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The Certificate Qualified as to Inventories

RAPID strides have been made by the accountancy profession in recent years in improving the quality of its services to clients. Accountants have found through years of study and experience that much of the detail work, once thought necessary, could be eliminated, and more constructive work substituted to the ultimate benefit of their clients. However, there still remains at least one glaring weakness in the accountant's report—the certificate qualified as to inventories because of the absence of inventory verification on the part of the accountant. This weakness is recognized throughout the profession. Many accountants believe that it is an unavoidable condition, because in their opinion the accountant is not qualified to verify inventories as to quantities with any degree of accuracy. Most bankers are of the opinion that the accountant should assume responsibility for inventories. It is but natural that bankers should do so. But, there are also many accountants of high standing in the profession who feel that the accountant should accept responsibility for inventories, and believe that he is qualified so to do.

Mr. C. Oliver Wellington, in an address before the New England Chapter of the Robert Morris Associates, advocating the extension of the accountant's responsibility for inventory verification, presented the case so well that the substance of his thesis is worth repeating.

Accountants, as a rule, are unusually particular in establishing the existence of the amount of cash and receivables as stated in the balance sheet. In most cases, however, they make little or no attempt to verify inventories. Yet, in most trading and manufacturing companies inventories may represent more than one-half of the current assets. Any attempt at "window dressing" or inflating the value of the assets may be concealed much more easily in the inventory account than in any other asset account. Surely, a balance sheet in which inventories have not been verified is not of much value, when it is possible that the inventory, which usually amounts to more than all the other current assets, may be grossly inflated.

Many times the client restricts the work of the auditor and will not permit him to make any verification of inventories whatsoever. In such cases, the accountant can only accept the certificate of the company official as to the inventory, and qualify his certificate accordingly, so as to protect himself and put any reader of the balance sheet on notice.

Usually the inventory is counted, priced, extended, and footed by the client and later is subjected to certain tests by the auditors. Such tests, according to present auditing practice, generally comprehend verifying, by test-checking, the valuation at cost or market; test-checking the typed copy of the inventory against the original inventory sheets and perhaps against the perpetual inventory records; investigating ownership of goods and the inventory cut-off; test-checking extensions and footings; and applying gross profit and rate of turnover tests to the inventory figure. The auditor is supposed to make sufficient tests to satisfy himself as to the substantial accuracy of the inventory. The extent of the tests depends upon the effectiveness of the system of internal check and the accuracy of the cost system. After completing these tests satisfactorily, the auditor can certify to the inventory without qualification except as to quantities, which are accepted as certified by the client.

While the certificate qualified as to quantities only is more desirable than the certificate which disclaims all responsibility for inventories, it is, nevertheless, far from being effectual in reassuring the

banker as to the correctness of the inventory. The fact that the auditor may have tested the prices, footings, and extensions is rather insignificant when one considers that quantities might be grossly overstated.

The certificate that is of maximum value to the banker is that in which the accountant unqualifiedly certifies to the correctness of the inventory as well as to the other balance sheet items. To be able to so certify, the auditor and his assistants must, in addition to verifying prices and computations, supervise the taking of the inventory, and be reasonably sure that the inventory is counted, weighed, or measured correctly. If the auditor closely supervises the inventory procedure and makes adequate checks of quantities, he should, in most cases, be qualified to express a reliable opinion as to the correctness of inventories.

The first step to be taken by the accountant who intends to supervise the inventory work is to review the methods which the client proposes to use in taking the inventory, in order to satisfy himself that those methods are calculated to produce a correct inventory and to suggest any changes which may be necessary. Accountants certainly should be qualified to pass upon the adequacy of a plan of procedure for taking the inventory. Such a task is in line with their work of designing systems of accounts and systems of office routine.

While the inventory work is in progress, the auditor's duty is to supervise, with the help of his own assistants, the work of the client's employes who are taking the inventory. It is necessary for the auditor and his assistants to make frequent tests to see that proper descriptions, quantities, weights, etc., are recorded on the inventory tags. The tags should not be collected until the auditor's assistants have completed their tests and have satisfied themselves that all items have been tagged. After the tags have been collected and all accounted for, and the data contained on them transferred to the permanent inventory records, the auditor should make sufficient tests to assure himself that such data have been transferred correctly. For that purpose, the auditor should have a stub from each tag, containing the same information as on the body of the tag.

