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Correspondence: Inventory Pricing, Future of the Small Accounting Firm

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INVENTORY PRICING

Editor, THE JOURNAL OF ACCOUNTANCY:

SIR: The question as to what should be the proper basis for pricing inventories has arisen quite frequently of late, and as there seems to be some measure of doubt on the subject this letter may help to enliven the discussion and possibly hasten the time when there will be unanimity of opinion.

To begin with, the writer is in accord with the editorial opinion expressed in THE JOURNAL OF ACCOUNTANCY to the effect that the basis of "cost of market" is not perfect but is being advocated and used only in the absence of a more accurate basis. I do not, however, believe that all inventories which are classified as being priced at "cost or market" are actually priced on the proper basis. This, to some accountants, may appear to be a radical utterance, but I have known of such instances, particularly in the cotton-mill industry.

Numerous cotton mills follow the practice of "hedging" in order to avoid losses due to market fluctuations. This is practised in several ways, depending upon local conditions. Some mills contract with a cotton dealer for the purchase of a quantity of cotton for delivery over a period of time, the price of cotton to be a fixed amount over or under the market quotation for a particular month, subject to the buyer's call, such fixed amount being known as "basis." The dealer ships the cotton in accordance with the specifications in the contract and invoices it at the market upon the date shipped plus or minus the "basis," and the buyer remits for the invoiced price.

Officers of the mill having such a contract will sell cloth on the basis of the contract, and as the cloth is sold an equivalent amount of the cotton on contract is "called", which immediately fixes the price of such cotton. When the price of the cotton on a particular invoice has been fixed a settlement is then made by the dealer refunding to the buyer the excess of the invoiced cotton over the "fixed" price, or receiving from the buyer the excess of the fixed price over the invoiced price.

Where loose cotton is available, the mill will buy it and at the same time sell cotton futures of an equivalent amount, closing such futures as cloth sales are made.

Cotton-mill inventories are usually priced at "cost or market," but the cost is usually taken to be the invoiced price, whereas that is not the case. My contention is that the true basis for inventorying call cotton or local cotton purchased with short futures sold against it is invoice price, and that the mill can not properly record any loss on such inventory.

Let us assume a typical case and note the results from using both bases:

Carlton Mills contracts for 2,500 bales of "mobo" type cotton at 250 points on May delivery to be at the rate of 250 bales a week for a period of ten weeks starting November 12, 1929.

At December 31, 1929, there have been eight shipments or a total of 2,000 bales of such shipments, having been billed at the May quotation on the shipping date plus 250 points, giving the following cost for cotton:

Date	Quantity	Market price	Provisional invoice amount
November 12, 1929........	250 bales	16.04	$23,175.00
" 19, 1929........	250 "	16.10	23,250.00
" 26, 1929........	250 "	16.25	23,437.50
December 3, 1929........	250 "	16.40	23,625.00
" 10, 1929........	250 "	16.50	23,750.00
" 17, 1929........	250 "	16.60	23,875.00
" 24, 1929........	250 "	16.90	24,250.00
" 31, 1929........	250 "	16.00	23,125.00
Totals................	2,000 bales		$188,487.50

Sales against the above cotton and the market price on the date on which the prices were fixed were as follows:

Date	Cotton equivalent of cloth sold	Market price at time of fixation	Fixed invoices
November 25, 1929........	600 bales	16.20	$56,100.00
December 12, 1929........	150 "	16.50	14,250.00
" 18, 1929........	300 "	16.65	28,650.00
" 26, 1929........	200 "	16.95	19,450.00
Totals..................	1,250 bales		$118,450.00

Balance of contract is unfixed, 1,250 bales of which 750 have been received and paid for at provisioned prices. The 1,250 bales upon which price had been fixed resulted in paying the dealer additional amounts totaling $1,212.50 which represents the difference between the provisional invoices and the fixed invoices on the first 1,250 bales invoiced.

As at December 31, 1929 the mill had the following inventories:

Raw cotton, 557 bales..................	278,500	pounds
In process..........................	100,000	"
Finished cloth.......................	200,000	"

or the approximate equivalent of 1,250 bales of cotton.

As it is impossible to state which particular bales of cotton were used to produce the cotton in process or the finished cloth, it is customary (where more or less attempt is made to obtain accurate results) to use the reverse chronological order of purchases to arrive at the cost of cotton contained in the two above-mentioned inventories. Where accurate records are not maintained—and even in some cases where there are accurate records—the same procedure is followed in valuing the cotton inventory.

