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The Accountant's Relation to Inventory*

By Henry C. Magee, C.P.A.

In verification of inventory the accountant's first duty is to see that "purchases account" has been charged with the amount of all invoices for goods which have been delivered to the division for which inventory is to be taken, and that credit has been given for all goods returned by the stockkeeper of the division—the stockkeeper in his turn seeing that all goods received are listed down to the last minute and that any goods returned to manufacturers and already listed shall be stricken from the list and credited in office to purchases. For this purpose a register must be kept of packages of goods turned over by the receiver of the stock to be checked off as bills are signed by the buyer and returned to the receiver as evidence of completed delivery. Sales account must be given credit for all goods sold up to the last minute of period under accounting and charges made to sales for any returns on such account—care being taken that any goods listed after inventory is commenced, and sold and credited to sales before inventory is completed, must be stricken from the list, and if sold goods are returned and charged back against sales before close of inventory, care must be taken to see that such goods are listed in the inventory.

A fruitful source of error is the charging and crediting of "last minute items" without corresponding listing or deduction from inventory and *vice versa*. The new manager of an old division is much troubled by bills saddled on his record although for goods received and listed or sold in the previous manager's business. Strictly speaking, such charges are not just, but proprietors frequently claim with fairly good logic that an adjustment is reached in the general average of conditions affecting each buyer's fiscal period. For example, a new buyer sometimes depreciates an old buyer's stock according to his own ideas rather than the facts. Nevertheless extraordinary instances of this kind require special consideration and agreement as such items really belong against surplus or deficit, as the case

* From the author's forthcoming work on Department Store Accounting.

may be, of previous operating account. Goods received during the last part of a fiscal period are sometimes not distributed until after inventory is closed unless they are needed for immediate trade requirements. Neither are the invoices charged to purchases—thus neither goods nor invoices are considered among the assets and liabilities of the business. This is proper if the goods are for the succeeding season but would not be proper if the merchandise belonged to a past season and was late delivered—the obligation to receive resting on the proprietor. The auditors should require evidence of outstanding obligations for merchandise, as it sometimes happens that there is an obligation on the part of a manager to receive merchandise which has been held off by mutual consent but which has depreciated below the agreed purchase price. Possibly conditions such as this offset each other but the question should be raised.

It is sometimes the custom for one manager to superintend the listing of another manager's stock instead of his own, but circumstances influence conditions.

An account should be opened on the general ledger entitled "Inventory," entering and closing the various inventories therein so that a comparison of total inventories may be shown by reference thereto. Separate accounts should be provided for sales and for purchases.

The accountant should see how the inventory has been taken, that is, that it has been taken in such manner as to make it possible to identify the record of the items wth the items themselves. This is in itself so essential and so patent that it may be thought superfluous to speak of it; but it is a principle often disregarded. For example, I have known instances wherein the only sign that stock has been inventoried was a "memo" slip of paper with the word "taken" placed on a table to signify that goods thereon had been listed. If the "memo" blew off, the stock would in all probability be taken again. It will naturally be asked how the accountant is to know whether or not such mistakes have been made if called upon months afterward to make up a report in which that inventory plays a part when he did not assist in checking the inventory at the time when it was taken.

The answer is that he should inquire how the inventory was taken at the time of listing; what precautions were taken to

prevent errors of omission or commission; and whether or not the accounts since inventory have been kept so as to render it possible to discover approximately the present stock-in-trade. If conditions proper to the making of such approximation had been neglected the report should so state.

There is always a relation between the inventory and the turn-over varying according to the business and then varying in each business according to the successful or otherwise conduct of that business and this variation should be closely investigated. An accumulation of stock-in-trade without a corresponding increase in business simply means at the best that stock has been bought that cannot be turned into either finished product (if raw material) or into sales (if finished goods) and at the worst it means deliberately padding the inventory. Merchants often think they can develop profits merely by taking goods on the shelves at marked prices nothwithstanding that such goods may be out of season or style—in fact may be souvenirs, instead of merchandise.

Another way of padding the inventory is by baldly increasing the quantity figures and prices of the inventory to show an apparent profit for a particular period. This is surely "sowing the wind" and the whirlwind harvest will not be long delayed.