The auditor, of course, should give special attention to goods in the receiving room to determine if any goods are on hand for which the liability has not been entered on the books, or if any goods have not been received for which the liability has been recorded. Also in the shipping room he should make certain that no goods have been shipped and not billed, or that no goods have been billed and not shipped.

There is no reason why the accountant must count every article in the inventory to assure himself of the correctness of the quantities. Accountants have long since found that even in a general audit it is not necessary to foot every column or verify every transaction in detail. Reasonable tests, properly selected, are sufficient to establish the general accuracy of the accounts. Likewise, if the auditor makes test counts of a reasonable number and variety of items in the inventory and maintains strict supervision and adequate internal control, he can feel reasonably sure that the inventory has been counted and listed correctly.

The accountant, in making his tests, will, of course, make use of all the protective and labor-saving practices which are within his knowledge as a result of his auditing experience. He will formulate and apply various standards of judgment which will reduce the work of counting without destroying the effectiveness of the test, such as counting the number of items in a standard space or translating cubical contents into weights. He will make test-openings of boxes or barrels and test-borings in piles to see that they actually contain what they are supposed to con-

tain. In a soap factory the accountant might make test-openings of boxes supposed to contain soap ready for shipment to see that such boxes actually are filled with soap.

The question of obsolescence is said by some to present an insurmountable difficulty to the auditor in verifying inventories. Yet, many cases might be cited where accountants have discovered that inventories were inflated because of unsalable stock being included. It does not seem unreasonable to believe that any difficulty which might exist would become less with each repetition of the inventory work for a certain type of business and as the auditor becomes more familiar with conditions within that industry. In this connection, the use of running inventory records, and aging of the stock will indicate what items should be most carefully investigated for unsalability. If the inventory records show 25,000 units of a particular article on hand, and only 1,000 units have been sold in the past year, it is evident that much of that stock probably will be unsalable. Also, in many cases, such as in the men's and women's clothing business, the goods are marked to indicate the season in which they were purchased, so that it is possible to determine, without much difficulty, whether or not a large supply of old stock is being carried. In all cases where an accountant does not feel capable of judging an inventory correctly, he can, and should, supplement his work by obtaining the advice of engineers or experts familiar with that particular business.

Of course, it is manifestly impossible for accountants to assume unqualified responsibility for inventories of certain businesses, such as jewelry stores, where a highly technical knowledge is required to be able to measure and value the inventory intelligently. In such cases auditors must continue to rely on the qualified certification of inventories. However, when allowed to make proper verifications, there is no reason why accountants should not accept the responsibility for inventories in the many cases in which they are qualified to assume such responsibility.

Bankers can make it possible for the accountant to submit an unqualified certificate by urging upon their borrowers the necessity of a general audit, including unrestricted verification of inventories. Only when such an audit is made, is the accountant in a position to give an unqualified certificate. If given the opportunity to make the necessary verifications, an ever-increasing number of the leading accountants today will be more than willing to express a reliable opinion on inventories as well as the other balance sheet items, because they realize that, in most cases, they are qualified to render such service, and because they believe that such action would be a great forward step in rendering service to their clients and to the public.

Born; A Natural Business Year

IN observing the recent action of the Associated Fur Manufacturers, Inc., of New York, one may be pardoned, perhaps, for taking pleasure and pride in repeating to oneself, "The vision of our forefathers has been justified."

Many years ago, when Mr. Sells advanced the idea of the natural business year, concurrence in the principle was not in any sense lacking, but the difficulty of obtaining the coöperation of industry in putting the principle into practice was manifest. The interest in the idea seemed for the moment to be a selfish one on the part of accountants who, from the time accountancy practice developed in this country, have had to struggle with the backbreaking burden imposed by the closing of accounts at the end of the calendar year.