

December 25, 2020

To JICPA members

The Japanese Institute of Certified Public Accountants

Remote Work Series No.2

Considerations In Relation to Remote Attendance at Physical Inventory Counting

<<I. Introduction>>

On March 18, 2020, the Japanese Institute of Certified Public Accountants published “Audit Considerations Related to COVID-19 (Part 1)”, which discusses the impact that countermeasures for COVID-19 have had on matters to keep in mind in cases where a physical inventory counting on site or attendance at such inventory counting must be considered. However, in auditing engagements mainly for the fiscal year ended March 31, 2020, we observed examples of attendance at physical inventory counting being performing remotely (hereinafter “remote attendance at inventory counting”).

Since the emergence of COVID-19, companies and governments have worked on digital transformation and remote work initiatives formed in response to that experience. With the virus spreading as it is currently, we assume that it will remain necessary for auditors to consider performing remote attendance at physical inventory counting.

These “Considerations” consist of issues related to remote attendance at physical inventory counting that have been considered by members in response to the current situation. They do not constitute new requirements, but while respecting the requirements of Auditing Standards Committee Statements, auditors in a remote work environment should take them into account from the perspective of their practices.

<<II. What is remote attendance at physical inventory counting?>>

In Paragraph A1 of Auditing Standards Committee Statement 501, “Audit Evidence - Specific Considerations for Selected Items” (hereinafter, “ASCS 501”) it is assumed that management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the company’s perpetual inventory system. If the inventory is material to the financial statements, where not impracticable the auditor is required to ascertain the existence and the condition of inventory by attending a physical inventory counting (ASCS 501, Paragraph 4). Furthermore, in this context, attendance at a physical

inventory counting is intended to mean that an auditor goes to the site where the physical inventory counting is being conducted by the company, observes the performance of the physical inventory counting, and also ascertains the existence and condition of inventory.

However, it is assumed that there will be exceptional cases in which it is impracticable for the auditor to attend the physical inventory counting. There might be various reasons for this, including effects arising from COVID-19 countermeasures, such as a request from the audit client to cancel the physical inventory counting, or restrictions on entering the country in which the inventory is held being imposed by the government of that country.

For cases such as these, the auditor may consider the remote attendance in order to have a presence at a physical inventory counting taking place at a distant location. In such situations, it may be possible to achieve attendance at a physical inventory counting from a remote location by leveraging recent camera technology, image processing technology, and communications technology for sending and receiving image data, so that the auditor and the audit client can transmit and receive the state of the physical inventory and other required information.

- A typical approach to remote attendance at physical inventory counting is for the circumstances of the physical inventory counting being performed by the audit client to be captured using a video camera and sent to the auditor via a telephone line or the Internet.
- When conducting remote attendance at the physical inventory counting, with regard to the circumstances of the physical inventory counting transmitted from the audit client or to the number and condition of inventory, the auditor shall communicate in a timely fashion with the audit client via the telephone line or the Internet, resolving any questions they may have, discussing whether corrections are needed, and obtaining further confirmation as required.
- When sending or receiving the circumstances live coverage of the physical inventory counting during remote attendance and conducting necessary communications, depending on the location of the physical inventory counting and the state of the assets being counted there are times when sophisticated camera and communications equipment may not necessarily be needed, and when the work can easily be performed using a cellular phone, such as a smartphone that incorporates a video camera.
- During remote attendance at physical inventory counting, it is likely that somebody from the audit client will hold the video camera to show in detail the circumstances of the physical inventory counting where the inventory is located, as well as the number and condition of the inventory, and transmitting it to the auditor.

In these “Considerations”, it is assumed that the audit client will perform the physical inventory counting at the location where the inventory is held, and that the auditor will attend from a distant location.

[Example 1] What is remote attendance at physical inventory counting?

In these “Considerations”, remote attendance at physical inventory counting means...

