inventories in order to prevent the losses through distortion and theft. Also, the different expenses incurred by the inventory consumption have a distinctive fiscal treatment function of the destinations of this consumption, and several interpretations exist which can generate, in practice, in many situations, fiscal risks. Due to this reason it is important to identify solutions for optimisation (reduction) of fiscal costs related to the inventory losses, considering the fact that in the current economic context, the negative impact from a fiscal point of view could reach approximately 35% of the value of the expenses incurred with the degraded inventories, the destroyed inventories or the missing inventories (16% income tax and 19% VAT). Due to these considerations, within this article a series of audit procedures and techniques used for the internal audit of inventories will be discussed.

1. The presentation of internal audit in the literature

The internal audit represents “the independent and objective activity for insurance and consultancy developed to add value and improvements for the operations of an organization. This helps an organization to reach its objectives by imposing a systematic approach, disciplined to the evaluation process and increasing the efficiency in the processes of managing the risk, control and governance” (Institute of Internal Auditors – IIA, 2015). The role of internal audit is (1) to perform prognoses which offer insurance regarding the correct design and efficient operation of structures and governance processes and (2) to supply adequate advice concerning the potential improvements of structures and governance processes (Turlea and

Mocanu, 2016). For a long time, the internal audit was viewed as a support activity for the external audit. Today the internal auditor is more considered as a consultant for management (Chersan, 2016). The internal auditors are responsible to help the management, being actively involved in solving all the crucial problems of the organization and supplying recommendations and support for the business lines, management and auditing comity (Zinca-Voiculescu, 2016). The responsibility for the establishment of the internal audit department falls upon its manager (de Konig, 2007). The internal audit from today plays an extensive role, being subject to many risks and to a more strictly control applied by the interested parts and is also the object of more expectations and pressures concerning the resources (Deloitte, 2014; Ernst & Young, 2010; PricewaterhouseCoopers – PwC, 2014a, 2014b). The internal audit exhibits an independent and preventive character nowadays (Ciuhureanu, 2016) and has as a main role to prevent the abnormalities (Morariu and Crecana, 2009). Therefore, we consider that the internal audit is not only compulsory but also a requirement for organizations.

Even if the internal audit appeared as a profession in 1940 following the establishment of IIA in USA, this was implemented in Romania about ten years ago, not enough time being passed so that it reaches maturity (Stanciu, 2016). The importance of internal auditing was acknowledged by the Romanian Chamber of Financial Auditors by adopting the Decision no. 88/2007 for approving the Norms for internal auditing and the International Standards for Professional Practice of Internal Audit. According to OUG no. 75/1999 concerning the financial auditing activity, republished, all the entities with financial situations which are under the incidence of financial auditing are under the obligation to organize internal auditing. Also the compulsory norms from the International Professional Practices Framework – IPPF were issued by IIA and adopted by the Decision no. 48/2014 of CAFR. The internal audit has been atypically developed in Romania, starting first in public entities and then in the private ones (Bota-Avram and Popa, 2011).

There is a high number of studies which correlate the quality of the internal audit process with the level of the performance of the organization. For this article we focus on the audit of inventories. We consider that the inventories cost optimization as a result of exercising the

internal audit function may lead to a better performance of one entity.

2. The research methodology

The research presented in this article is of qualitative type. We tried to present the internal audit function according to the literature and to exemplify the techniques and procedures which should be applied in the internal audit process of inventories.

3. The internal audit techniques and procedures used for the inventories auditing mission (with examples)

In the introduction of this section, the inherent and control risks which are specific to inventories – risks that the audit must take into consideration during the mission planning stage – will be considered. In the opinion of specialists (Munteanu, Zuca and Vera, 2016) there is a series of risk factors which can affect inventories, such as:

- Volume of transactions regarding acquisitions, production and sales are in general increased, contributing in this manner to the increase of the risk of account errors occurrence;
- Sometimes special procedures are necessary for the determination of the quantity or value of inventories, such as the appreciation of inventories assessment, performed by other experts;
- Very often, the inventories are stored in different locations, generating in this manner difficulties both in the performance of their control for the prevention of theft or physical degradation, as well as in the accounting of the inventories which are in transit;
- Inventories are vulnerable to the modification of the economic circumstances which can generate the reduction of demands, sales and, consequently, application of different treatments in such cases for their assessment;
- Inventories can be subject to certain returns (for example, packaging materials).

