

Physical stock inventory – the possibility of applying audit procedures of the COVID-19 pandemic period to the future

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Abstract: The obligation of the assets and the liabilities inventorying of the accounting units is based on Act no. 563/1991 Coll., On Accounting. The accounting units which have the obligation to verify the financial statements by the auditor must provide unrestricted access to all information relevant to the preparation of the financial statements to the auditor. In this context, essential requirements are places on the auditor regarding the obligation to attendance at the physical stock inventory counting, if the inventories are material to the financial statements. The auditor conducts audit procedures that provide the sufficient and appropriate audit evidence. The assessment of the information obtained in this way is always dependent on the professional judgment of each auditor. The paper presents the application of the audit procedures at the physical stock inventory especially during the COVID-19 pandemic period in accordance with regulations, and offers possible views on usage of these procedures to the future.

Keywords: inventories; physical stock inventory; audit procedures; COVID-19 pandemic period

JEL Classification: M41, M42

1 Introduction

The obligation of accounting units to inventorying assets and liabilities is included in Act No. 563/1991 Coll., On Accounting, as amended. There is no decree on the inventorying for business entities in the current legislation, the business entities can use for inspiration Decree No. 270/2010 Coll., On Inventorying of Assets and Liabilities, as amended, which is intended for state non-profit organizations. The inventorying accounting procedures are regulated strictly by Czech Accounting Standard 007 Inventory differences and losses within the norms of natural stock depletion. An integral part of the regulations relating to the inventorying of the assets and liabilities is certainly an internal directive of the accounting unit, which specifies the actual execution of the inventorying of the assets and liabilities. With regard to the verification of financial statements, the accounting units are obliged to provide the auditor all information relevant to the preparation of the financial statements, including evidentiary information about existence and condition of the inventories through the auditor's participation at the physical stock inventory.

In modern history, epidemics and pandemics have tended to avoid the Czech Republic. The COVID-19 pandemic, which demonstrably appeared in the Czech Republic in March 2020, represented a major impact not only on the Czech economy (www.nzip.cz). The COVID-19 pandemic meant a risk for domestic companies, especially in the form of a lower number of employees who either had to enter quarantine, or were forced to stay at home with their children due to closed schools, as well as the risk of a reduction in the number of customers, the government restrictions in the form of a temporary ban on business activities in 2020 or the varying degrees of the restrictions on trade and services in 2020-2022.

Thus, during the pandemic, companies faced the obligation to comply with the condition of the inventorying, just as auditors faced the obligation to personally participate at the physical stock inventory. At that moment, these were situations that were hard to imagine for the companies and the auditors. The question remains in what form, to what extent, and therefore in what quality physical stock inventories were conducted by the company, by what procedures were used to obtain audit evidence about the existence and condition of the company's inventories, and whether it is possible to learn from the pandemic time, and try to use certain auditor's procedures to the future years as well.

2 Methods

In the following chapter, the legal obligation to audit accounting units is defined in accordance with Act No. 563/1992 Coll., On Accounting, as amended. Subsequently, the inventorying and the physical stock inventory are described according to the current legal regulations of the Czech Republic, i.e. Act No. 563/1992 Coll., On Accounting, Decree No. 500/2002 Coll., by which certain provisions are conducted of Act No. 563/1991 Coll., On Accounting, for accounting

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units that are entrepreneurs recording in the double-entry bookkeeping system and Czech Accounting Standard 007 Inventory Differences and Losses within the Norms of Natural Declines in Inventories (hereinafter CAS 007). An essential part of the paper is the definition of the conditions and obligations of the auditor to attendance at the physical stock inventory counting, if the inventories are material to the financial statements, according to the International Auditing Standard 501 “Audit evidence – specific considerations for selected items” (hereinafter ISA 501).

The paper presents and analyzes the issue as described in the regulations listed above. The main research methods used in the paper are the method of description, analysis and synthesis. The subject of this paper is, based on the legislative definition of the physical stock inventory and the auditor's obligation to attendance at this physical stock inventory counting, to demonstrate the audit procedures applied not only during the COVID-19 pandemic period and to offer the possible use of the audit procedures from the pandemic period to the following years.

