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Auditor's Responsibility in Regard to Verification of Inventories*

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Owing to the dearth of court decisions in this country defining or limiting an auditor's responsibilities, the subject of this paper will be dealt with from the standpoint of moral responsibility—the result of negligence in most cases being loss of prestige, rather than a more severe penalty.

At the outset let it be stated that it is not the function of an auditor to take an inventory, but to verify the result in terms of money after the physical work has been completed.

An inventory may embrace almost any kind of physical asset, fixed or current, in almost any kind of business, occupation or profession. It may be relatively large or small as compared with the other assets under audit. There may or may not be book inventories to be used as guides; and in the case of a manufacturing concern the auditor may be confronted by any bookkeeping condition, from a total lack of cost accounts to a most elaborate and accurate system. The purpose for which the auditor is employed or specific instructions will have a distinct bearing on the scope of the verification and of his responsibilities in connection therewith.

An auditor may be conducting an investigation on the very subject of inventories, or one in which the inventory plays no part whatsoever, or his employment may cover varying degrees of responsibility between the two. His clients may be the proprietors, bondholders or the executors of a business; he may be employed by an intending purchaser or by a bank considering the advancement of funds; he may qualify as expert for plaintiff or defendant and be conducting an investigation by court order under subpœna "duces tecum." In short, he may represent anyone who has legal access to the books and records for any legal purpose whatsoever—but in wording his certificate an auditor should bear in mind that it may be used for purposes other than those stated or inferred.

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In making the following remarks it cannot be too strongly urged that the extent of an auditor's responsibilities varies in proportion to the scope of his instructions, and his judgment in each case should primarily be based thereon.

The verification of an inventory is, in a large percentage of cases, the most troublesome item on a balance-sheet that an auditor has to deal with, particularly if it be one of stock-in-trade, affecting as it does the gross profits. A clear knowledge of the nature and customs of the business and of the methods employed is frequently essential in order satisfactorily and intelligently to verify the figures submitted without a disproportionate or prohibitive amount of work.

Years ago it was the custom among accountants to qualify their certificates by prefixing the phrase "Subject to the accuracy of the inventory," but this qualification has fallen into disuse, chiefly because of its casting suspicion upon the accuracy of the accounts as a whole. Custom and practice have since decreed certain duties to be performed by the auditor beyond the scope of which his responsibilities cease.

The more important points to be considered in the verification of an inventory, coming within the scope of an auditor's responsibilities, follow.

Summary

The auditor's copy should be kept in his possession, actual or mary before commencing detailed operations, to be used, by means of symbols, as an index of work completed.

The auditor's copy should be kept in his possession, actual or constructive, during the entire progress of the work and never be lent to officials or to the office staff under any pretext whatever after the auditing has commenced.

If the official copy of the inventory is kept in the possession of the auditor throughout the verification, the same purpose is served; but this is frequently impossible or undesirable for various reasons, and it is always possible and desirable to make a copy of the summary for the working papers however condensed it may be. The point is that inventories have been altered after an auditor has passed upon them. Care should be exercised to preclude the possibility of such an occurrence without detection before certification of the accounts.

Mathematical Accuracy

It is an auditor's duty to verify footings and extensions in sufficient detail to become satisfied as to their substantial accuracy and he will be held responsible for undetected errors of relative importance. No hard and fast rule can be laid down as to the scope of the work, as the conditions present in each case will determine it.

The method of internal check may be taken into consideration—e. g., whether mechanical or otherwise—and it is reasonable to place more reliance on the work of an efficient office force than on results obtained by a force of low clerical standard.

In the case of manufacturing concerns, the extent and accuracy of the cost system and its related accounting controls have an important bearing on the amount of detailed verification necessary with respect to work-in-progress and finished goods. An auditor may be justifiably influenced, in outlining the work, by the facts that the gross profits differ widely from or substantially agree with normal or anticipated figures.

If an auditor has reason to believe, from collateral evidence, that an important mathematical error exists, it is his duty to find it and his responsibility is not lessened because of the amount of work involved.

Basis of Values

It is an auditor's duty to satisfy himself that the inventory has been taken at cost or market, whichever is lower, except as hereinafter stated, and that unsalable or depreciated items have not been priced in excess of nominal or depreciated values. The decrease of turnover may put him on his guard that unsalable items are being carried at their original cost and a comparison with a previous inventory will sometimes disclose the items in question.

The prices of commodities should be verified with original invoices as to cost, and the market value may be determined by an examination of invoices for goods of like nature shipped close to the balance-sheet date or in some cases by a scrutiny of trade papers.