The decision of the Irish court of appeal in the case of the *Irish Woolen Company Ltd. vs. Tyson et al.* in 1890 (see *Encyclopedia of Accounting* vol. 1 page 182, article by LAWRENCE R. DICKSEE) in which it was sought to make the auditor liable, *inter alia,* for the overstating of the value of the stock-in-trade, held (following the *Kingston Cotton Mills* case) that the auditor was not responsible for the inventory. Referring to the account of the *Kingston Cotton Mills Company Ltd.* case (1896) we find the trial judge, MR. JUSTICE VAUGHN WILLIAMS, decided against the auditor, holding him guilty of negligence in relying on the certificate of the managing director as to the amount and value of the stock-in-trade, even though he definitely stated to the shareholders the source of information.

The decision in regard to the stock-in-trade was, however, overruled by the court of appeal in the same year, *viz.:* 1896, LORD JUSTICE LOPES in the course of his judgment made some very interesting remarks upon the duties of auditors. He said in part:

It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a blood-hound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely on their representations provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. I should be sorry to see the liability of auditors extended any further than *in re. The London and General Bank,* in which the auditors had been held for not taking adequate steps to see that the shareholders were made cognizant of the contents of a special report submitted to the directors but not included on the balance sheet for the stockholders. Indeed I only assented to that decision on account of the inconsistency of the special statement with the stockholders' balance sheet, which satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.

JUSTICE LINDLEY, also in the case, affirmed:

I pass now to consider the complaint made against the auditors in this particular case. The complaint is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not honestly believe to be true. It is said, however, that they were culpably careless. The circumstances are as follows: For several years frauds were committed by the manager, who in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and value of the cotton and yarn in the company's mills. He did this at the end of the years 1890, 1891, 1892 and 1893. There was no book or account (except the stock journal, to which I will refer presently) showing the quantity or value of the cotton or yarn in the mill at any one time. It would not be easy to keep such a book nor is it wanted for ordinary purposes. There is considerable waste (twenty or twenty-five per cent on the average) in the manufacture of yarn from cotton, and the market price of both cotton and yarn are subject to great fluctuations. The balance sheet of each year contained in the asset side entries of the value of the stock-in-trade at the end of the year, and those entries were stated to be as per manager's certificate. The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance sheet, and they took the value of the stock-in-trade at the end of the year from the stock journal. This book contained a series of accounts under various heads purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors, and was inserted as an asset in the balance sheet, but as per manager's certificate.

The summary always corresponded with the amounts summarized, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarized. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager and the entry in the balance sheet showed that they did so. I confess that I cannot see that their omission to check the returns was a breach of duty to the company. It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the material necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet. In this case the auditors relied on the manager. He was a man of high character and unquestioned competence. He was trusted by everyone who knew him. The learned judge has held that the directors were not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to stock-in-trade in hand and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason. The stock journal showed the quantities—that is the weight in pounds—of the cotton anl yarn at the end of each year. Other books showed the quantities of cotton bought during the year. If these books had been compared by the auditors they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shown in the stock journal and so much less that the stock journal could not be right, or, at all events was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But although it is no doubt true that such a process might have been gone through and that if gone through the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's returns? I cannot bring myself to think that they were, nor do I think that any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matter on which information from such a person was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who has to account for the cash which he receives and whose own account for his receipts and payments could not reasonably be taken by an auditor without further inquiry. The auditor's duty is not so onerous as the learned judge has held it to be: The order appealed from must be discharged with costs.

These extracts refer to legal responsibility but it is significant that the trial judge held the auditor legally responsible, thus upholding the plaintiff's view of the matter, even if the decision was reversed. The fact seems to be that much more is to be expected of an auditor by his clients than a strict interpretation of the law will sustain and I am glad that it is so because it widens the scope of an auditor's responsibilities and helps to place the profession in the van of modern vocations.

Following my previous remarks on the subject of turn-over, I note that one of the authorities, from whose article I have taken JUSTICE LINDLEY'S opinion (MR. JOHN A. WALBANK) brings up the question of proportioning stock-in-trade to turn-over and cites the following from the accounts of the Kingston Cotton Mills.

