AUDIT OF INVENTORIES

PROBLEM NO. 1

The Pasay Company is a wholesale distributor of automobile replacement parts. Initial amounts taken from Pasay's accounting records are as follows:

- **Inventory at December 31, 2005 (based on physical count on December 31, 2005)**: P400,000

- **Accounts payable at December 31, 2005**:

<table>
<thead>
<tr>
<th>Vendor</th>
<th>Terms</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anito Company</td>
<td>Net 30</td>
<td>9,000</td>
</tr>
<tr>
<td>Victoria Company</td>
<td>Net 30</td>
<td>36,500</td>
</tr>
<tr>
<td>Winston Company</td>
<td>Net 30</td>
<td>48,000</td>
</tr>
<tr>
<td>Sogo Company</td>
<td>Net 30</td>
<td>74,000</td>
</tr>
<tr>
<td>Rotonda Company</td>
<td>Net 30</td>
<td>167,500</td>
</tr>
</tbody>
</table>

  **Total**: P167,500

- **Sales in 2005**: P5,000,000

Additional information follows:

1. Parts held on consignment from Anito to Pasay amounting to P9,000, were included in the physical count of goods in Pasay's warehouse on December 31, 2005, and in accounts payable at December 31, 2005.

2. P15,000 worth of parts which were purchased from Sogo and paid for in December 2005 were sold in the last week of 2005 and appropriately recorded as sales of P21,000. The parts were included in the physical count on December 31, 2005, because the parts were on the loading dock waiting to be picked up by the customer.

3. Parts in transit on December 31, 2005, to customers, shipped FOB destination, December 28, 2005, amounted to P11,000. The customers received the parts on January 6, 2006. Sales of P15,000 to the customers for the parts were recorded by Pasay on January 2, 2006.

4. Retailers were holding P50,000, at cost, of goods on consignment from Pasay, at their stores on December 31, 2005.

5. Goods were in transit from Rotonda to Pasay on December 31, 2005. The cost was P8,000 and these were shipped FOB shipping point on December 29, 2005.

**REQUIRED:**

Determine the adjusted balances of Inventory and Accounts Payable as of December 31, 2005 and Sales for the year 2005.

PROBLEM NO. 2

You were engaged by Quezon Corporation for the audit of the company’s financial statements for the year ended December 31, 2005. The company is engaged in the wholesale business and makes all sales at 25% over cost.

The following were gathered from the client’s accounting records:
SALES

<table>
<thead>
<tr>
<th>Date</th>
<th>Reference</th>
<th>Amount</th>
<th>Date</th>
<th>Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 27</td>
<td>SI No. 965</td>
<td>40,000</td>
<td>Dec. 28</td>
<td>RR No. 1059</td>
<td>24,000</td>
</tr>
<tr>
<td>Dec. 28</td>
<td>SI No. 966</td>
<td>150,000</td>
<td>Dec. 30</td>
<td>RR No. 1061</td>
<td>70,000</td>
</tr>
<tr>
<td>Dec. 28</td>
<td>SI No. 967</td>
<td>10,000</td>
<td>Dec. 31</td>
<td>RR No. 1062</td>
<td>42,000</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>SI No. 969</td>
<td>46,000</td>
<td>Dec. 31</td>
<td>RR No. 1063</td>
<td>64,000</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>SI No. 970</td>
<td>68,000</td>
<td>Dec. 31</td>
<td>Closing entry</td>
<td>(3,000,000)</td>
</tr>
<tr>
<td>Dec. 31</td>
<td>SI No. 971</td>
<td>16,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td>Closing entry</td>
<td></td>
<td></td>
<td></td>
<td>(5,530,000)</td>
</tr>
</tbody>
</table>

Note: SI = Sales Invoice  RR = Receiving Report

PURCHASES

<table>
<thead>
<tr>
<th>Date</th>
<th>Reference</th>
<th>Amount</th>
<th>Date</th>
<th>Reference</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance forwarded</td>
<td>P5,200,000</td>
<td></td>
<td>Balance forwarded</td>
<td>P2,800,000</td>
<td></td>
</tr>
</tbody>
</table>

You observed the physical inventory of goods in the warehouse on December 31 and were satisfied that it was properly taken.