As to footings and extensions, the verification of prices may need to be substantially complete or merely a test, depending upon the conditions present in each case.

In the case of manufacturing concerns the auditor should familiarize himself with the method of costing. He should ascertain the soundness of the burden rate by the amount of under or over absorbed expenses and the treatment of costs if and when the plant was on part time or shut down. He should be familiar with the scope of the items comprising the burden—e. g., whether selling expense has been included or whether interest on the investment or other debatable items had been added to cost—for upon the facts present will depend the wording of his certificate. The auditor should be careful to see that finished product has not been taken at selling prices. In short, he should see that no profit is included in the inventory except in the case of certain contract jobs subject to architects' or engineers' certificates and except in a very few lines of business, such as shipbuilding, where a proportion of profit is permissible owing to the length of time spent on the manufacture of one unit of production and in order to stabilize the profits.

The question of profits included in an inventory is now of special importance owing to its effect upon the federal income and excess profits taxes. It is of interest to note that the commissioner of internal revenue has ruled that inventories must be taken at cost, not market, in the following explanatory note on corporation income tax form 1031, revised October, 1916: "In case the annual gain is determined by inventories, merchandise must be inventoried at cost price, as any loss in salable value will ultimately be reflected in the sales during the year when the goods are disposed of."

If an auditor, therefore, is making up an income tax return for a corporation, his responsibilities as to inventory values of merchandise are determined by the commissioner's rulings, however widely he may differ from him as to the principles involved.

In the case of trading concerns, undelivered goods representing executed sales may legally be valued at selling prices, title having passed and the seller having become the bailee, but owing to the difficulty of differentiating between executed and executory sales and to the possibility of an accepted cancellation of the order prior to delivery, the auditor should not pass unnoticed the point in question, particularly if the amount involved is relatively large.

The auditor should satisfy himself that trade discounts have been deducted in pricing commodities, but not cash discounts, the test of distinction, sometimes difficult to make, being whether the discount is deductible in any event or contingent upon payment within a specified time. As to this point an auditor is usually justified in assuming facts "upon information and belief" after a test has been made by him.

It is most desirable that an inventory of stock-in-trade be taken on the same basis at the end as at the beginning of a fiscal period, and where prices are constantly or widely fluctuating, it is sometimes desirable, if market is below cost, to create a reserve for the difference, rather than to make the gross profits reflect a temporary loss, i. e., the same procedure as is permissible with respect to securities.

The auditor has no right to insist that an inventory be valued in one way or another. He may offer suggestions and if they be not complied with, his remedy lies in adjusting the total figures for inclusion in the accounts to be prepared by him, in order to give an unqualified certificate (possible and desirable in certain cases) or in letting the original figures stand and in protecting himself by qualification if necessary.

Goods in Transit

It is an auditor's duty to ascertain that if goods in transit are included in the inventory the corresponding liability has been set up in the accounts.

It is important to note that the invoice date is at best but prima facie evidence and of limited accounting value, as many invoices are post-dated under special agreements affecting discounts; some are dated prior or subsequent to shipment through carelessness; and still others are not dated at all. It must also be borne in mind that the date of an invoice, except as above noted, represents the date when the seller parts with the goods, and that due allowance must be made for the period of transit. Bills for carriers' charges are frequently of assistance in passing upon debatable items, and obviously of much greater value are chronological records of goods received.

If an auditor finds that the date of receipt of goods is shown upon the invoice, he may usually accept the record without further research, but he must exercise care to find out whether goods recorded as being received while the inventory was in progress were or were not included therein and that the accounts have been adjusted accordingly. In some cases he will find notations on invoices indicating the inclusion or exclusion of the goods, and he need not go behind this evidence except in special cases.

If incoming goods have reached the f. o. b. point, they may properly be included in the inventory. If not, they should be excluded.

Period of Inventory Taking

The period of inventory taking is a most important point, chiefly in large inventories, and one that is frequently overlooked.

Gross mistakes have been made through an error in time of or confusion during inventory taking, the circumstances of which were known to the officers, but the importance of which from an accounting standpoint were not appreciated until brought to their attention by the auditor.

In many cases, therefore, it is the duty of the auditor to make inquiry from a responsible officer as to when the inventory was taken; how long it took; whether the plant, store or whatever the place was closed down or not; if not, what system was adopted with respect to incoming and outgoing goods; and generally whether those superintending the physical work had clearly in mind that results were needed for accounting purposes as of a specific date and were capable of producing the results desired. If it later proves that the auditor was misinformed as to these points, the responsibility lies with his informant, except in special cases, wherein the attendant circumstances should put him on his guard as to careless statements or an intent to mislead.