Stock at 31st December		Sales for year
1889	£29,760	£119,727
1890	44,482	122,694
1891	53,918	106,382
1892	60,966	91,694

	Per cent Gross Profit	
1889	29.95	£119,727
1890	29.62	122,694
1891	36.53	106,382
1892	38.93	91,694

It will be recalled that the managing director exaggerated the quantities and prices at the end of 1890-1891-1892-1893. Taking Mr. WALBANK'S figures I have figured out the number of turn-overs of stock:

1899	4.02
1890	2.76
1891	1.97
1892	1.50

The enormous decrease in stock turn-over and the increase of stock show on their face that there is something utterly wrong. The following figures show the facts plainly:

	Inventory	Turnover of stock	Per cent gross profits on sales	Amount of gross profit	Per cent of gross profit to amount invested as per inventory
1889	£29,760	4.02	29.95	£35,858	120.40
1890	44,482	2.76	29.62	36,342	81.75
1891	53,918	1.97	36.43	38,755	71.77
1892	60,966	1.50	38.93	35,696	58.40

I have calculated the profit on the investment from the inventory, whereas it should be on the average of the stock-in-trade throughout the year, but the variation would apply to each year in about the same proportions so that the above example will give a fair idea of facts. Furthermore, no one who carries too high

stocks throughout the whole year can expect a proper inventory, any more than one who carries a load of bad habits throughout the year can expect to unload on the first of January.

It will be noted that notwithstanding the managing director's manipulation he barely maintained his amount of gross profit; in fact, in 1892 he fell below 1889's amount of gross profit (even though his percentage of gross profit to sales showed an increase) in spite of the fact that from his own showing it took more than twice as much stock to do three-quarters of his former business, and furthermore, he cut his rate of profit on investment more than in half. The expense of carrying this stock would operate materially to reduce the net profit and the fraud was probably discovered because the manager was calling for more material while his record of stock-in-trade showed an abundance of goods on hand.

In my opinion the inventory of the stock-in-trade should be taken in accordance with the most approved methods of each line of business, the record being sectionalized, so that a check may be made at almost any time between fiscal periods. A comparison by sections should also be made showing the rise and fall between the corresponding seasons of different fiscal periods as well as between the different months or weeks of the same fiscal period, so that the relation between stock-in-trade and total turn-over (sales) may be readily observed.

The turn-over is generally reckoned by dividing the average stock at cost into the total sale instead of purchases. As comparative profits and expenses are figured for reasons of convenience on the basis of sales, the turn-over is also taken on that basis and the result is the same in either case when brought down to gross profit.

Where the total inventory is large the sectionalizing not only of the inventory but also of the purchases and sales is a prime necessity as by that means can undue increases in stocks be best discerned, and if the turn-over figures are carried out to two or three decimals even slight variations are quickly noted. All this information should be at the command of each division manager and his lieutenants and frequent comparisons should be made for the benefit of all concerned.

An estimated inventory is often kept by adding to the physical inventory taken at the beginning of the period the purchases since

and then deducting the estimated cost of the goods sold. The amount of profit realized from the sale of goods varies according to the season, some parts of the year being more profitable than others, by reason of better prices and better volume—thus greatly reducing the burden of the "overhead." However, with profit conditions agreeing a very good guide can be provided by means of a current estimated inventory but it never takes the place of a vigilant personal supervision of the goods themselves.

The aim of the best merchants and manufacturers is to have material on hand only in such quantities as are necessary for rapid consumption. This rule should not be departed from without due consideration of four possible factors, *viz.*: Interest on the outlay for raw material and labor; insurance and storage charges; depreciation from all sources especially changes in machinery, pattern, style and rust, moth, etc.; and theft.

The rule in taking inventory is to list at cost or market price whichever is the lower. A vigilant stockkeeper does not wait for inventory time but is repeatedly going through his stocks to see where accumulations lie as well as where short lines are, reporting to superintendent or buyer as to the hills and hollows. The golden mean is nowhere so necessary as in stockkeeping. Notwithstanding the importance of good stockkeeping it is probably the most neglected single division of every business and its lack is probably responsible for nearly all the failures in manufacturing and mercantile business.

When inventory is taken at invoice price a reserve should be provided equal to the cash discount deducted at payment for inventoried goods—the undiscounted—unpaid—invoices to be deducted from the amount of inventory before figuring the reserve. The gross profit is often taken by considering invoice price as cost. The cash discount is shown as a separate profit for each division. The reason for deducting the amount of the unpaid invoices from the amount of the inventory is because no credit for cash discount should be taken until earned and that part of the inventory covered by the unpaid bills should be considered as costing the amount named on face of the invoice.

Merchandise or raw material that does not turn quickly is as a rule marketed at a sacrifice and the money reinvested in turnable goods. Of course different lines of goods turn at different rates and net profits generally vary in proportion, but each line

has its approximate rate and it becomes necessary to study the situation with the utmost care. A good method is to take the inventory on loose sheets requisitioned from the statistical department. In large establishments this is a special bureau, but the same principle may be employed if the duties of statistician, bookkeeper, entry clerk and stenographer are performed by the one person.