Assuming that the only cotton received during the last eight weeks of the year were the shipments on the 2,500 bale contract, what is the cost price of cotton to be used in determining whether to use cost or market and what price should be used (market at December 31, 1929, May 16.00 spot 15.85, quotations for "mobo" type 200 points on May 2, 180 points on spots)?

Further assume that the 557 bales of raw cotton are identified as being part of the last 1,250 bales received, and ignore the technical points which would only further confuse matters, such as the fact that the average bookkeeper or cost clerk would invariably use the provisional instead of the fixed prices in arriving at average cost, etc. We now find that the cost (per books) of the last 1,250 bales purchased amounted to $119,350.00 or an average cost of 19.10 cents per pound as compared with a May market cost of 16.00 plus 2.00 or 18.00 and a spot market of 15.85 plus 1.80 or 17.65.

Here this customary practice is in error. The average mill would use the market price of spots at 17.65 cents per pound for inventory valuation and believe the inventory correctly valued and therefore correctly stated on the balance-sheet. As a matter of fact, at December 31, 1929, it would be more correct to value 750 bales of the inventory at the provisional cost price, as any market fluctuations are automatically taken care of at the time of fixing the price.

If the price were to be fixed on December 31, 1929, on the 750 bales on hand at provisional prices the mill would receive a refund on the provisional price.

In view of these facts it is my firm opinion that any merchandise purchased on a provisional-price basis, or any merchandise against which futures had been sold, should be inventoried at the provisional price regardless of the market, as a lower market entails a refund to the dealer, and a higher market does not, in my opinion, warrant setting up any additional liability.

Yours truly,

H. J. Beairsto.

New York, N. Y., September, 1930

"THE FUTURE OF THE SMALL ACCOUNTING FIRM"

Editor, The Journal of Accountancy:

Sir: At the recent annual meeting of the American Institute of Accountants, an address was delivered by Mr. Eustace LeMaster on "The Future of the Small Accounting Firm." While the speaker disclaims the purpose, he paints a rather sad picture of the small office, by which term we usually mean one which employs from three to twenty staff accountants and do not include practitioners without a staff of accountants. In hearing his address, or in reading it in The Journal of Accountancy, one is reminded of a reunion of a post of the Grand Army of the Republic in that there are only a few left and they won't last long. Cheer up, old man, the case is not as hopeless as it looks.

The small office has a bright future, but it needs hard and intelligent work to develop it. The public at large does not know what effective service the small accounting office can render and at what insignificant cost when compared with its actual value. Accounting, tax, industrial and management problems can be handled by the principals of the small accounting office, in conjunction with the regular audits, in such a way that the service easily pays for itself. It is true that the major portion of the business public does not know very much of these services and that in the past they have heard of accountants only in relation with catching thieves and getting credit at the bank, but it is also true that the period of enlightenment is at hand. Progressive small firms have, during the past, judiciously and effectively dispelled the belief that accountants are merely thief-catchers or credit-supporters. They have pounded into people the idea that professional accountants are real advisors of business. It is now probable that organized accounting bodies will take up the idea and develop it in a perfectly logical and ethical way. The beginning for this has been made. Notwithstanding the many mergers of recent years, the business of the smaller accounting offices has grown by leaps and bounds, though it now is divided among an ever increasing number of offices.

Contrary to general opinion, the small office has decided advantages over the larger in all work except the audit for clients whose books and accounting records are located over the entire country. Such clients are few in number and form a small part of all the concerns in the United States that do business and have, or ought to have, regular accounting service. These smaller clients doing business locally can be most effectively served by the small office in which the partners can personally supervise the work at close range.

There frequently creeps into professional discussions the thought that the work of the larger is more accurate than that of the smaller offices. Whether this is because the irresponsible free lance who is so often reckless in his work is considered to be among the small office group or whether it is based on an unwarranted assumption is not known; it is certain, however, that reports contested in the courts do not bear out the contention. The best that can be said is that both large and small offices have advantages as well as disadvantages. If the small office is considered as personally conducted, it would seem to have much in its favor in all cases except those where clients' offices are scattered throughout the country.