2.1 Statutory audit obligation

The obligation to audit Czech accounting units by their categories is regulated by Act No. 563/1991 Coll., On Accounting. The category of the accounting unit is always decisive for the verification of the financial statements by the auditor. Large and medium-sized accounting units are always required to have their financial statements verified by the auditor, small accounting units only if one criterion is exceeded for two consecutive periods, on the condition that it is joint-stock company or state funds. For other small accounting entities, the rule of exceeding two criteria for two consecutive periods applies. Act No. 563/1991 Coll., On Accounting then lists the required criteria. The obligation to verify the financial statements for micro accounting units is imposed only by special legal regulations. Act No. 563/1991 Coll., On Accounting also lists cases in which accounting units do not need to have their financial statements verified by the auditor.

2.2 Inventorying and physical stock inventory according to legislative regulations

The obligation to conduct the inventorying to document the balances of individual items (i.e. the assets and liabilities) of the financial statement is imposed on all accounting units by Act No. 563/1991 Coll., On Accounting. Act No. 563/1991 Coll., On Accounting regulates the obligation of the inventorying in Part Five with only two paragraphs, namely § 29 and § 30. Müllerová & Šindelář (2016) describe the purpose of the inventorying as ensuring the control of the factual correctness of the accounting and the control of the reality of the valuation of the assets and the liabilities in the accounting.

The accounting units conduct the inventorying in accordance with the provisions of Act No. 563/1991 Coll., On Accounting, either at the time when they compile the financial statements (i.e. periodic inventorying), or during the accounting period (i.e. continuous inventorying):

- *Periodic inventorying* – the accounting units can start the inventory no earlier than four months before the balance sheet date and end the inventory no later than two months after the balance sheet date. The accounting units can set a day for ascertainment of the actual state, which also precedes the balance sheet date, and they can complete the ascertainment of the actual state according to the accounting records that demonstrate the increases and decreases of the assets and the liabilities incurred between this date and the date of the financial statements.
- *Continuous inventorying* – the accounting units can conduct the continuous inventorying only for the inventories for which they record according to the types or to their storage locations or materially responsible persons, and also for long-term tangible movable asset that is constantly in motion and does not have a permanent place where it belongs. Each accounting unit determines the term of the inventorying, each type of the inventories and long-term tangible assets must be inventoried at least once per accounting period.

Accounting units determine the actual state of all assets and liabilities through the inventorying, and verify whether the ascertained actual state corresponds to the state of the assets and liabilities in the accounting, and whether there are no reasons for correction items charging (Decree No. 500/2002 Coll.). The actual state of the assets whose existence can be visually assessed, i.e. long-term tangible assets, inventories or financial assets (e.g. cash, valuables etc.), is found out through a so-called physical stock inventory. The accounting units can determine the actual state by e.g. counting, measuring, weighing or similar numerical methods during the physical inventory (Act No. 563/1991 Coll., On Accounting).

The accounting unit is obliged to record any identified inventory differences to the current accounting period for which the inventorying is conducted, even if the inventorying is only conducted at the beginning of the following accounting period (CAS 007). The inventory differences mean the differences between the actual state established by the physical or documentary stock inventory and the state in the accounting – the actual state is lower than state in the accounting, the difference is marked as the deficit, and according to CAS 007, it is recorded to other operating costs; the actual state is higher than state in the accounting, the difference is marked as a surplus, and it is recorded to other operating revenues.

2.3 Auditor's attendance at the physical stock inventory

As set out in ISA 501, the auditor's objective is to obtain the sufficient and appropriate audit evidence about the existence and condition of the inventories. At the same time, if the inventories are material to the financial statements, the auditor is obliged to obtain the sufficient and appropriate audit evidence about the existence and condition of the inventories by:

- attendance at the physical stock inventory counting in order to evaluate the management's instructions and procedures for recording and controlling the results of the entity's physical stock inventory; observe the performance of management's count procedures; inspect the inventories and perform test counts;
- performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventories count results.

ISA 501 also regulates situations that may arise in practice:

- the physical stock inventory is conducted at a date other than the date of the financial statements – the auditor shall perform audit procedures to obtain audit evidence about whether changes in the inventories between the count date and the date of the financial statements are properly recorded;
- the auditor is unable to attend at the physical stock inventory counting due to unforeseen circumstances – the auditor shall make or observe some the physical stock inventory on an alternative date and perform audit procedures on transactions between the two dates;
- the auditor's attendance at the physical stock inventory is not possible – the auditor shall perform alternative audit procedures to obtain sufficient and appropriate audit evidence regarding the existence and condition of the inventories. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with International Auditing Standard 705 "Modifications to the Opinion in the Independent Auditor's Report" (hereinafter ISA 705).