Each department of the business should be given a number beginning with 1. Each department should have as many sheets as required and every sheet should bear the number of the department as well as the number of the sheet. For example, department No. 1 uses 100 sheets; the first would be numbered "Dept. No. 1 sheet No. 1" the second, "Dept. No. 1 sheet No. 2," and so on in consecutive order, each line of each sheet also being numbered commencing with No. 1. The lines of each sheet are numbered so as to identify the entries in cases of errors or other need. Corrections of the inventory after the sheets have been turned into the statistical department are made on correction sheets provided for the purpose. For example, inventory sheet No. 10 Dept. No. 1 bears the following record, as turned into the statistical department:

DEPARTMENT NO. 1 SHEET NO. 10

Line No.	Lot No.	Quantity	Yards gross or pieces	General description	Invoice cost per unit	Total cost	Selling price per unit	Total Selling price
1	107	10		Style No. 875 Beaver Overc'ts	30 00	* 200 00	50 00	500 00

* See correction sheet.

The correction would be noted on the correction sheet of Department No. 1 as follows:

CORRECTION, DEPARTMENT NO. 1

Sheet No.	Line No.	Cost or value reported	Cost or value should be	Retail reported	Retail should be
10	1	200 00	300 00		

The total of the corrections are then made up and the net deducted from or added to the reported amount.

A register should be kept by the statistician showing the number of sheets given to each department. These should be

checked back, any spoiled sheets to be marked void and turned in immediately so that the register may be correspondingly marked.

If the inventory is taken in duplicate one copy is sent to the statistician as soon as the goods are listed and proved, to be extended. The department extends its copy and forwards it to the statistician where the result is compared by him with the result obtained by extending and totaling the first copy.

In other instances the inventory is taken only in original, but there is a perforated margin to the sheet numbered the same as the body of the sheet and ruled for a separate extension of prices. The extensions of the department taking the inventory are made on this perforated margin leaving blank the extension column in the body of the sheet. When the inventory is extended on the marginal strips by the departments the sheets are sent to the statistician, who removes the strips, filing them by department and then by number in each department. Then the sheets are again extended, this time in the regular extension column of the sheet, under the direction of the statistician and sorted by department and number, and a comparison is made to see whether or not the two results tally.

In checking cost of stock-in-trade, cost may be cost on shelves where stock has been opened, checked, examined, marked and shelved; and when in ware-house then cost up to that stage. In both cases cost includes buying, transporting and receiving charges. Some do not include freight and expressage even when directly paid by the buyer, preferring to have that margin as unstated reserve; but no amount of cost is permissible beyond that of replacement at time of inventory in the condition in which stock then is.

One of the advantages of the first plan—that is taking inventory in duplicate—is that the sheets may be sent by sections to the statistician as soon as the goods are listed, to be verified while the balance of the inventory is taken. Better time will be made throughout. The sheets for each division should be received and acknowledged by the head of such division and an account kept by him of the number of sheets charged to him by the statistician. He in turn should keep record of his distribution of the sheets to the sectional heads of his division. Each sectional head should designate each subdivision of his section

by letter, placing a fixed mark against each subdivision and then list his stock accordingly.

For example, the manager of department No. 1 receives 100 sheets for his inventory, numbered for his department and from 1 to 100 inclusive. He has ten lieutenants to whom he in turn delivers the sheets taking proper record thereof under the captions section No. 1, 2, 3, etc., up to 10. Each lieutenant before he begins to take stock marks his subdivisions A B C, etc. The designations are not to be removed from the subdivisions without due warrant.

Whether the inventory is a final or merely a current one makes considerable difference. If current it is often taken currently as much as a week or more before closing period and deductions made of individual items or of sales during the intervening time, after deducting estimated margin of profit from said sales. In the latter case if all the parties continue it adjusts itself, provided no difference in the order of distribution of profits is permitted.

As each lot of goods is listed the names of the "calling" and "entering" clerk should be signed by each in the space provided on the inventory sheet which should be followed by the "caller back" and the "entry checker" both signing the inventory sheets in the spaces provided for the signatures.

In some instances in taking inventory in department stores a season letter is placed on each price ticket to indicate the season or year of purchase. Columns are ruled on the inventory sheet to take in the current and several past seasons, goods purchased prior to which are entered in the sundry column. Thus for instance in an inventory taken on December 31, 1913, the present season might be taken as "E," season "D" being the first half of 1913, "C" the latter half of 1912, "B" the first half of 1912. The goods purchased prior to 1912 to be entered in column "A" which would be headed "'A' and prior seasons."

