**Chapter 14, Auditing Inventory Processes: Tracking and Costing Products**

**In the Land Development and Home Building Industry**

**A1 Why is it fairly easy for large home building companies to use job order and specific identification costing methods?**

Job order and specific identification costing methods are fairly easy in this industry because the production is of discrete housing units, to which labor and materials can be easily traced. Direct materials are typically some standard amount based on architectural and engineering specifications. Direct labor can be the amount that is paid to a subcontractor responsible for building a specific unit.

**A2 What is the relative area method for allocating common costs in the home building industry, and when is it appropriate?**

When using the relative area method for allocating common costs, a particular parcel or unit is allocated common costs based on its portion of the land or space relative to the total. This method is generally appropriate when all the parcels of land and residential units are relatively uniform.

**A3 What is the appropriate way for inventory in the home building industry to be written down if its fair value permanently drops below cost? What is the applicable accounting standard?**

The applicable accounting standard is FASB ASC 360-10-05-4, and it states that value is evaluated by comparing estimated future undiscounted cash flows of inventory assets to the recorded costs of the assets. If the cost is higher than the relevant calculated cash flow amount, the recorded amount of the inventory is written down.

**A4 When is the percentage of completion method used in the residential home building industry and why?**

Percentage of completion is typically used for revenue recognition for multifamily buildings. The percent that the building is complete is calculated and then that percentage of revenue for presold units is recognized. (Note, as discussed later in the chapter, the seller must estimate the impact of expected cancelled contracts.)

Page 760

**B1 How does the inventory cycle interact with other business cycles?**

Inventory is purchased as a function of the acquisition and payments cycle and is sold as a function of the revenue and collections cycle. It also interacts with the human resources cycle for labor inputs.

**B2 What additional issues must manufacturers address regarding inventory that do not affect other types of businesses?**

1. Producing finished goods from raw materials

2. Physical security over inventory before, during and after the production process

3. Proper authorization for the movement of materials and finished goods

4. Effective cost accounting

**B3 What is the purpose of a cost accounting system? What different types of information can be used in different businesses?**

A cost accounting system accumulates information on the addition of inputs into work-in-process inventory. The different types of information used in a cost system may be:

1. quantity of units of inputs used

2. cost dollars included

3. movement of goods

**B4 How does the human resources cycle and payroll affect the cost accounting records?**

Information from the human resources cycle, about inputs of labor to inventory must be captured by the cost accounting system.

**B5 What should and should not be included in overhead?**

Included are product costs and overhead related directly to the manufacturing processes. Excluded are administrative costs and other period expenses.

**B6 What happens to variances known as over- and underapplied overhead?**

Variances from over- and underapplied overhead are allocated among the inventory accounts and cost of goods sold, or simply posted to cost of goods sold.

Page 762

**C1 In what ways might inventory recordkeeping differ when the purpose is for operating management versus the preparation of financial statements for external users?**

In order to manage the production process, operating management keeps track of units of inputs on hand and units of inventory at various stages of completion. Managers may run the company, at least for the short run, using information on inventory units, and cost information only for those items they can control or change. In contrast, to be able to produce financial statements for external use, the company needs to track and record the cost of direct materials, in-process inventory and finished goods inventory in dollars, including any costs of manufacturing that must be allocated.

**C2 How does job order costing differ from process costing?**

In job order costing, work-in-process costs are aggregated for each individual inventory item or project. A job cost record is used to document total traced material costs, direct or traced labor costs and the allocated overhead or common costs. In process costing, work-in-process components are the same but are aggregated based on batches rather than specific inventory projects and different supporting documents are appropriate.

**C3 When standard costing is used, multiple variances result. Why?**

Under standard costing estimates of direct costs and overheads are assigned to inventories throughout the accounting period. Hence there will be differences between these actual and estimated costs.

**C4 Why is market value important to the accounting for inventory?**

GAAP requires market value of the inventory to be considered and compared to the recorded cost. When the market value of inventory has permanently gone below its cost, the inventory must be written down.

Page 765

**D1 On what do controls in the inventory cycle focus?**

Physical security

Authorization for the movement of inventory before and during the manufacturing process

Appropriate cost accounting

**D2 What are the purposes of the controls? What do they try to accomplish?**

Prevent the loss of the assets

Promote efficient and effective operations of the business

Enable the company to produce credible financial reports

**D3 What source is the biggest threat to inventory assets in a manufacturing business?**

Theft and damage caused by “in house” sources

**D4 Why are physical controls over inventory assets important?**

Their significant dollar magnitude and the ease with which inventory items (especially small items) can be stolen or misused if they are not physically controlled

**D5 What controls are effective for the movement of inventory?**

1. Authorization for the movement of inventory, backed up by documentary support, such as approvals for raw materials to be moved from stores to the manufacturing process

2. Documentation supporting the accountability of each worker taking custody of goods.

3. Segregation of duties.

Page 767

**E1 What is accomplished through a walkthrough?**

A walkthrough allows the auditor to understand the client’s information system for inventory transactions and to gain evidence on design effectiveness. Inquiry of employees and observation of their activities may provide some evidence on operating effectiveness of controls.