3 Research results

The Results chapter first of all presents the most common problem areas associated with the physical stock inventory. Furthermore, it summarizes the possible applied audit procedures in obtaining audit evidence through the participation or non-participation of the auditor at the physical stock inventory counting because of the moment of conducting this inventory according to current regulations, and also focuses on the audit procedures applied during the COVID-19 pandemic, and offers possible uses to the following years.

3.1 Physical stock inventory – problem areas

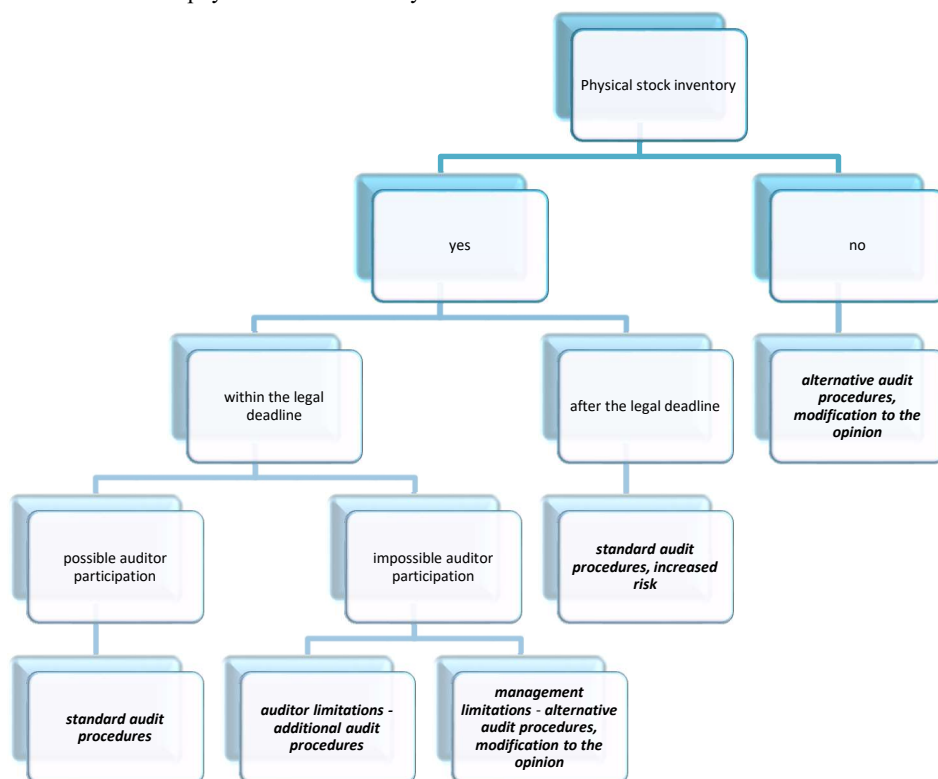
§ 30 paragraph 6 of Act No. 563/1991 Coll., On Accounting, allows accounting unites to start the physical stock inventory no earlier than four months before the balance sheet date and to complete it two months after the balance sheet date, this gives accounting unites enough space to conduct the physical stock inventory. Nevertheless, problematic areas appear, especially e.g.:

- setting an unreasonably short deadline for conducting the physical stock inventory;
- insufficient definition of the inventoried assets;
- non-updated internal directive, or even the internal directive does not exist, or the accounting unit does not follow the internal directive when conducting the physical stock inventory;
- the physical stock inventory is not conducted, the record balances from the accounting are written down;
- conducting the physical stock inventory for a long time before the balance sheet date – insufficient proof of the inventories level between the physical stock inventory and the balance sheet date, misrepresentation of the actual inventories level to the balance sheet day;
- some problems with recording of the inventory differences – the differences are recorded into the following accounting period instead of the current period, the deficits are incorrectly recorded as tax-deductible costs, furthermore, the deficits are incorrectly recorded as tax-deductible costs.

