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THE AUDITOR'S RESPONSIBILITY FOR OBSOLESCENCE

Lyman W. Oehring, Jr.

Detroit

ONE OF THE most perplexing financial problems confronting the business world today is the continual increase in the level of inventories. It can be observed in the financial statements of clients, in published reports generally, and almost daily in newspaper articles. Congress has made the inventory problem in the automotive industry the subject of an investigation. A portion of the dollar increase in inventories can be attributed to the increased costs of production resulting from the continuous increases in wages and fringe benefits. Competition and consumers' desires, however, have been the major factors increasing the inventory level. The public has become increasingly style conscious and has demanded more models, styles, and colors of almost everything it buys. Competition has forced sellers to have their products in these different combinations available because a consumer ready to buy does not want to wait.



As advisers to business, accountants as professional people and we as a firm have been continually working with business to determine and maintain the most efficient inventory levels. However, it is not the purpose of this article to pursue the accountant's efforts in this area. Rather it is to look at the problems that confront the auditor in forming an opinion on the fairness of a client's financial statements. It is in this area that the auditor is presented with the question of inventory obsolescence.

Obsolescence is defined in part in Kohler's *Dictionary for Accountants* as "the loss in usefulness of an asset, occasioned by the approach to the stage of economic uselessness through progress of the arts; economic inutility arising from external causes. Obsolescence refers to disappearing usefulness resulting from invention, change of style, legislation, or other causes having no physical relation to the object affected." Although cost is the primary basis for the accounting for inventories, it is generally recognized that we must depart from cost when we are confronted by obsolescence. Accounting Research Bulletin No. 43 states in Chapter 4, Statement 5, that "a departure from the cost basis of pricing the inventory

is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as market."

It is apparent, then, that a discussion of obsolescence breaks down into two major determinations: first, does it exist; and second, how much is chargeable to the current period. Practically speaking it is sometimes difficult to make this distinction, since computations designed to ascertain how much obsolescence exists are often necessary to determine the existence of obsolescence. In order to present an analysis of the subject, this article will deal with it as two separate problems.

CAUSES OF OBSOLESCENCE

Generally speaking, all types of inventory are subject to obsolescence. However, this article will deal with manufacturing inventories since obsolescence in retail stores is a rather specialized subject. Manufacturing inventories can be broken down into the two major categories of production and service parts. Production inventories generally consist of raw materials, purchased parts, work in process, finished goods, and supplies. Service parts may consist of parts, subassemblies, and assemblies and are normally carried in the final condition in which they will be sold. They are usually necessary for all lines of consumers' durable goods and machines for industrial processing. The service parts inventory will normally be higher in industries whose products are subject to periodic style and engineering changes, such as the automobile industry.

PRODUCTION INVENTORIES

In the case of production inventories obsolescence can occur in a number of ways, all of which are of equal concern to the auditor. Physical condition, although not technically obsolescence, plays an important part. If material is in poor condition it will either have to be scrapped or costs will have to be incurred to restore it to usable condition. In either case the loss has already occurred and should be charged to the current period even though physical disposition by sale or scrapping, or physical restoration may be made in a later period.

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Changes in the engineering specifications of a part or assembly will, in all probability, either completely obsolete the units already on hand or at least make it necessary for them to be reworked. It is entirely possible that some raw material will also be rendered useless.

A reduction of production schedules can cause obsolescence in all classes of production inventories, especially in industries that are subject to style and model changes. Such reductions may be caused by a number of circumstances, such as new products by competitors, innovations in existing products either by competitors or by the company itself, and unfavorable changes in general economic conditions or in economic conditions of specialized customers.

Inventory obsolescence arising from production cutbacks and engineering changes may be a clue to another type of charge which is not technically inventory obsolescence. That is the matter of vendors' claims. Most purchase orders are issued for specified quantities and are shipped by the vendor on releases issued by the customer. In many cases tooling is produced or purchased by the vendor, who will recover his cost in the selling price of the part produced. If at any time the original order is changed, canceled, or reduced, the vendor will in all probability be reimbursed for parts and material on hand as well as for the unrecovered cost of specialized tooling.

Another condition which can cause inventory obsolescence, although not usually encountered in most well-managed companies, is plain overbuying. This generally comes about through inadequate forecasting or actual mistakes.

SERVICE PARTS INVENTORY

Companies should physically segregate service parts from production inventories. Obsolescence in connection with inventories of service parts has peculiarities of its own. In many cases some of the parts are old and may represent the supply for a number of years. The demand for service parts is entirely dependent on former sales of products and their quality. Condition of the inventory is a very important factor in connection with service parts, just as it is for production inventories. Long periods of storage, in some cases under adverse conditions, can result in physical deterioration.

