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Accounting Questions: Elimination of Physical Inventories; Wholesale Egg and Poultry Business

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ACCOUNTING QUESTIONS

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ELIMINATION OF PHYSICAL INVENTORIES

Question

Will you please advise me in regard to taking physical inventories, and what stand the accounting profession takes in regard to eliminating physical inventories at one particular time of the year in favor of the practice of taking periodical check-ups throughout the year so as to cover all items over a twelve months' period.

Are there any companies who are doing away with the physical inventory taking as far as you know?

Answer No. 1

In reporting on the accounts of a company which instead of taking a physical inventory of all of its merchandise, etc., at one date keeps perpetual-inventory records thereof and from time to time during its fiscal year takes physical inventories of various portions, so that at some time within the year it has verified by actual count the showing of its perpetual-inventory records with respect to all items contained therein, we consider that the perpetual-inventory records as at the date of audit are the equivalent of original inventory sheets prepared by physical count at that date. In a complete audit report there would be a brief paragraph describing the company's method of arriving at inventory values and the extent of their verification; if a balance-sheet were submitted with no more than an accompanying certificate or presentation letter the inventory item on the balance-sheet would show parenthetically "As taken and priced by the management."

If by the second part of the question your inquirer refers to the possibility of a company dispensing entirely with its physical inventory and relying wholly on perpetual-inventory records without periodical comparison with physical stock, our answer is in the negative.

Answer No. 2

We have found it to be the general practice to require physical inventories at the close of each fiscal year. Periodical checkups are made particularly to provide current comparisons with perpetual-inventory and stock records.

We do not know of any companies who are doing away with the physical inventory taking.

Answer No. 3

So far as we know, the accounting profession has not taken any definite stand in regard to eliminating physical inventories at one particular time of the year in favor of the practice of taking periodical checkups throughout the year so as to cover all items over a twelve months' period.

It is the practice of some companies, however, which maintain perpetual-inventory records to make periodical checkups and compare same with the perpetual-inventory records. The number of times the physical inventory is taken depends, to a great extent, on the difference between the physical inventory and the perpetual inventory at the time the physical inventory is taken.

To illustrate: If one department shows a wide divergence between the physical and perpetual inventories, that department is checked regularly for a period of months for the purpose of reducing the shortages. In the event that the shortages become insignificant, then the period for taking physical inventories is increased. This is particularly true in certain department stores where retail-inventory records are maintained, although in our experience we have seen the method used by some manufacturing concerns.

In our opinion, the general practice is to take physical inventories, but certain types of businesses adapt themselves to the method set forth in the question, and in those particular cases in a well-managed business such method of taking inventory might be acceptable for statement purposes. However, the prevailing opinion appears to be that physical inventories, where possible and practicable, should be taken at the statement date.

Wholesale Egg and Poultry Business

Question

Egg Business. Client in wholesale egg business. Operates buying stations at strategic country points. Eggs graded and shipped in carloads to a warehouse for storing. Client then borrows from warehouse on stored eggs. When market conditions are unsettled or, in client's opinion, a downward trend is expected, a hedge is placed by a short sale on the futures exchange. If, in client's opinion, market should rise, no hedge is placed, or a previous short sale is closed by purchase on the futures exchange. During period from spring storing season to fall using season, client may be hedged and unhedged several times, which of course means that there is an alternate nonspeculative and speculative position maintained. Monthly operating statements are desired.

(1) How shall eggs be inventoried? In the meat packing industry, market prices are used for inventory purposes. Is the use of market prices permissible in this business? If not, what is the proper basis?

If eggs are hedged, what inventory basis shall be used? How shall a paper loss or profit on the hedge be treated? How shall profits or losses on closed hedge transactions be handled in the accounts?