**E2 What are the five management assertions**

Existence or occurrence

Completeness

Rights and obligations

Valuation and allocation

Presentation and disclosure

**E3 How and why are controls in the other cycles important to the inventory cycle?**

Sales, purchases and human resources all have an impact on the inventory cycle. The sales cycle produces transactions with the outputs of the inventory cycle. Purchases and human resources cycles produces inputs to the inventory process. Sales transactions that reduce finished goods inventory must be controlled and correctly recorded. Purchases of input materials must be properly controlled and accounted for so that the additions to the cost of inventory are correct. Payment for labor that should be included in the cost of inventory must be properly captured so that it can be correctly added.

Page 774

**F1 What kinds of information about inventory can be obtained through substantive analytical procedures?**

1. Whether the inventory balance makes sense relative to purchases and cost of goods sold.

2. Whether inventory includes operating costs that should be expensed rather than being capitalized as a part of inventory

3. Changes such as an increase in the inventory balance, a decrease in cost of goods sold, or increase in purchase discounts or purchase returns can signal that the auditor needs to dig deeper into the audit of transactions affecting inventory.

4. Indication of slow moving inventory and the need to further examine the value of inventory or possibility of obsolescence.

**F2 How has inventory fraud been used to misstate financial statements?**

To inflate income by, for example,

-including fictitious inventory in inventory balances

-overstating year end inventory using inventory in transit

-overstating units produced, including phantom inventory

-overstating inventory, misstating inventory in transit

-overstating inventory, including inventory multiple times

-failing to write down inventory

**F3 What aspect of the inventory audit is mandatory?**

The auditor is required to directly and personally obtain evidence about the existence of inventory through observing the company’s physical verification or count of inventory.

**F4 At what times during the financial accounting cycle do companies perform physical counts of inventory, and why might it be different for different companies?**

Companies perform physical counts of inventory at year end, or at other times, and some companies count periodically throughout the year. Counts at times other than period end may be for a portion of inventory, rather than 100%. Sometimes companies count a sample of inventory and project the results of the sample count to the entire inventory. The quality of the perpetual inventory records has an impact on the options the company has in terms of its inventory count. Without good perpetual records and controls the company generally needs to count 100% of inventory at fiscal year end. Other impacts on inventory count policy are the nature of the goods and the likelihood of shrinkage whether due to error, fraud or natural factors.

Page 777

**G1 What items related to inventory may need to be estimated?**

1. The percent to which in-process inventory has been completed.

2. The allocation of overhead or common costs.

3. Any reduction in value below recorded cost.

**G2 What internal controls and other policies should management implement and follow relating to estimates?**

1. Identify situations for which accounting estimates are required.

2. Identify relevant factors that may affect accounting estimates.

3. Accumulate relevant, sufficient, and reliable data on which to base estimates.

4. Develop assumptions of the most likely circumstances and events with respect to the relevant factors.

5. Calculate estimated amounts based on assumptions and other relevant factors.

6. Determine that estimates are presented in conformity with accounting standards and disclosure is adequate.

**G3 What does the auditor need to consider in assessing accounting estimates?**

The auditor needs to understand the process and underlying assumptions and determine if they are reasonable. The auditor needs to recalculate the estimates based on the company’s methods and assumptions. The auditor needs to trace the estimates in to the company’s records to determine that the calculated estimates were used.

**G4 What does the auditor consider in concluding on whether management’s underlying assumptions for estimates are appropriate?**

1. Whether they address the important factors affecting the estimate.

2. Whether they are sensitive enough to produce a good estimate when underlying factors change.

3. Whether they are consistent or different from the company’s experiences.

4. The subjectivity of the assumptions and whether they are likely to be biased.

Page 783

**H1 What are the important aspects of disclosure for inventory that need to be assessed by the auditor?**

1. Related party transactions

2. The costing method is properly described and any changes in the method or the way it is applied are adequately explained

3. If the company uses LIFO, disclosure needs to include information on any LIFO liquidations

4. The classification among raw materials, work-in-process and finished goods

5. Information on any valuation adjustments made

6. Inventory that is pledged, warranty obligations and significant commitments made to purchase or sell inventory

**H2 “Specific identification of direct, traceable cost is used for inventory costs in residential homebuilding.” What does this statement mean?**

The direct costs are recorded correctly as inventory costs for individual units and these direct, specific identification costs are properly estimated and accrued at the end of the quarter or year.

**H3 Why is the auditor concerned about proper matching of revenues and costs of sales for houses that are sold shortly before the fiscal year end?**

The concern is that all the proper costs that may have been incurred but not yet billed or paid for (and any allocations) are properly included in the cost of the house sold, so they can be properly matched against the sales revenue.

**H4 What steps does the auditor follow for estimates of future sales values and costs?**

1. Obtain the company’s methods for making the estimates, assumptions underlying the estimates and documentation supporting the calculations.

2. Evaluate the method and assumptions for reasonableness and recalculate the estimates.

3. Trace the estimates into the company’s allocation calculations for common costs.

4. Examine supporting documents for estimates of future sales value and costs and the purchase of common costs already incurred.

**H5 What documents can the auditor examine to obtain evidence about common costs already incurred?**

The types of documents that support incurred common costs include contracts, closing statements, invoices, checks supporting cash disbursements, debt instruments with interest information, and the company’s calculations of its costs of capital.