- ◆ The audit client performing physical inventory counting
- ◆ With necessary information on the circumstances of implementation and attendance at physical inventory counting
- ◆ Communication between auditors and audit client, to enable attendance at a distant location

	Physical attendance at physical inventory counting	Remote attendance at physical inventory counting
Physical inventory counting	Performed by audit client	As on left
Method of attendance	Viewed directly by auditors with their own eyes	Viewed indirectly by auditors using communications technology

<<III Considerations In Relation to Selecting Targets for Remote Attendance at Physical Inventory Counting>>

1. Cases where the inventory is material to the financial statements but attendance at physical inventory counting is impracticable

When the inventory is material to the financial statements, in order to obtain sufficient appropriate audit evidence of the existence and condition of the inventory, where not impracticable the auditor is required to attend a physical inventory counting (ASCS 501, Paragraph 4). In such cases, it is necessary to bear in mind that simple inconvenience to the auditor, or problems related to the difficulty, time, or cost involved with the audit procedure, are not in themselves sufficient reason for the auditor to omit attendance at physical inventory counting (ASCS 501, Paragraph A12).

Nevertheless, there may be exceptional cases in which inventory at a certain business location is material to the financial statements, or in which there is a need to deal with the risk of material misstatement associated with this inventory, and in which it is impracticable to attend a physical inventory counting (refer to “II. What is remote attendance at physical inventory counting?”). In such situations, the following measures may be implemented:

- (1) In cases where the inventory in question is under the custody and control of a third party,

the auditor shall pay attention to performing the following:

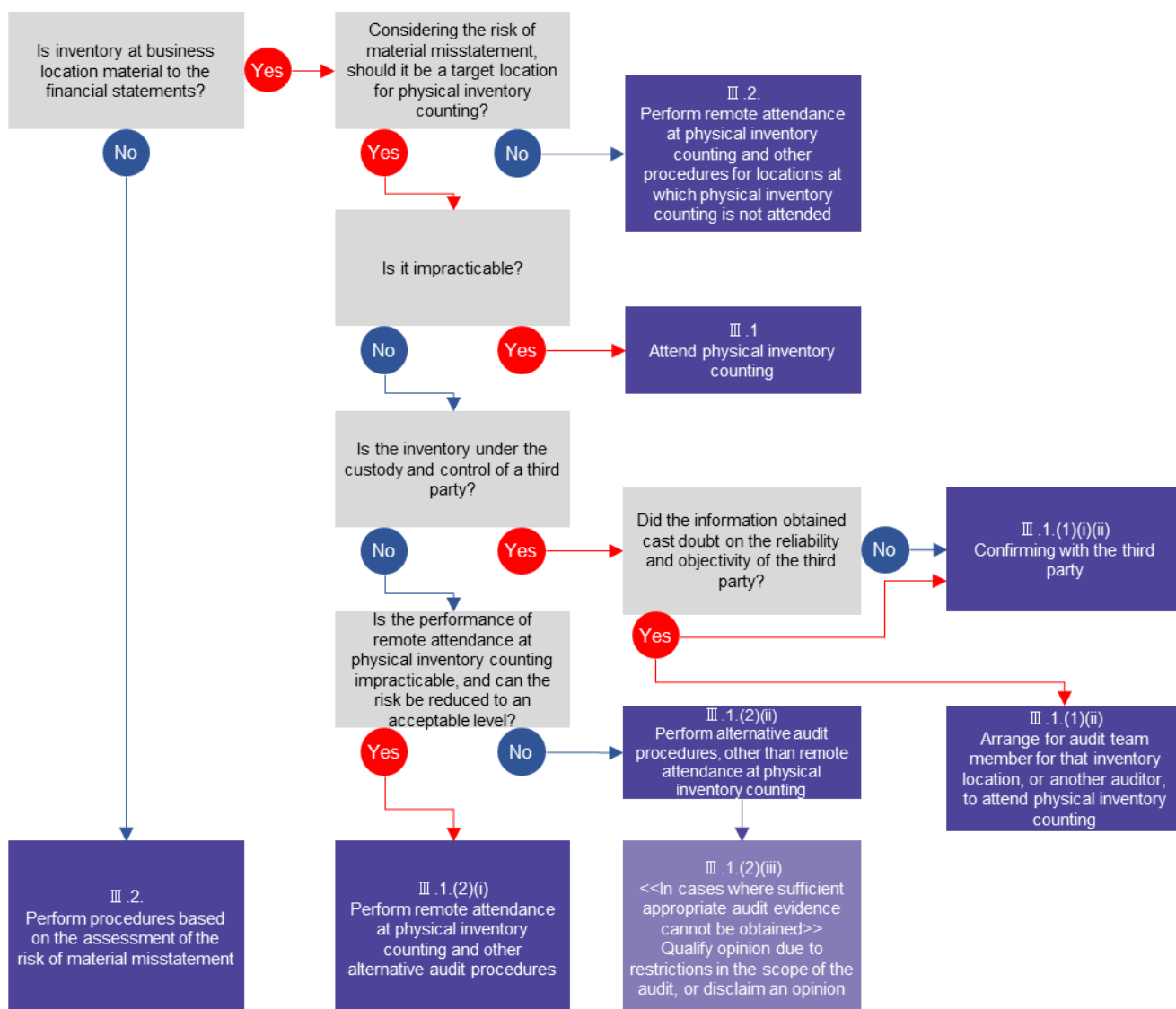
- (i) Obtaining sufficient appropriate audit evidence of the existence and condition of the inventory by confirming the number and condition of the inventory with the third party.
 - (ii) In cases where the information obtained casts doubt on the reliability and objectivity of the third party, considering alternative or additional procedures such as arranging for a member of the audit team for that location, or another auditor, to attend a physical inventory counting (ASCS 501, Paragraph A16).
- (2) In cases where the inventory in question is not under the custody and control of a third party, the auditor shall give careful consideration to performing the following:
- (i) Obtaining sufficient appropriate audit evidence by means of remote attendance at physical inventory counting and other alternative audit procedures (ASCS 501, Paragraphs 7 and A13).
 - (ii) Performing alternative audit procedures other than remote attendance at physical inventory counting in cases it is determined that not only attendance at physical inventory counting but also remote attendance at physical inventory counting is impracticable (refer to “IV. Considerations When Performing Remote Attendance at Physical Inventory Counting 2. Designing and implementing audit procedures”).
 - (iii) Considering giving a qualified opinion due to restrictions in the scope of the audit, or disclaiming an opinion, if sufficient appropriate audit evidence cannot be obtained even after performing alternative audit procedures other than remote attendance of physical inventory counting (ASCS 501, Paragraph 7).

