

# cpab risk alert

## Third party involvement in the inventory management process

**This audit risk alert provides consideration for auditors who are relying extensively on external confirmations to evaluate the existence and condition of inventory (or other assets) held by a third party.**

The Canadian Public Accountability Board (CPAB) has observed an increasing number of Canadian reporting issuers outsourcing all or part of their inventory management systems. This practice is often used in retail, manufacturing and distribution when reporting issuers rely on third-party custodians, public or private warehouses, third-party count services or other inventory management providers. Outsourcing is also used in industries such as investment funds with an objective of providing investors with a convenient way to hold precious metals, base metals and other non-traditional investments such as radioactive materials.<sup>1</sup>

We are concerned about the quality of audit evidence some auditors obtain relating to the existence and condition of inventory held by third parties compared to when it is held directly by the reporting issuer. When a reporting issuer holds inventory in house, the reporting issuer establishes processes and procedures for documenting and monitoring inventory movements and performs periodic physical inventory counts. The auditor obtains an understanding of the reporting issuers' processes and performs procedures to assess the existence and condition of inventory and whether the records reflect quantities determined during the inventory count(s). However, when inventory is held by a third party, we observed that some auditors are limiting their audit procedures to requesting a confirmation from the third-party as to the quantities and condition of the inventory held on behalf of the reporting issuer. This is done on the basis that nothing has come to the auditor's attention that raises doubt about the integrity and objectivity of the third-party.

Canadian Auditing Standard (CAS) 501, *Audit Evidence – Specific Considerations for Selected Items* requires auditors to obtain sufficient appropriate evidence about the existence and condition of inventory.<sup>2</sup> CAS 505, *External Confirmations*, requires the auditor to evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.<sup>3</sup>

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<sup>1</sup> The audit evidence obtained by auditors of an investment fund that hold physical assets can be analogous to inventory.

<sup>2</sup> CAS 501, paragraph 4.

<sup>3</sup> CAS 505, paragraph 16.

When third-party warehouses are involved, we observed that some auditors do not perform procedures to obtain a sufficient level of understanding of the processes and controls in place at the third-party warehouse to support the reliability of the confirmations obtained.<sup>4</sup> Examples of recent inspection findings include:

- Auditors did not obtain a sufficient understanding of the nature and significance of the services provided by the third-party warehouse, oversight of those services and their effect on the reporting issuer's system of internal control. For example, there was insufficient consideration of contract terms which allowed the third-party warehouse to commingle the inventory and imposed restrictions on the reporting issuer from having any lien, pledge or encumbrance, security interest or other claim that would impair the warehouse's ability to use the inventory as their working stockpile.
- Auditors relied on confirmations from third-party warehouses as the primary source of audit evidence. By doing so, they implicitly relied on the operating effectiveness of the internal controls at the third-party warehouse without any further evaluation or testing.
- Auditors did not perform audit procedures that were responsive to the risks, nor performed additional procedures needed to substantiate the amounts included in the third-party confirmation. For example, significant reliance was placed on testing performed on a sample of purchases of inventory during the year. While this testing provided evidence of the accuracy and occurrence of these transactions, it did not provide evidence over the existence of inventory at year end.
- Auditors inappropriately relied on industry standards, the reputation of a third-party warehouse, and/or industry-specific regulations to conclude on the reliability of the information provided by the third-party warehouse. This was insufficient evidence to substantiate the reliability of the information provided. For example, regulations related to moving and physically storing regulated materials do not provide evidence over the design, implementation and operating effectiveness of controls relevant to the completeness and accuracy of the inventory records maintained on behalf of the reporting issuer.

When a reporting issuer engages a third-party inventory service provider, it relies on the effective operation and functioning of the provider's infrastructure, equipment and personnel hired to store, safeguard and manage its asset. The reporting issuer also relies on the provider's ability to maintain accurate records of its inventory balances and transactions. Even when third parties are well-established or are highly rated within their industry, those facts do not necessarily mean that the controls are operating effectively or that the information provided is reliable. While these third parties may be part of a regulated industry or hold accreditations, the certifications held may not be relevant to the assessed risks of material misstatement.

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<sup>4</sup> The concerns outlined in this publication are consistent with those highlighted in our August 2022 publication [Auditing in the crypto-asset sector](#).

## Illustrative scenario

The scenario presented below is an example of good practices observed in files with no findings. Facts have been modified or excluded to protect the identity of the reporting issuer.

A reporting issuer stores substantially all of its inventory with a third-party warehouse who manages inventory for multiple reporting issuers. The magnitude of inventory held at the third party is material to the financial statements.

The engagement team obtained an understanding of the nature and significance of the services provided by the warehouse. The engagement team:

- Obtained and reviewed the service-level agreement stating that the inventory cannot be comingled, and inventory is specifically identifiable using unique product numbers.
- Obtained an understanding of the relevant controls in place at the warehouse.<sup>5</sup> This understanding was obtained through a combination of obtaining and reviewing the third-party warehouse's service organization report and inquiry with management to understand how they exercise oversight of the third party.
- Evaluated whether the third-party warehouse was a service organization.

Based on their risk assessment procedures, the engagement team identified a significant risk over the existence of inventory held at the third-party warehouse. The engagement team requested a confirmation from the third-party warehouse to confirm the quantity and condition of inventory at the balance sheet date. Due to the assessed risk and magnitude of the inventory balance, the engagement team performed the following additional procedures that were determined to be appropriate in the circumstance:

- Attended the year-end inventory count that management performed at the third party (which was at a date other than year-end) and performed test counts, among other procedures to evaluate the existence and condition of inventory.
- Obtained and evaluated the third-party warehouse's service organization report covering the controls over the recording and movement of inventory between the count date and the reporting issuer's year end.
- Evaluated the design, implementation and operating effectiveness of the user entity controls related to the inventory held at the third-party warehouse, which included management's controls for the periodic reconciliation between the warehouse's records and the reporting issuer's records.

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<sup>5</sup> CAS 315, paragraph 26 (a).

## Key takeaways

The illustrative scenario represents substantially all the reporting issuer's inventory held at a single warehouse. However, we have also observed some reporting issuers relying on the services of multiple third-party warehouses. In these cases, the auditor has inappropriately concluded that the use of multiple third-party warehouses reduces the risk of material misstatement when the inventory held at these third parties, individually or in aggregate, is often significantly material to the financial statements of the reporting issuer.

Considering the magnitude of inventory (or other analogous assets) held by third parties on behalf of the reporting issuer, auditors need to obtain a sufficient understanding of relevant terms within the service agreements. In many cases, these third-party warehouses do not have service organization reports available to provide evidence over the reliability of their processes and controls covering the recording and controlling of inventory. In situations where a service organization is not available, auditors may need to be provided with appropriate access to determine the reliability of information reported by the third-party warehouse. To obtain sufficient appropriate audit evidence regarding the existence and condition of inventory at the balance sheet date, the auditor needs to obtain evidence that supports the reliability of tracking and reporting of inventory by the third-party warehouse. If it is not possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, the auditor must evaluate whether the overall objectives of the CAS can be satisfied.

Early identification and assessment of risks of material misstatement related to the use of third parties is critical to ensure the auditor is able to plan and execute sufficient appropriate audit procedures. Firm leadership needs to create and promote a culture that supports engagement teams in having difficult conversations with audit clients, which may include a delay in issuance of the financial statements.

## Learn more

CPAB continues to monitor emerging issues through our inspections and share our observations through various communications. For more information refer to our [website](#).

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