A summary is made of each season's goods showing how long they have been in the establishment. The management can thus see at a glance how much old stock each department manager is carrying. However, in a large retail establishment a vigilant stockkeeper should not allow merchandise to accumulate from year to year because the depreciation, interest and storage charges, not to mention theft, would naturally eat up any reason-

ably expected profit in carrying the goods over. (Of course it often happens that goods must be delivered in advance of a season in order to be ready in time for their proper season. For instance, goods imported from abroad may be treated specially.)

It may be said that a buyer or other subordinate may change the season letters rather than show record of old stock. Of course he can, and he can also change the quantity and price records, but he cannot capitalize such changes and pay dividends on such capitalization.

By sectionalizing a comparison may be made in such detail as may be required, and the overlooking of merchandise to be listed may be reduced to a minimum. It also shows at a glance the investment in the different departments, sections and subdivisions of the sections and would be apt to show up excess of stock as well as padding of figures. If there should be a mistake in listing or non listing, it is much easier to trace it by the sectional method. It often saves the taking of stocks a second time. If they are taken a second time a comparison, section by section, of the second taking with the first will help to shorten the labor of verification.

No departure should be made from the regular method of taking inventory without the written approval of the financial management as a change in method of listing goods (for example, from "regular" to "net" or from "net" to "regular") may have the effect of changing the apparent profits for a period and might lead to the declaration of dividends not earned.

Goods returned (outgoing) at or about inventory time, if already listed, should be marked off list and the amount deducted from accounts payable. For incoming merchandise and accounts receivable the process should be reversed.

Goods on memorandum and "C. O. D." sales require most careful consideration and checking especially in the matter of incoming merchandise. It sometimes happens that buyers and division managers think they can manipulate the records by obtaining goods on "memo" and selling therefrom, thus showing better sales for a period without apparent increase in stock; but the day of reckoning always comes, and in the case of attempted manipulation always at the worst time.

Goods received on "memo" should be specially recorded and checked—and that frequently—so that there may be continuous

supervision of this liability, and the receiving room records should not be closed until a regular invoice is passed. It is always the practice to do this checking at time of taking inventory, but an accountant should look with suspicion—at least of carelessness—on a manager who allows goods to come in on "memo" and make current sales therefrom, with settlement only at fiscal periods.

Outgoing goods on "memo" are added to the stock records of each division. This should be done by each division manager and checked from the record in the office. It is generally done by taking the total of outstanding (outgoing) "memo" merchandise and adding the amount to the last inventory sheet—referring in the entry to the authorizing voucher which should be signed by the "memo" bookkeeper.

Goods sold "C. O. D.," for which return has not been made at inventory closing, should be credited to "sales account" as "open C. O. D. sales" and the entry cancelled *per contra* on the first day of the new period—as the sales account is credited by cash when the payment is made.

Goods sometimes needed for stock at inventory time but for which no invoice has been received may be taken on a *pro forma* invoice, so marked as to be held to check against regular invoice, so that no credit will be taken for sales without a corresponding liability; but a record of the *pro forma* invoice should be kept in the receiving room so that it may be returned and checked against the regular invoice.

A glance over each division of the inventory will indicate to the accountant what tests he wishes to make to assure himself of general correctness, bearing in mind that great diversity of lines of merchandise always means high stocks, often not properly "sized." A test of prices and quantities may be checked by examination of the stocks and checking the prices and quantities in such cases, but a physical survey of all stocks should always be made by the accountant where he values an inventory.

A perpetual inventory is kept by placing in code on the sale schedules the cost as well as selling prices; deducting the amount from the inventory plus the purchases at cost and selling prices the remainder should be the amount of goods on hand, at both cost and retail, barring loss due to theft and any difference due to clerical errors.

In a large retail establishment this may seem to be troublesome but I have been credibly informed by an officer of an establishment doing a business of several millions of dollars a year, that this plan has been followed with marked success and especially in those cases wherein a temporary and particular supervision is required.

The sectionalizing of inventories is often carried to great detail, becoming more and more practicable as advancement is made in the manufacture of accounting machinery which tabulates by electricity with great speed and accuracy. Therefore the same allowance as that mentioned is not to be expected in future from the "bench," and it should not be forgotten that the cases cited herein are nearly twenty years old. Much more responsibility rests on the profession today and much is expected of us. We should always endeavor to be in advance of what is expected.