Within this section, the main internal audit procedures that the auditor must apply during the mission of auditing

the inventories will be described. As such, the procedures which must be taken into consideration for the development of the mission as well as the audit tests which are necessary within the described procedures will be synthesised and presented below.

A first procedure consists in *obtaining information regarding the existent controls*. Within this procedure, information regarding the following items are obtained:

- a) Company's organisational chart;
- b) Documents used (format, pre-numbering) and flows for the circuit of documents and information (flow-chart);
- c) The existence and coherent application of purchasing, reception, storage, inventory outflow procedures etc., as well as their inclusion in the manual containing company's own policies and procedures;
- d) Controls upon pledged inventories and/or upon inventories at third parties;
- e) Method for accounting inventories (permanent/intermittent inventory);
- f) Assessment method used for removing inventories (FIFO, LIFO, CMP etc);
- g) Assignment of responsibilities and segregation of tasks;
- h) Manner in which the security against fire, deterioration or calamities is assured;
- i) Physical monitoring of inventories (periodicity, procedures, capitalization of results, depreciated inventories, perishability, provisions).

Following to the collection of information regarding the existent controls, the auditor will apply *the testing/assessment procedure for the existent controls*, monitoring the circuit of documents/information and verifying the exercising controls. Within this procedure, the auditor will perform the following tests of detail:

✓ *Test of detail regarding the acquisition of inventories*

In the organisational chart of the company there is an acquisition department which manages all acquisitions necessary for the development of the activity. This department develops the orders to suppliers. The ordering form developed in this respect is authorised by the responsible persons, according to the internal procedures adopted by the company. For the verification

of the enforcement of the internal procedures related to the acquisition of inventories, the auditor will initiate conformity tests.

Thus the auditor will select a representative sample of orders issued by the supply department and will verify the acquisition documents for all selected inputs. As such, the auditor will start to verify the accurate development of acquisition documents and will verify the enforcement of the internal procedures. For this purpose, the auditor will verify if the quantities and unitary prices from the acquisition invoices are reconciled with the data included in the goods received note and with the data operated in the inventory management. Also, the auditor will verify the observance of the company's internal procedures with respect to the following items: authorisation of acquisitions, selection of suppliers, persons responsible for signing acquisition documents and authorisation of payments for suppliers.

✓ *Tests of detail regarding the inventories output*

In order to verify the enforcement of the internal procedures related to the inventories output, the auditor will initiate conformity tests. Thus the auditor will select a representative sample of inventories and will verify the documents related to the output from storage houses, respectively the consumption/transfer requisition form. As such, it is necessary that the auditor will ensure that the systematic evidence of these forms is in place; the auditor will have to verify also the observance of the internal procedures regarding the authorisation of output inventories. At this point also, the auditor will verify the manner in which the method selected by the company with respect to the release of inventories is observed and if this method is applied in a consistent manner from the point of view of the audit evidence the documents related to the movements of inventories on each product (requisition forms).

✓ *Tests of detail regarding the inventories management*

It should be noted that the auditor is not responsible for actually monitoring the inventories or for coordinating this activity. The auditor's task is limited to observing the development of the inventory in accordance with the internal settled procedures and to ensuring the existence of inventories. As such, the auditor must ensure that:

- All inventories were inventoried (counted one time);

- Depreciated inventories and the inventories with slow movement were identified separately;
- All cut-off procedures were observed (inputs and outputs were registered in the correct fiscal year);
- Will check on a sample base the accuracy of the inventory for certain items;
- Will draft working charts for the applied verification tests;
- Will monitor the use of pre-numbered labels for the identification of inventoried inventories (in order to avoid the omission or double inventory);
- Collection by the responsible person of all inventory lists and marking of the non-used ones (the same thing is applied for labels).

Following the participation to the inventory, the auditor will obtain a copy of the inventory lists and will verify the accuracy of the computations.