3.2 Physical stock inventory – audit procedures

Figure 1 summarizes the possible applied audit procedures because of the physical stock inventory by the accounting unit and the auditor's attendance. The content of the figure is subsequently characterized in more detail.

Figure 1 Audit procedures within the physical stock inventory



Source: Own processing

A frequent variant is the situation, when the accounting unit has conducted **the physical stock inventory within the legal deadline with the personal attendance of the auditor** who performs the standard audit procedures. The main purpose of the auditor's attendance at the physical stock inventory counting is to check and evaluate the setting and application of the physical stock inventory process itself in the accounting unit, and recalculate the selected inventories sample, which must be sufficiently large. In practice, the accounting unit has a total of six month to conduct the physical stock inventory, so the physical stock inventory can be conducted at a date other than the date of the financial statements:

- The physical stock inventory is conducted before the balance sheet date with the attendance of the auditor, the auditor conducts the standard audit procedures on the physical stock inventory date, and verifies the transactions (i.e. increases and decreases) between the date of the physical stock inventory and the balance sheet date, it is so-called “*rollforward method*”. However, the auditor must verify the data of increases and decreases specific inventories items with the help of accounting documents, which the auditor must support with the audit evidence, such as delivery notes, invoices, etc.
- On the other hand, the auditor uses “*rollback method*”, if the physical stock inventory is conducted by the accounting unit on a later date than the balance sheet date. The auditor must retroactively recalculate the final balances of the specific inventories items through the accounting documents made after the balance sheet date, which must be further verified again by the auditor.

If **the auditor's attendance at the physical stock inventory counting is not possible**, even though the accounting unit conducts the physical stock inventory within the legal deadline, this may be due to either limitation from the auditor's side, or limitation from the management's side. The limitation from the auditor's side is due to an unforeseeable event (e.g. quarantine during the pandemic). The auditor may replace his attendance at the physical stock inventory counting with another person who must meet the requirements of § 14e paragraph 3 of Act No. 93/2009 Coll., On Auditors, as amended (it must be a team member who is sufficiently trained). However, if the auditor is unable to replace his attendance with the authorized team member, the auditor is required to conduct the physical stock inventory on another date, and conduct audit procedures on transactions between the two dates. The auditor is able to obtain the sufficient and appropriate audit evidence about the reliability of the physical stock inventory conducted by the accounting unit only in this way. The auditor can then proceed to other additional audit procedures based on his professional judgment and according to the amount of assessed audit risk. The limitation from the management's side of the auditor's attendance at the physical stock inventory counting could have been caused during the pandemic, for example, by the fact that the company's management either did not allow, or expressly prohibited the auditor's personal attendance due to the spread of the risk of transmission of COVID-19. The auditor must decide whether to conduct the alternative audit procedures, as ISA 501 states. However,

ISA 501 does not specify exactly what is meant by alternative audit procedures. ISA 501 only adds that if the auditor cannot conduct alternative procedures that would ensure to obtain the sufficient and appropriate audit evidence about the existence and condition of the inventories, the auditor is required to modify his opinion in the auditor's report. The alternative audit procedures are thus able to cover increased audit risk, which is caused by limitation of the audit procedures from the management's side. If it is possible to conduct alternative procedures, it is not necessary to modify the auditor's opinion. The auditor can consider the alternative audit procedure, for example, a remote audit access with the help of an online transmission, supplemented by the inspection of the warehouses, and the recalculation of the inventories sample on another day. The auditor's decision criterion, whether to use the remote audit access and apply the alternative audit procedures, is the evaluation of the risk of the frauds at the accounting unit, and the setting of its internal control system. At the beginning of the remote audit access, it is also necessary to mention that this procedure is not suitable in all cases, because not everything that the auditor obtains through simple observation, questioning, or inspection can replace the remote audit access. The remote audit access also has its limitations consisting of, for example, a possible manipulation, an organization of the warehouse spaces, an increased risk of the correctness of the calculation, a nature of the inventories (for example, when the inventories are measured in volume, weight, etc.), the need to call in an expert, and last but not least, it is also necessary to consider the possibility of a technical failure of the online transmission. Despite existing limitations, the auditor must decide, on the basis of his professional judgment, whether or not the alternative audit procedure is appropriate and provides audit evidence. The auditor should sufficiently document the procedure of the remote audit access through the recording. A person making the recording also plays an important role here. For the sake of objectivity, it should be the person completely independent of the inventory committee, the accounting office, the warehouse management, etc. – i.e. the employee who will only conduct the instructions given by the auditor. On the other hand, the auditor may also decide, based on his professional judgment, that the remote audit access is not credible. This may be a situation where the auditor conducts the audit for the first time in the accounting unit, i.e. the auditor does not have sufficient knowledge of the overall inventorying process in the accounting unit. Furthermore, the internal control system related to storage is not sufficiently set up, the warehouses are not clearly organized, or due to the creation of new warehouse spaces. In this case, the auditor is obliged to modify his opinion in the auditor's report in accordance with ISA 705, and to inform the management of the accounting unit about this fact.