(2) How shall loans be shown on balance-sheet? Eggs in storage against which there is a loan will not be released by the warehouse until the loan is paid. Can the loan be shown thus:

Current Assets (figures assumed):		
Inventory unpledged . .		$20,000
Inventory pledged	$30,000	
Loans secured by warehouse receipts on this mdse.	27,000	3,000
Total inventory—net		$23,000

or must these loans be shown as current liabilities, with the pledged inventory shown in the gross amount under current assets?

Poultry Business. Client above also engages in wholesale poultry operations, buying live poultry in small lots from many farmers and killing and dressing them. Various lots are intermingled in the process of grading after they are killed.

What is the proper inventory method as to price? May market values (less an amount to compensate for distribution costs) be used for pricing the inventories?

Answer No. 1

Inventorying eggs: Experience has demonstrated that cost or market, whichever is lower, is the most satisfactory and reliable basis of valuing inventory. Commodities like dressed meat, involving rapid turnover, in respect of which the inventory on hand at the end of the month may be expected to be sold within two or three days are an exception. Sale prices in such cases afford an expedient and practicable basis of valuing inventory, because the inventory usually is sold at the month-end sale prices.

For this reason the dressed-poultry inventory may be inventoried at sale prices less a percentage representing the inquirer's experience as to distribution costs and profit.

In the case of eggs, however, which are held for a long period, inventorying them periodically at varying sale prices would distort the accounts. Accurate and complete data should be reported by the buying stations concerning quantities and costs of the several grades of eggs bought and the cost of operations in buying and grading, which costs should be spread over the purchases. The eggs placed in warehouse should be identified (a) by grades, (b) by purchasing stations, and often (c) by producers, whose eggs may command a premium in the market. An elaborate system of accounting is not needed to allocate the costs and buying stations' expenses to the several grades and lots.

Once determined, these allocated costs may remain unchanged except when a lot may be carried into a lower price period, when such stock should be inventoried at market, if below cost.

If lots become mixed so that they are no longer identifiable there is no recourse but to price them at sale market less marketing expense and profit. As this will result in distortion of the accounts, as stated above, effort should be made to retain the identity of the lots.

Hedging. Hedging is in effect a form of insurance. The value of the inventory as such is not affected by hedging. Separate accounts should be maintained for the hedging transactions, and the profit or loss on each determined. These profits or losses may be shown in the profit-and-loss statement, or they may be offset against the losses or profits of the hedged lots in the month in which the latter are sold and the corresponding hedging transactions closed. That is to say, the profit or loss for each current month should be determined by combining closed hedging transactions with sales operations; for the year to date, commodity transactions and hedging transactions being kept separate.

Pledged inventory and loans. Loans should not be offset against the pledged commodity but should appear on the liability side of the balance-sheet. The two items should be described (using assumed amounts) thus:

Inventory (of which $30,000 is pledged to secure loans per contra) $50,000

Loans payable, secured by warehouse receipts on merchandise per contra $27,000

Answer No. 2

(1) I can see no reason for departing from the lower-of-cost-or-market basis.

In view of the fact that monthly operating statements are under consideration, the most desirable practical treatment would be to value all eggs at the lower of cost or market even where hedges exist. Any profit or loss on open hedges could be shown as footnotes, and profits and losses on closed hedges should then, of course, be taken direct into operations. It seems to me that the intelligent operator can follow his position with statements of this kind. If, however, it is desired to prepare more formal statements, there would appear to be no objection to allowing for the hedged position in stating the inventory. If this were done such portion of the inventory as was covered by hedged sales would be valued at the sales price and any excess at the lower of cost or market.

(2) I would advise against deducting loans from the current assets. It would seem correct to me, in the case cited, to state the inventory at $50,000 indicating that $30,000 thereof was subject to pledge in connection with loans of $27,000, and to show the liability for $27,000 on the liability side of the statement as current.

(3) Here again I can see no reason for departing from the lower-of-cost-or-market basis, unless it is felt, for the purpose of monthly statements, that strict accounting form can be dispensed with.