Thus the charts with the results of the verification tests will be compared. Also, the quantities and values according to the inventory lists will be compared with the data from the accounting system and if the reconciliation is not possible, the differences are analysed and clarified (respectively the authorisation and accountancy of the inventory losses/overstock).

According to the International Audit Standards (ISA 240), the auditor must assess also the inherent fraud risks which could be generated through the adoption by the entity of internal non-feasible inventory procedures or procedures which are not compliant with the legal provisions. In this respect, the international norms propose the performance of the following audit tests:

- Examination of inventory records of the entity in order to identify locations or elements which need a special attention during or after the development of the inventory;
- Monitoring of inventories at certain locations in a non-planned manner or the performance of inventories at all locations at the same date;
- Performance of inventories at or close to the end of the finalisation of the reporting period for minimising the risk of inadequate handling during the inventory period and at the end of this period;
- Development of certain additional procedures during the monitoring of the inventory, for example, a more rigorous examination of packed elements, the

manner in which they are stacked or labelled. In this respect, the use of the services of an expert might be necessary;

- Comparison of the quantities for the current period with previous periods, on classes or categories of inventories, location, or other criteria, or comparison of the inventoried quantities with continuous records;
- Use of computer assisted audit techniques in order to test additionally the compilation of physical inventories – for example, sorting function of the number of the label in order to test the controls related to labels or function of the current number of the elements in order to test the possibility to omit or duplicate an item.

In the final part of this section it is necessary that the auditor will verify the functions segregation procedure within the entity, procedure which plays an important role in the process of inventory management. According to the practical experience, this procedure can identify potential risks in the activity of inventory management, by testing the compatibility of functions exercised by the operational departments of the entities (acquisitions, financial – accounting etc). Considering this aspect, the review of the internal procedures of entities with respect to the delegation of the responsibilities to the persons/departments authorised to develop the following activities presented in **Table no. 1** is proposed.

Table no. 1. Segregation of functions	
Description of the procedure	Process
Acquisition of inventories	<ul style="list-style-type: none"> ▪ Selection of suppliers ▪ Approval of suppliers ▪ Issuance of the order ▪ Approval of the order ▪ Reception of inventories ▪ Drafting the goods receipt notes ▪ Solving issues with suppliers ▪ Approval of invoice payment ▪ Record of inventory input ▪ Registration of acquisition in the accounting system ▪ Storage of inventories in good conditions ▪ Access to inventories in warehouses ▪ Issuance of supply requisition forms
Inventory consumptions	<ul style="list-style-type: none"> ▪ Approval of supply requisition forms ▪ Issuance of transfer notes ▪ Approval of transfer notes ▪ Registration of warehouses output documents ▪ Accounting of outputs ▪ Dispatch of products from warehouses
Monitoring of inventories	<ul style="list-style-type: none"> ▪ Warehouses inventories ▪ Inventory of other stocks ▪ Capitalization of inventories ▪ Drafting the Inventory minute ▪ Approval of inventory differences and their registration ▪ Accounting of inventory differences

A sensible aspect is represented by the losses registered at the level of inventories. In case of known inventory losses (perishability, technological losses, etc.) the risks can be quantified, due to the fact that these risks are generated by known events/decisions, being taken into consideration. In case of unknown inventory

losses, in practice, it was frequently acknowledged that they are caused mainly by thefts, both from the part of third parties as well as from the part of the company's own employees. Unknown losses (meaning the losses generated by the differences which occur following the reconciliation of factual inventories, following the

inventory) can be diminished through the implementation of measures, such as, for example: organisational measures aiming at optimising the management of inventories, through the enforcement of an effective security system, through the conclusion of contracts related to the inventories insurance with companies

specialised in this field of activity etc. Each of these measures show, however, advantages and disadvantages, which are quantifiable at the level of costs. The opportunity of implementing such measures can have a series of implications, such as the ones synthesised in **Table no. 2**.