2. Reconsider whether or not physical inventory counting of inventory at business locations is required

Taking into account COVID-19, reassess whether inventory at business locations for which attendance at physical inventory counting was performed in previous fiscal years is material to the financial statements. In cases where it is determined that inventory at business locations is not material to the financial statements, attendance at physical inventory counting by the auditor is not required for the current fiscal year. Also, the auditor shall take into account the assessment of the risk of material misstatement and perform audit procedures other than attendance at physical inventory counting.

In such cases, the auditor shall keep in mind the nature, timing and extent of audit procedures, when considering whether the risk of material misstatement with regard to the existence and condition of inventory can be reduced to an acceptably low level.

[Example 2] Flowchart for selecting targets for remote attendance at physical inventory counting



<<IV. Considerations When Performing Remote Attendance at Physical Inventory Counting>>

1. Dealing with risk of material misstatement and detection risk in relation to inventory

When assessing whether or not to remotely attend a physical inventory counting, the auditor must come to a reasonable judgment from the perspective of reducing the audit risk to an acceptably low level, for example by obtaining sufficient information on the following. For that reason, based on the policies and procedures of the audit firm, an expert opinion may be sought (Auditing Standards Committee Statement 200, “Overall Objectives of the Independent Auditor”, Paragraph A27).

- Economic environment

- Experience and information obtained when attending inventory counting in audits in previous fiscal years in relation to the location
- Occurrence and status of new material events occurring at the audit client
- Assessment of risk of material misstatement in relation to inventory , and status of misconduct risk
- Status of perpetual inventory system at audit client
- Type of other obtainable audit evidence
- Reason for request from audit client to cancel attendance at physical inventory counting

When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence (Paragraph 7 of Auditing Standards Committee Statement 500, “Audit Evidence” (hereinafter, “ASCS 500”). The reliability of the information used as audit evidence, and in turn the probative force of the audit evidence itself, is influenced by the source of the information, the type of information, and where relevant the circumstances in which the information was obtained, including the internal controls over its creation and management. In general, audit evidence provided by original documents is deemed to have greater probative force than audit evidence provided by documents converted to an electronic medium through digitalization, etc. (ASCS 500, Paragraph A31).