When performing sales and purchases cut-off tests, you found that at December 31, the last Receiving Report which had been used was No. 1063 and that no shipments had been made on any Sales Invoices whose number is larger than No. 968. You also obtained the following additional information:

a) Included in the warehouse physical inventory at December 31 were goods which had been purchased and received on Receiving Report No. 1060 but for which the invoice was not received until the following year. Cost was P18,000.

b) On the evening of December 31, there were two trucks in the company siding:
   • Truck No. CPA 123 was unloaded on January 2 of the following year and received on Receiving Report No. 1063. The freight was paid by the vendor.
   • Truck No. ILU 143 was loaded and sealed on December 31 but leave the company premises on January 2. This order was sold for P100,000 per Sales Invoice No. 968.

c) Temporarily stranded at December 31 at the railroad siding were two delivery trucks enroute to Brooks Trading Corporation. Brooks received the goods, which were sold on Sales Invoice No. 966 terms FOB Destination, the next day.

d) Enroute to the client on December 31 was a truckload of goods, which was received on Receiving Report No. 1064. The goods were shipped FOB Destination, and freight of P2,000 was paid by the client. However, the freight was deducted from the purchase price of P800,000.

QUESTIONS:

Based on the above and the result of your audit, determine the following:

1. Sales for the year ended December 31, 2005
   a. P5,250,000  b. P5,400,000  c. P5,150,000  d. P5,350,000

2. Purchases for the year ended December 31, 2005
   a. P3,000,000  b. P3,018,000  c. P3,754,000  d. P3,818,000

3. Inventory as of December 31, 2005
   a. P864,000  b. P968,000  c. P800,000  d. P814,000

4. Accounts receivable as of December 31, 2005
   a. P350,000  b. P370,000  c. P220,000  d. P120,000

5. Accounts payable as of December 31, 2005

You observed the physical inventory of goods in the warehouse on December 31 and were satisfied that it was properly taken.

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QUESTIONS:

Based on the above and the result of your audit, determine the following:

1. Sales for the year ended December 31, 2005
   a. P5,250,000  b. P5,400,000  c. P5,150,000  d. P5,350,000

2. Purchases for the year ended December 31, 2005
   a. P3,000,000  b. P3,018,000  c. P3,754,000  d. P3,818,000

3. Inventory as of December 31, 2005
   a. P864,000  b. P968,000  c. P800,000  d. P814,000

4. Accounts receivable as of December 31, 2005
   a. P350,000  b. P370,000  c. P220,000  d. P120,000

5. Accounts payable as of December 31, 2005
Makati Company is preparing its 2005 financial statements. Prior to any adjustments, inventory is valued at P1,605,000. During your audit, you found the following information relating to certain inventory transactions from your cutoff test.

a. Goods valued at P110,000 are on consignment with a customer. These goods were not included in the ending inventory figure.

b. Goods costing P87,000 were received from a vendor on January 5, 2006. The related invoice was received and recorded on January 12, 2006. The goods were shipped on December 31, 2005, terms FOB shipping point.

c. Goods costing P85,000, sold for P102,000, were shipped on December 31, 2005, and were delivered to the customer on January 2, 2006. The terms of the invoice were FOB shipping point. The goods were included in the ending inventory for 2005 and the sale was recorded in 2006.

d. A P35,000 shipment of goods to a customer on December 31, terms FOB destination was not included in the year-end inventory. The goods cost P26,000 and were delivered to the customer on January 8, 2006. The sale was properly recorded in 2006.

e. The invoice for goods costing P35,000 was received and recorded as a purchase on December 31, 2005. The related goods, shipped FOB destination were received on January 2, 2006, and thus were not included in the physical inventory.

f. Goods valued at P154,000 are on consignment from a vendor. These goods are not included in the physical inventory.

g. A P60,000 shipment of goods to a customer on December 30, 2005, terms FOB destination, was recorded as a sale in 2006. The goods, costing P37,000 and delivered to the customer on January 6, 2006, were not included in the 2005 ending inventory.

REQUIRED:

1. Compute the proper inventory amount to be reported on Makati’s balance sheet for the year ended December 31, 2005.
2. By how much would the net income have been misstated if no adjustments were made for the above transactions? (Disregard tax implications)

PROBLEM NO. 4

You were engaged to perform an audit of the accounts of the Manila Company for the year ended December 31, 2005, and you observed the taking of the physical inventory of the company on December 30, 2005. Only merchandise shipped by the company to customers up to and including December 30, 2005 have been eliminated from inventory. The inventory as determined by physical inventory count has been recorded on the books by the company’s controller. No perpetual inventory records are maintained. All sales are made on an FOB shipping point basis. You are to assume that all purchase invoices have been correctly recorded. The inventory was recorded through the cost of sales method.

