UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT
MANAGE INVENTORIES

Control practices

The following control objectives provide a basis for strengthening your control environment for the process of managing inventories. When you select an objective, you will access a list of the associated business risks and control practices. That information can serve as a checklist when you begin reviewing the strength of your current process controls.

This business risk and control information can help you assess your internal control environment and assist with the design and implementation of internal controls. Please note that this information is at the generic business process level and many companies will need to go beyond generic models to address the specific business processes that support the financial and nonfinancial disclosures being made. You can combine the insight of this business risk and control information with your industry-specific knowledge and understanding of your company's environment when conducting internal control assessments and designing and implementing recommendations.

Effectiveness and efficiency of operations

A. <u>Inventories are properly safeguarded.</u>
B. <u>Recorded balances are substantiated.</u>
C. <u>Recorded balances are evaluated.</u>
D. <u>Management establishes overall objectives of inventory policy.</u>

Effectiveness and efficiency of operations

A. Inventories are properly safeguarded.

Business risks

- Inventory will be lost, stolen, destroyed, or temporarily diverted.
- Product will be moved into or out of storage without proper authorization.
- Product moved into or out of storage will not be documented or recorded.

Control practices

1. Segregate production and custodial responsibilities from accounting activities.
2. Segregate activities involved in supervising and compiling the physical inventory from individuals performing the actual count.
3. Safeguard inventory against unauthorized usage by establishing physical or other compensating controls.
4. Protect inventory against physical deterioration. Adequately insure its value against loss.
5. Maintain perpetually controlled inventory stockrooms to safeguard the inventory and provide current information on inventory quantities available.
6. Periodically reconcile perpetual records with the general ledger.
7. Periodically count product in storage and reconcile to perpetual records, and investigate differences between physical count and accounting records.
8. Require product transfer documents for movements of product into or out of storage.
9. Pre-number product transfer documents, and investigate missing documents.

B. Recorded balances are substantiated.

Business risks

- Errors in the processing, summarization, and recording of inventory transactions will not be detected or will not be detected on a timely basis.
- Significant unrecorded charges for materials, labor, and overhead placed into production or transferred to finished goods will not be detected or will not be detected on a timely basis.
- Inventory records will be inaccurate and information provided to customers regarding product availability will be incorrect.
- Inventory instructions will not ensure a reasonably complete and accurate count of inventory.

UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT
MANAGE INVENTORIES

Control practices

1. Compare recorded balances with budgeted amounts, prior period amounts, and industry statistics periodically.
2. Analyze gross margins and unit costs by product lines periodically, and investigate significant fluctuations.
3. Reconcile inventory subsidiary records with the related control account periodically.
4. When inventory subsidiary records are reconciled with the related control account, require that differences be investigated by persons with no conflict of interest.
5. Confirm inventory in the custody of third parties periodically and investigate differences.
6. Count all standing inventory periodically and compare counts to recorded balances.
7. Adjust inventory records and control accounts appropriately for differences disclosed by verification procedures.
8. Prepare comprehensive, written physical inventory instructions, and communicate these instructions to the inventory crew in advance of the count date.
9. Designate an official to supervise the physical count.
10. Ensure that stocks are arranged, marked, labelled, or otherwise described to facilitate an accurate count by the count teams. Segregate stocks that are not to be counted.
11. Identify and segregate damaged, obsolete, scrap, and consigned inventory clearly to facilitate recognition for accounting purposes.
12. Use pre-numbered count tags or sheets and account for them following the count (for example, check the sequence of serially numbered count documents, and investigate missing and/or duplicate documents).
13. Require verification of quantities recorded on inventory tags by individuals independent of those actually performing the physical counts.
14. Provide written instructions for verifying a proper cut-off of production, shipping, receiving, stockrooms, customer returns, and accounts payable.
15. Reconcile results of the physical inventory with the general ledger. Prepare appropriate adjusting entries.
16. Investigate the underlying causes of significant differences between the physical count and the book balance.
17. Report significant differences between the physical count and the book balance to operating and financial management.
18. Perform periodic and systematic cycle counts of the perpetual inventory (at least twice a year for high dollar items and annually for all other items).

C. Recorded balances are evaluated.

Business risks

- While accurately reflecting historical events, recorded inventory balances will not reflect realistic evaluations under current conditions.
- Inventory on hand will be obsolete, damaged, or spoiled.

Control practices

1. Identify and report periodically inventory items that are slow moving, obsolete, defective, or in excess of normal operating requirements.
2. Compare quantities in stock periodically with production requirements over a normal operating cycle or reasonable period of time.
3. Analyze key ratios, trends, and variances.
4. Identified excess and obsolete stock is disposed of in a timely manner.
5. Determine the required provisions for obsolescence, declines in carrying value of inventories, and specific inventory write-offs.
6. Require management review and approval for inventory write-offs and provisions.
7. Determine unrealized losses on work-in-process periodically by comparing total costs-to-date and estimated costs-to-complete with net realizable values.
8. Compare recorded amounts with market values periodically.
9. Determine the provisions or write-offs required to record inventories at net realizable value.

D. Management establishes overall objectives of inventory policy.

Business risks

- Inventories will not be managed in accordance with management objectives.

Control practices

1. Develop overall criteria for inventory levels.
2. Develop guidelines for budgets and production plans.
3. Ensure that specific guidance is provided on the management of particular inventory lines, such as the maximum and minimum inventory levels for major product lines.