Another variant is the situation when **the accounting unit has conducted the physical stock inventory after the legal deadline**, e.g. because the accounting unit did not have time to conduct the physical stock inventory during the pandemic. The accounting unit should ideally conduct the physical stock inventory as soon as possible, as it is obliged to comply with the obligations of Act No. 563/1991 Coll., On Accounting, and this fact should be stated and explained in an appendix to the financial statements. The auditor must then assess the impact of this fact on the accounting unit's financial statements in terms of increased risk. The auditor conducts the standard audit procedures, but should also focus, among other things, on checking of the settled inventory differences (i.e. deficits and surpluses), whether they were charged by the accounting unit into the accounting period to which they actually belong, and not to the following accounting period. Furthermore, the accounting unit can face the sanctions for failure to comply with the obligation to conduct the inventorying of the assets and liabilities within the legal deadline according to Act No. 563/1991 Coll., On Accounting.

If **the accounting unit does not conduct the physical stock inventory**, the auditor cannot participate at the physical stock inventory counting, and the auditor must communicate this fact to the management and to persons entrusted with administration and management. The auditor must consider the effect of not conducting the physical stock inventory on the audit risk assessment, especially in the area of frauds. The physical stock inventory is the main control consisting in verifying the condition and existence of the inventories. In the event that the accounting unit does not conduct the physical stock inventory (the inventories are material to the financial statements), it is rightly considered a serious deficiency of the accounting unit's internal control system. At the same time, it has an impact not only on the evaluation of risks in the area of the inventories, but also in the area of completeness and correctness of the costs and revenues amount. In such a case, the auditor may again use the alternative audit procedures. Again, if alternative audit procedures cannot be conducted because the auditor evaluates them as insufficient to obtain audit evidence, the auditor is required to modify the opinion in the auditor's report in accordance with ISA 705. By the fact that the accounting unit risks modifying the opinion in the auditor's report as a result of the physical stock inventory not being conducted, it also commits an offense according to § 37a paragraph 1 letter g) of Act No. 563/1991 Coll., On Accounting which is punishable by a sanction of up to 3% of total assets. Without the inventorying, the accounting is incomplete, inconclusive, does not reflect the actual state of the assets and the liabilities, and is therefore not correct.

4 Conclusions

The inventorying obligation of the accounting units is based on Act no. 563/1991 Coll., On Accounting. Although the law leaves enough time to conduct the physical stock inventory, the accounting units often tend to underestimate the

physical stock inventory, to conduct it only formally based on the accounting documents, or not to conduct it at all. Although when the inventorying is conducting correctly, the accounting unit can at most reveal deficiencies in administration, such as poorly organized work in the warehouse or divided competences, or even how the management of the accounting unit seriously intends to do with controls in the area of the inventories. Otherwise, the accounting unit will at most find that the accounting balances correspond to the actual balances. Without the inventorying, the accounting is incomplete, inconclusive, does not reflect the actual state of the assets and the liabilities, and is therefore not correct according to § 8 paragraph 2 of Act No. 563/1991 Coll., On Accounting. In this way, the accounting unit commits an offense according to this Act which is punishable by a sanction of up to 3% of total assets.

The limitations associated with the given issue resulted mainly from the emergence of a completely new situation – the COVID-19 pandemic, with which neither the accounting units nor the auditors themselves had previous experience. The Results chapter presents the possible positions of the alternative audit procedures in the sense of the remote audit access, which, however, also has disadvantages, and therefore the use of this method is always dependent on the professional judgment of each auditor.

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