The following lists of sales invoices are entered in the sales books for the month of December 2005 and January 2006, respectively.

<table>
<thead>
<tr>
<th>Sales invoice amount</th>
<th>Sales invoice date</th>
<th>Cost of merchandise sold</th>
<th>Date shipped</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) P 150,000</td>
<td>Dec. 21</td>
<td>P 100,000</td>
<td>Dec. 31, 2005</td>
</tr>
</tbody>
</table>
REQUIRED:

Prepare the necessary adjusting entries at December 31, 2005.

PROBLEM NO. 5

The physical inventory of Taguig Company as of December 26, 2005 totaled P1,965,000. You agreed on the December 26 count as the company has a good internal control system. In trying to establish the December 31 inventory, you noted the following transactions from December 27 to December 31, 2005.

Sales (20% markup on cost) P 600,000

Credit memos issued:

For goods returned on:
December 15  27,000
December 20  35,000
December 29  36,000

For goods delivered to customers not in accordance with specifications 9,500

Credit memos received:

For goods returned on:
December 10  17,000
December 26  23,000
December 28  8,000

Purchases:

Placed in stock 120,000
In transit, FOB shipping point 50,000
In transit, FOB destination 33,000

REQUIRED:

Inventory as of December 31, 2005.

PROBLEM NO. 6

Mandaluyong Company is an importer and wholesaler. Its merchandise is purchased from several suppliers and is warehoused until sold to customers.

In conducting an audit for the year ended December 31, 2005 the company’s CPA determined that the system of internal control was good. Accordingly, the CPA observed the physical inventory at an interim date, November 30, 2005 instead of at year end. The following information was obtained from the general ledger:
Inventory, January 1, 2005 P 1,312,500
Physical inventory, November 30, 2005 1,425,000
Sales for 11 months ended November 30, 2005 12,600,000
Sales for the year ended December 31, 2005 14,400,000
Purchases for 11 months ended November 30, 2005 (before audit adjustments) 10,125,000
Purchases for the year ended December 31, 2005 (before audit adjustments) 12,000,000

The CPA's audit disclosed the following information:

a) Shipments received in November and included in the physical inventory but recorded as December purchases. P 112,500
b) Shipments received in unsalable condition and excluded from physical inventory. Credit memos had not been received nor chargebacks to vendors been recorded:
   Total at November 30, 2005 15,000
   Total at December 31, 2005 (including the November unrecorded chargebacks) 22,500
c) Deposit made with vendor and charged to purchases in October, 2005. Product was shipped in January, 2006. 30,000
d) Deposit made with vendor and charged to purchases in November, 2005. Product was shipped FOB destination, on November 29, 2005 and was included in November 30, 2005 physical inventory as goods in transit. 82,500
e) Through the carelessness of the receiving department shipment in early December 2005 was damaged by rain. This shipment was later sold in the last week of December at cost. 150,000

REQUIRED:

2. Cost of goods sold during the month of December 2005 using the gross profit method.
3. December 31, 2005 inventory using the gross profit method.

PROBLEM NO. 7

On April 21, 2005, a fire damaged the office and warehouse of Muntinlupa Company. The only accounting record saved was the general ledger, from which the trial balance below was prepared.

Muntinlupa Company
Trial Balance
March 31, 2005

<table>
<thead>
<tr>
<th></th>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>P 180,000</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Inventory, December 31, 2004</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>350,000</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>1,100,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>P 413,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>56,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>237,000</td>
<td></td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>180,000</td>
<td></td>
</tr>
<tr>
<td>Common stock, P100 par</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>520,000</td>
<td></td>
</tr>
</tbody>
</table>
The following data and information have been gathered:

a. The company’s year-end is December 31.

b. An examination of the April bank statement and cancelled checks revealed that checks written during the period April 1 to 21 totaled P130,000: P57,000 paid to accounts payable as of March 31, P34,000 for April merchandise purchases, and P39,000 paid for other expenses. Deposits during the same period amounted to P129,500, which consisted of receipts on account from customers with the exception of a P9,500 refund from a vendor for merchandise returned in April.

c. Correspondence with suppliers revealed unrecorded obligations at April 21 of P106,000 for April merchandise purchases, including P23,000 for shipments in transit on that date.