Table no. 2. Measures for reducing the risk of fraud in case of inventories

Measures for reducing the risk of fraud	Advantages	Deficiencies
1. Organisational measures aiming to optimise the inventories' management (acquisition of an effective software for the inventory management, employment of qualified personnel etc.)	Contributes to the reduction of the risk of operating errors occurrence; The costs generated by these measures are deductible from a fiscal point of view.	Do not contribute significantly to the elimination of thefts from the part of third parties or own personnel, in the conditions in which the entity did not assign persons responsible for inventory administration
2. Implementing of an effective safety/security system	Contributes especially to the diminishing of thefts; Costs generated with the security services are deductible from a fiscal point of view.	Additional costs with the security services; Limited effectiveness if the supervising of the outsourced security services is not performed, under the conditions in which these services undertake a limited level of responsibility for the losses.
3. Insurance of inventories, by means of concluding contracts with specialised companies	Costs generated with the insurance services are deductible from a fiscal point of view; The potential lack of inventories with non-imputable character are deductible from a fiscal point of view.	Significant costs with the insurance premiums; Difficulties in settling the situation in which a lack in the inventory is imputable; Increased risk of theft from the own employees, if there are no persons assigned as warehouse operatives according to the provisions of law.

Conclusions

The importance of our study lays in the close-up view of one of the most important elements from an entity, the inventories. Also because of the fact that the field of internal auditing is not well developed in Romania, we estimated that this article will be of significant importance for the practitioners in the field.

In case of entities which present a significant rollover of inventories, the implementation of an effective internal control system as well as of the internal audit function must constitute a preoccupation of the management / stakeholders, with the purpose of preventing and detection of risk of dilapidation of these categories of assets. We underline the fact that the internal audit is very important and plays a significant role in preventing

and detecting fraud, role which most of the times is under-evaluated by many entities.

The internal audit has the responsibility to analyse, by means of specific audit procedures and techniques (mentioned in the content of the first section), the destination of expenses incurred by the inventory consumption, the manner of evaluating these costs and the fiscal treatment, as well as the periodical monitoring of effectiveness indicators for the use of merchandise inventory (consumptions/incomes). As indicators of efficiency, the ones regarding the "Gross profit obtained from the sale of merchandise" (computation formula: "Gross profit obtained from the sale of merchandise / Incomes from the capitalization of inventories") and "Cost of the sold merchandise" (computation formula: "Cost of sold merchandise / Income obtained from

capitalization of merchandise”) are relevant. The detailed analysis of inventories expenses and their correlation with the incomes obtained from the capitalization of these inventories contributes to the reduction of risks of recording in the accounting evidence of expenses which are not related to incomes.

Verifying by the internal auditor of the conformity of acquisition/output procedures related to inventories from patrimony/inventory with the legal regulations in force which contribute to the increase of the degree of control of inventory administration as well as to the prevention of fiscal risks. The procedure related to the administration of inventories is very important; this procedure must provide an assurance that the counted inventories are the accurate ones. The accountability of inventories is an important procedure and must be performed with responsibility, due to the fact that it is the basis of recorded the inventory expenses and, consequently it influences the exploitation result. It should be noticed that irrespective of the accounting method adopted for the administration of inventories, the assessment of the inventories (at the input, output and balance) represent a problem; the resolution of this problem depends by the complexity of the sorts structures, taxation and profitability.

It is also important that the role of the internal audit regarding the presentation of proposal measures to the shareholders with respect to the risk management concerning the unknown inventory losses (detailed in the content of the article). For this purpose, it is necessary to support the opportunity of implementing such effective contracting measures for inventory losses. Even if these measures imply additional initial costs, on long term they can lead to the optimisation of inventory costs and can significantly diminish the fraud risks as well as the fiscal risks regarding the registration in the accounting inventories of the fiscal non-deductible expenses.

Considering the actual economic context, the decrease of costs, including in this way the inventory losses as well, could attract important competitive advantages so that the diminish of losses generated by inventories especially within the entities in which these assets have a significant weight must represent a very important objective. As such, it is necessary that the entity would implement its own adequate policies and procedures with respect to the management/administration of these categories of assets due to the fact that these patrimonial elements present a very high risk of fraud and most of the times this risk can be generated even by the company’s own employees.

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