Reflecting on the spirit of these provisions, auditors shall keep in mind that, even when remotely attending physical inventory counting based on images of the actual situation provided by video cameras or drones, etc., the audit evidence has been converted into digital form. They shall further take into account the audit risk (detection risk) that arises from digitalization, and the fact that the probative force of the audit evidence is different from that obtained from directly attending a physical inventory counting. They shall also consider whether or not they have been able to reduce the risk of material misstatement identified to an acceptable level in relation to the inventory at the business location targeted for attendance, and state the grounds for this in the audit report.

In cases where the evidence obtained from remote attendance at physical inventory counting conflicts with information obtained from attendance at physical inventory counting in previous fiscal years, as a procedure for dealing with the risk of material misstatement, the auditor shall consider whether remote attendance at inventory counting is still appropriate.

2. Designing and performing audit procedures

In response to the risk of material misstatement associated with the existence and condition of inventory, misconduct risk, and detection risk arising from the details of internal control or the digitalization of audit evidence, auditors may consider the following in order to obtain

sufficient appropriate audit evidence.



Considerations In Relation to Remote Attendance at physical Inventory Counting

- ◆ In cases where remote attendance at physical inventory counting is implemented on a date other than the final day of the fiscal year, audit procedures must be performed in relation to transactions carried out between the physical inventory counting date and the final day of the fiscal year (ASCS 501, Paragraphs 4 and 5).
- ◆ Based on experience from previous audit visits, in addition to assigning appropriate audit team members, consider whether audit client staff on site may be appointed to deal with requests from auditors.
- ◆ Obtain images of the actual situation captured by video cameras or drones, etc.
- ◆ When obtaining images of the actual situation, because it is difficult to detect cases in which the subject being recorded has been manipulated by the person taking the recording, or falsified at the time the recording was taken, the ease of capturing the inventory been recorded should be taken into account. Consideration should also be given as to whether the authenticity of information derived from images of the actual situation provided by video cameras or drones, etc. can be guaranteed. For example, the auditor may ask the person with the camera to show every corner of the location before beginning the physical inventory counting so as to confirm the overall layout, and specify to them the places they wish to capture. Also confirm whether by using multiple video cameras it may be possible to capture not only a small part of the storage area but every corner of the whole location, thus enabling the auditor to get an understanding of the number and condition of inventory items for the entire area.
- ◆ In relation to inventory that cannot be captured on camera, the auditor should obtain a location map and list of target inventory in advance in order to check the storage area.
- ◆ When the audit client is using cellular phones, check whether their location information can be used to confirm that the images being sent from the remote attendance at physical inventory counting are actually being sent from the target location.
- ◆ Explain the situation regarding the remote session to the company in advance and get their full understanding, as well as performing checks on the state of the video camera or communications equipment or other tools used, as necessary.



Other Considerations in Relation to Audit Procedures

- ◆ Consider implementing remote attendance at physical inventory counting in combination with other audit procedures, for example, by inspecting records or documentation showing that specific inventory items purchased before the physical inventory counting date or the final day of the fiscal year (ASCS 501, Paragraph A13) were sold after the date in question.
- ◆ Check whether the reliability of the audit client's perpetual inventory system is appropriately ensured.
- ◆ Check whether the images, etc. obtained from the remote attendance at physical inventory counting are congruent with the experience of physical inventory counting in previous fiscal years.
- ◆ If possible, after the date of the remote attendance at physical inventory counting but before the audit report is delivered, visit the storage area and check whether there are any discrepancies between the images obtained from the remote attendance and the site itself.
- ◆ In cases where the internal auditor attends physical inventory counting, inspect the results of the internal auditor's work and ask the internal auditor about the circumstances of the physical inventory counting.

Moreover, auditors must keep in mind that even when performing remote attendance at physical inventory counting, procedures normally performed during attendance at a physical inventory counting cannot be omitted. These may include performing test counts, obtaining copies of management's completed physical inventory count records (ASCS 501, Paragraphs A7 and A8), evaluating management's instructions and proceedings (collection of used physical inventory count records, treatment of unused physical inventory count records, recount procedures, identification of slow-moving or obsolete items, and control of the movement of inventory storage areas before and after the cut-off date), and obtaining copies of cut-off information related to movement in and out of inventory (ASCS 501, Paragraphs A4 and A5).