d. Customers acknowledged indebtedness of P360,000 at April 21, 2005. It was also estimated that customers owed another P80,000 that will never be acknowledged or recovered. Of the acknowledged indebtedness, P6,000 will probably be uncollectible.

e. The insurance company agreed that the fire loss claim should be based on the assumption that the overall gross profit ratio for the past two years was in effect during the current year. The company’s audited financial statements disclosed the following information:

<table>
<thead>
<tr>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>P 5,300,000</td>
</tr>
<tr>
<td>Net purchases</td>
<td>2,800,000</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td>500,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>750,000</td>
</tr>
</tbody>
</table>

f. Inventory with a cost of P70,000 was salvaged and sold for P35,000. The balance of the inventory was a total loss.

**QUESTIONS:**

Based on the above and the result of your audit, answer the following:

1. How much is the adjusted balance of Accounts Receivable as of April 21, 2005?
   a. P400,000  
   b. P360,000  
   c. P440,000  
   d. P354,000  

2. How much is the sales for the period January 1 to April 21, 2005?
   a. P1,430,000  
   b. P1,510,000  
   c. P1,519,500  
   d. P1,506,000  

3. How much is the adjusted balance of Accounts Payable as of April 21, 2005?
   a. P286,000  
   b. P237,000  
   c. P106,000  
   d. P343,000  

4. How much is the net purchases for the period January 1 to April 21, 2005?
   a. P650,500  
   b. P660,000  
   c. P673,500  
   d. P683,000  

5. How much is the cost of sales for the period January 1 to April 21, 2005?
   a. P786,500  
   b. P830,500  
   c. P835,725  
   d. P828,300  

6. How much is the estimated inventory on April 21, 2005?
   a. P570,000  
   b. P623,500  
   c. P587,775  
   d. P579,500  

7. How much is the estimated inventory fire loss?
   a. P579,500  
   b. P535,000  
   c. P477,000  
   d. P512,000
PROBLEM NO. 8

The work-in-process inventories of Parañaque Company were completely destroyed by fire on June 1, 2005. You were able to establish physical inventory figures as follows:

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2005</th>
<th>June 1, 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw materials</td>
<td>P60,000</td>
<td>P120,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>200,000</td>
<td>-</td>
</tr>
<tr>
<td>Finished goods</td>
<td>280,000</td>
<td>240,000</td>
</tr>
</tbody>
</table>

Sales from January 1 to May 31, were P546,750. Purchases of raw materials were P200,000 and freight on purchases, P30,000. Direct labor during the period was P160,000. It was agreed with insurance adjusters than an average gross profit rate of 35% based on cost be used and that direct labor cost was 160% of factory overhead.

REQUIRED:

Based on the above and the result of your audit, you are to determine:

1. Raw materials used
   a. P290,000
   b. P140,000
   c. P260,000
   d. P170,000

2. The total value of goods put in process
   a. P786,000
   b. P600,000
   c. P630,000
   d. P430,000

3. The value of goods manufactured and completed as of June 1, 2003
   a. P365,000
   b. P315,388
   c. P445,000
   d. P420,000

4. The work in process inventory destroyed as computed by the adjuster
   a. P314,612
   b. P185,000
   c. P366,000
   d. P265,000

PROBLEM NO. 9

Malabon Sales Company uses the first-in, first-out method in calculating cost of goods sold for the three products that the company handles. Inventories and purchase information concerning the three products are given for the month of October.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td></td>
<td>50,000 units</td>
<td>30,000 units</td>
<td>65,000 units</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>at P6.00</td>
<td>at P10.00</td>
<td>at P0.90</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td></td>
<td>70,000 units</td>
<td>45,000 units</td>
<td>30,000 units</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>at P6.50</td>
<td>at P10.50</td>
<td>at P1.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td></td>
<td>30,000 units</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>at P8.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>Oct. 1-31</td>
<td>105,000 units</td>
<td>50,000 units</td>
<td>45,000 units</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oct. 31</td>
<td>P8.00/unit</td>
<td>P11.00/unit</td>
<td>P2.00/unit</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

On October 31, the company’s suppliers reduced their prices from the most recent purchase prices by the following percentages: product C, 20%; product P, 10%; product A, 8%. Accordingly, Malabon decided to reduce its sales prices on all items by 10%, effective November 1. Malabon’s selling cost is 10% of sales price. Products C and P have a normal profit (after selling costs) of 30% on sales prices, while the normal profit on product A (after selling cost) is 15% of sales price.