The most important factor in obsoleting service parts is the supply on hand compared to expected usage. Because unit costs are higher when small quantities are ordered on an emergency

basis, service parts are usually purchased or manufactured in sizable quantities on the basis of expected usage. If the actual usage proves to be substantially less than the quantity carried in inventory determined by estimated usage, the excess parts will in all probability have to be scrapped.

The practice of carrying a large inventory of service parts also causes another problem. Technological progress and changes in economic conditions can cause a decrease in costs of large portions of service inventories, and in a competitive market the parts may have to be sold below cost.

The causes of inventory obsolescence in any particular company may consist of all or any part of the above in varying degrees. For this reason it is very important that the auditor have close contact with his client's problems. It is much easier to assist a client if the auditor knows the situation in regard to obsolescence and the areas in which it is most likely to be found. He should be thoroughly familiar with the client's products and his principal markets. He should keep abreast of economic conditions in general and specifically as they affect the business of his clients. He should learn about competitive products, both old and new, and evaluate their effect on his client's business. Through a close relationship the auditor can develop a "feel" of the business and will be in a better position to anticipate probable inventory obsolescence. This phase is important not only in assuring the auditor of proper inventory valuation, but also in helping clients eliminate obsolescence problems before they get serious.

AUDIT RESPONSIBILITY

In approaching the obsolescence problem to satisfy himself as to the fairness of the inventory valuation, the auditor is, in most cases, dependent on the client's system of handling obsolete inventory. Very few auditors have had the technical background necessary to determine whether or not specific items of inventory are still usable. For this reason it is imperative that he know thoroughly the client's policies and procedures as they relate to obsolete inventory. He should know if the client makes a continual review of the inventory or if it is reviewed once a year, such as year end or at time of physical inventory. He should know how the inventory is physically handled. Are obsolete items physically segregated? What procedures are provided for their disposal? It is imperative that the permanent audit files contain a complete description of the client's system of accounting for inventories and of how the

obsolescence problem is handled. The auditor must constantly advise his clients and work with them to improve their internal accounting for and disposing of obsolete inventory so that he is satisfied that, properly applied, it will result in proper inventory valuations.

In short, then, it is the auditor's job to see that the client has a satisfactory system for determining obsolescence and to satisfy himself that the system is functioning. A number of procedures are normally used, although they may not all apply to a specific client. In addition to this the auditor should make suggestions to his client and assist him in the whole problem of preventing or minimizing the occurrence of obsolescence.

The auditor's first contact with the inventory during an examination will normally come at the time he observes the taking of the physical inventory. This inventory does not have to be taken at the close of the company's accounting period but can be taken several months earlier if desired except in those cases where the company does not have an adequate cost accounting system. This will probably be his only opportunity to actually inspect the inventory and to determine its condition, storage facilities, and house-keeping and to test the policies for segregation of obsolete stock. It affords him a fine opportunity to learn informally from the employees who actually work with the inventory—an invaluable source of information—how old the inventory actually is and what they are doing about obsolete inventory as compared to the policies stated by management. Many times stated company policies are different from actual practices either through misinterpretation or the fact that in reality no system to disclose, segregate, and dispose of obsolete inventory is operating. Appropriate notes on obsolete inventory should be taken at this time for subsequent checking to the accounting records to see that inventory valuation has been properly handled.

The auditor's first step at the time of the audit will be to discuss the subject with responsible people in the client's organization who should be aware of any obsolete or slow-moving inventory. This will probably be done by the senior because of his familiarity with the client and his knowledge of the business. The discussion should provide him with basic information that can be substantiated by a test of detail records.

In some cases over-all tests may be informative. Records can be examined to see that the inventory is being relieved periodically for obsolete items and that revenue is being received from scrap

sales. Although this will not prove that adequate provision is being made for obsolete inventory, the lack of such transactions may be an indication of an unsatisfactory condition, as almost all businesses that carry inventories are faced with obsolescence of some magnitude. Another step the auditor can take is to relate current inventory levels with current sales volume and forecasted business in the immediate future. It is important here to examine current figures, since under certain conditions a reduction in volume can occur rather suddenly. It should be noted that this step will produce results only in extreme or uncontrolled situations.