However, the sales department, call it by any name you will, is the most important part of an accounting office. There is no lack of technical skill in the accounting profession, and if any one can get signed contracts for accounting work at proper compensation, there is little doubt that the work will be done accurately, carefully and efficiently. Ordinarily, the sales department of a large concern is more efficient than that of a small one, and in this respect accounting offices are no exception to the general rule. What accountants in small offices need is not so much more technical skill in handling cases as a better sales plan or sales department. It goes without saying that advertising, as it is generally understood, is ineffective and wasteful in accountancy. Yet the practitioner who specializes in personal service to clients in industrial and management problems, in contradistinction to preparing balance-sheets for credit purposes or catching dishonest cashiers, should let the public know that he is available for such engagements. If a national concern has offices in fifty different cities, it is only natural that it should announce the fact on cards and letterheads. There is nothing wrong in the announcement of the specialist in management nor that of the national concern. No concern that makes contracts for fees should be barred from judicious publicity; contracts and publicity seem to go hand in hand.

The speaker at the annual meeting referred to a Spokane banker who classifies accountants under two headings: those who make statements as the clients want them and those who do not. If the client does not ask the accountant to sacrifice his integrity or to state an untruth, it is not apparent what harm there is for the accountant to try to make statements as the client wants them. The best accountants would not feel flattered to be classed as practitioners who prepare statements in a way that clients do not want them, and, on the other hand, they could not be induced to prepare misstatements. Judging by newspaper reports on a certain contemplated merger, the small offices do not make up the entire first group of accountants mentioned above.

The same speaker mentioned another banker who lost a considerable sum of money through the failure of a large commercial firm and, after reciting the various details of the affair, he wound up with a threat made by the banker, "This is going to hurt all of the local accountants—severely." This threat calls for a challenge. On the facts as related by the speaker, there is nothing to show that the threat was justified because the local accountant had been careful to cover himself by qualifications which apparently had been overlooked by the banker, and had probably secured as large an order as was possible under all the conditions. One can not find him blameworthy, unless he did more than is charged. It might be mentioned that there is nothing new in this condition. In every case of failure, there is a search for the scapegoat and accountants are defenseless until court action is brought and then it costs money to defend lawsuits. It is highly probable that that particular banker got all the information he actually insisted upon, and that he merely discovered that, as usual, hindsight is superior to foresight.

Probably by way of illustrating that the small office may at times not be fully equipped to handle accounting work, the speaker quotes an attorney who recently made an address to a jury in the following language: "All that is required in this state to become a certified public accountant is that you be nineteen years old, of good moral character and pass an easy examination" and adds that the attorney's description is not uncalled for. Perhaps it is not, but I have an idea that in most states the accountant who is certified by the state has a pretty good knowledge of accounting though, as in other professions, he may lack the actual practical experience in handling audits. It is not my intention to maintain that the individual practitioner is fully qualified to handle any audit; what I am referring to principally is the small office employing a staff of accountants. The possession of a C. P. A. certificate is a valuable aid in the building of a substantial practice and unless an accountant has powerful support or connections, he is facing a tremendous task if he attempts it without the certificate from the state. No professional accountant should ever take seriously the disparaging remarks on the value of his C. P. A. certificate.

Credit men have much to atone for. Ever so often they will read into a report something that is not there or something that is plainly stated as not being the case. It is of record that a credit man considered a balance-sheet certified because it was in a cover bearing the printed name of the accountant. This is a particular danger to the small office which specializes in reports for management purposes which are required to be signed and authenticated. We should perhaps have each class of work clearly indicated by a title which can not be misunderstood, but although a good beginning was made in this direction, the work has not progressed much beyond the initial stage. The various accounting organizations would do well to follow this movement and standardize the terms and publish them to credit grantors. This would be of much benefit to the smaller offices and would remove an obstacle to their work that has been created by undue attention to certified balance-sheets.

The successful future of the small professional accounting office is well assured and organized accountancy can do a great deal by developing the activities upon which it thrives, or in any event the law of self-preservation will take care of the problem if the profession as a whole fails to act. The field outside certified balance-sheets is large and fertile for the smaller offices, and, though the work is more arduous than the mere auditing for credit purposes, it is too valuable to be long neglected by the profession as a whole.

It would probably be a good idea for the profession to point out a few improprieties of bankers. At least, in return for the coöperation extended by accountants, they ought to refrain from having audits of their depositors made by their staff, in competition with the professional, usually small, accounting office. When accountancy is as well organized as is, for instance, the legal profession, there will be no need to worry about the small accounting firm.

Yours truly,

MARTIN KORTJOHN

New York, December 4, 1930.