QUESTIONS:

Based on the above and the result of your audit, determine the following:

1. Total cost of Inventory at October 31 is
   a. P565,000
   b. P557,310
   c. P655,500
   d. P617,500
2. The amount of Inventory to be reported on the company’s balance sheet at October 31 is

3. The Allowance for inventory write down at October 31 is

4. The cost of sales, before loss on inventory writedown, for the month of October is
   a. P1,298,500   b. P1,022,260   c. P1,293,650   d. P1,208,000

PROBLEM NO. 10
Select the best answer for each of the following:

1. Which of the following audit procedures probably provides the most reliable evidence concerning the entity's assertion of rights and obligations related to inventories?
   a. Trace test counts noted during the entity's physical count to the entity's summarization of quantities.
   b. Inspect agreements to determine whether any inventory is pledged as collateral or subject to any liens.
   c. Select the last few shipping advices used before the physical count and determine whether shipments were recorded as sales.
   d. Inspect the open purchase order file for significant commitments that should be considered for disclosure.

2. An auditor most likely to inspect loan agreements under which an entity's inventories are pledged to support management's financial statement assertion of
   a. Existence or occurrence.   b. Completeness.   c. Presentation and disclosure.   d. Valuation or allocation.

3. An auditor selected items for test counts while observing a client's physical inventory. The auditor then traced the test counts to the client's inventory listing. This procedure most likely obtained evidence concerning

4. Periodic cycle counts of selected inventory items are made at various times during the year rather than a single inventory count at year-end. Which of the following is necessary if the auditor plans to observe inventories at interim dates?
   a. Complete recounts by independent teams are performed.
   b. Perpetual inventory records are maintained.
   c. Unit cost records are integrated with production accounting records.
   d. Inventory balances are rarely at low levels.

5. A client maintains perpetual inventory records in both quantities and pesos. If the assessed level of control risk is high an auditor will probably
   a. Apply gross profit tests to ascertain the reasonableness of the physical counts.
   b. Increase the extent of tests of controls relevant to the inventory cycle.
   c. Request the client to schedule the physical inventory count at the end of the year.
   d. Insist that the client perform physical counts of inventory items several times during the year.

6. After accounting for a sequential of inventory tags, an auditor traces a sample of tags to the physical inventory listing to obtain evidence that all items
   a. Included in the listing have been counted.
   b. Represented by inventory tags are included in the listing.
   c. Included in the listing are represented by inventory tags.
   d. Represented by inventory tags are bona fide.
7. If the perpetual inventory records show lower quantities of inventory that the physical count an explanation of the difference might be unrecorded

8. The physical count of inventory of a retailer was higher than shown by the perpetual records. Which of the following could explain the difference?
   a. Inventory item has been counted but the tags placed on the items had not been taken off the items and added to the inventory accumulation sheets.
   b. Credit memos for several items returned by customers had not been recorded.
   c. No journal entry had been made on the retailer’s books for several items returned to its suppliers.
   d. An item purchased “FOB shipping point” had not arrived at the date of the inventory count and had not been reflected in the perpetual records.

9. An auditor is most likely to learn of slow-moving inventory through
   a. Inquiry of sales personnel
   b. Inquiry of warehouse personnel
   c. Physical observation of inventory
   d. Review of perpetual inventory records.

10. Purchase cut-off procedures should be designed to test whether all inventory
    a. Purchased and received before year-end was paid for.
    b. Ordered before year-end was received.
    c. Purchased and received before year-end was recorded.
    d. Owned by the company is in the possession of the company at year-end.

11. The audit of year-end inventories should include steps to verify that the client’s purchases and sales cutoffs were adequate. This audit steps should be designed to detect whether merchandise included in the physical count at year-end was not recorded as a
    a. Sale in the subsequent period
    b. Purchase in the current period
    c. Sale in the current period
    d. Purchase in the subsequent period

12. An auditor’s observation of physical inventories at the main plant at year-end provides direct evidence to support which of the following objectives?
    a. Accuracy of the priced-out inventory.
    b. Evaluation of lower of cost or market test.
    c. Identification of obsolete or damaged merchandise to evaluate allowance (reserve) for obsolescence.
    d. Determination of goods on consignment at another location.

– End of AP-5905 –