The above tests can give the auditor some feeling about the inventory as a whole but in all probability will not detect specific trouble spots. At this point the auditor must turn to detailed testing. His tests, of course, must be geared to the types of detail records maintained by the client. In some cases he may be able to check results concerning inventories and sales of specific products. This is useful where a number of specialized products are produced each having their own inventory. Where raw materials and parts can be used interchangeably on a number of different products this test is impractical, and in this situation the obsolescence problem is minimized.

Perpetual unit inventory records are maintained by many companies for both production and service parts inventories. These records will usually show receipts, disbursements, and other relevant information such as desired quantities and minimum quantities. Because of the number of parts that may comprise an inventory, it is not practical or necessary to check all of them in detail. The auditor can, however, review the records generally and select specific items to examine in detail. He should satisfy himself that the perpetual records are reasonably accurate by examination of source data—e.g. receiving reports and shipping documents—in support of indicated transactions. He should determine that optimum and minimum inventory levels were determined by adequate study, so that he can then appraise the quantity on hand by comparing it with indicated usage. Here again discussions with the client's employees may reveal trouble spots.

Another audit step is to determine that the inventory is not carried at a cost which is in excess of the cost to replace it. This is especially important in the area of service parts since they probably have been accumulated over a period of years. Tests of vendors' invoices will cover similar items that are being purchased currently.

For any item in the inventory a comparison can be made with the expected selling price to see that the cost will be recovered.

Correspondence with vendors in connection with work on accounts payable may reveal claims for canceled or reduced orders. These in turn may be an indication of obsolete inventory.

MEASURING OBSOLESCENCE

Now that the causes of obsolescence have been discussed, together with methods used by the auditor to discover its existence, there is still the problem of measuring it. For obsolete inventory that is definitely distinguishable and physically segregated the problem is simple. It is just a matter of relieving the inventory for its cost. This cost may be total cost, cost to rework, or cost less estimated salvage value. When obsolete inventory is not definitely distinguishable the solution is more difficult. Partial obsolescence is very intangible. Here again the auditor will probably be faced with the problem of not having the necessary technical knowledge to make an accurate determination and must rely on determinations made by the client. The role of the auditor, then, is to challenge the client's determinations and the validity of his assumptions. To do this intelligently he must, as was previously stated, have a thorough knowledge of his client's business and business in general.

The measurement of obsolescence in service parts inventories is difficult because it is normal to carry a supply of older items. One method is to eliminate parts which have had little or no activity for a specified period of time (three years, five years, or whatever period is judged to be reasonable). This entails a continual review of the perpetual records. It should be noted that small usage in the two or three years that a part is first carried in the service parts inventory is not necessarily indicative of obsolescence, since it may take that long before there is much need for service. Another method is to reduce the carrying amount of the compiled inventory to a specified percentage of cost depending on the age of the parts. Although this method is somewhat arbitrary, it is currently in use and has the advantage of consistency and has, over a period of time, a tendency to reflect the inventory at recoverable amounts. It also makes allowance for undiscovered obsolescence not provided by the first method above.

Once the client has made a determination of how much obsolescence exists in the inventory, the inventory must in some manner be reduced by that amount. If the determination involves complete obsolescence of specific items they can be eliminated entirely from

the inventory compilation. In order for this method to be successful there must be provision for physical segregation of the obsolete material. If this is not done the obsolete items might be carried indefinitely, with the corresponding waste of storage costs and tie-up of working capital in addition to the danger of including the items in subsequent inventories. In cases where part or all of the inventory has suffered a partial loss in value it is necessary to determine obsolescence by educated estimates. The amount so determined can be eliminated from the general ledger inventory account by deducting the item from the gross inventories on the inventory recapitulation. In this manner dollar control over the inventory is maintained while the general ledger inventory amount is a sound reflection of the value of the inventory. When general ledger reserve accounts are used to record the obsolescence factor the inventory account does not reflect the sound inventory value and inventory reserves generally are subject to challenge by the Internal Revenue Service. In any of the above methods it is important to retain permanent records as to the calculation of the obsolescence factor.

The subject of inventory obsolescence and how it should be handled is not a simple one. It takes considerable thought and judgment. The idea of the auditor knowing his client's business cannot be stressed too strongly. The audit program does not normally go into detailed tests. Therefore, when a program says "By reviewing the client's procedures for accounting for obsolete inventory, by discussion with responsible employees, and by reviewing the current inventory quantities as compared with usage and recent purchases, ascertain that no significant amount of obsolete, unsalable, or unusable material has been included in the inventory," what is envisaged is not a short series of mechanical tests but a thorough coverage of the area with all the specialized knowledge and skill at the auditor's disposal.