In organizations wherein the accounting is known by the auditor to be conducted efficiently and regarded as of paramount importance he may and usually does assume that errors coming within the scope of this caption have been obviated.

We find, therefore, that, under certain conditions, the auditor is justified in verifying the stated date of the inventory, if he has reason to believe that accounting principles have not been properly considered, the purposes of the audit having an important bearing on the scope of his inquiry in the premises; and if adjustments cannot be made because of lack of information, his remedy lies in the withholding or qualification of his certificate.

Consigned Goods—Inward

It is the auditor's duty to ascertain that no goods held on consignment have been included in the inventory except, of course, in the case of a factor—and in the event of a factor also trading on his own account care must be exercised in determining whether or not the factor's own goods have been mixed with those of his principals. Obviously, in many cases, an auditor must rely on inquiry, and if he be misinformed the same rules must apply as those recited under the foregoing caption. There are, however, cases in which consigned goods are of such a totally different nature from the balance of an inventory as to make it negligence for the auditor to pass them without adjustment. In many cases where full records of consigned stock are kept and the contracts available, the auditor could offer but little excuse for certifying consignor's property as being that of the consignee.

Upon the information given and the possibility of independent verification depends the extent of an auditor's responsibility in the matter.

Consigned Goods—Outward

It is the auditor's duty to ascertain that consigned goods, outward, have been taken at prices not to exceed cost to consignor, whether in the hands of consignor's own selling agencies or elsewhere, except that in some cases involving a greater distance from the f. o. b. purchasing point additional carriers' charges may be added.

Original Inventory Sheets

If an official copy has been made, it is the duty of the auditor, in many cases, to inspect the original inventory sheets, however roughly they may have been compiled, and to test the accuracy of the official inventory, as to quantities, by comparing at least the large items. The scope of the test, however, will depend upon the conditions present in each case. If errors are found in a short test, the auditor should pursue the work to a point where further possible errors are relatively negligible.

If the auditor is credibly informed, as sometimes happens, that the original inventory sheets have been destroyed or lost, his responsibility for errors in copying ceases, except that, should he have reason to believe the inventory to be understated or overstated by a relatively large amount and be unable to locate the error through other operations, he may withhold or qualify his certificate, as in other contingencies.

In many cases the auditor is specifically relieved of responsibility for copying errors, and in practice the operation is omitted in a large percentage of cases, through reliance on the official copy, but it is a most fertile field for errors and the auditor should not pass lightly over the matter in cases where the responsibility for undetected errors remains his.

Gross Profit Test

If an error of relatively large amount still exists in an inventory of stock-in-trade after adjustments have been made for all errors brought to light by the operations outlined under the foregoing captions, it will be reflected in the ratio of gross profit to sales; and any material change therein not warranted by existing conditions known to the auditor should form the basis for further inquiry as to principles and possibly a more exhaustive examination for clerical errors.

If the material change cannot be satisfactorily explained away through further effort, the auditor has again the wording of his certificate to fall back upon, for he will be held responsible for the opinion expressed therein.

Certificates on Inventories

It is the duty of the auditor to see that the inventory total is certified by a responsible officer and, if the inventory be a large one, that each section is certified correct as to quantities by the employee who superintended the physical work. These certificates are frequently found on the original sheets.

In manufacturing concerns the head of the cost department should certify his section as being in agreement with controls and underlying detail records, and it is often desirable to have the factory superintendent countersign it, although at times it will be found that he is in ignorance of certain administrative burden charges.

It is often desirable for the auditor to obtain for his files a separate certificate, executed by a responsible officer, reading, in the case of a trading concern, somewhat as follows: "I hereby certify that the inventory of merchandise amounting to $........, a summary of which is attached hereto, was taken as of (date) by responsible employees, that the items are priced at cost or market, whichever the lower, that no unsalable, depreciated or consigned goods are included therein, that the original sheets have been carefully compared as to quantities, and that, to the best of my knowledge and belief, the inventory is correct in all other respects."

If the auditor obtains such a certificate, it will, in many cases, obviate his going into many of the points heretofore discussed, but upon the purposes of the audit and the scope of his instructions depends the amount of reliance to be placed upon it and the extent to which responsibility for errors is thus shifted from his shoulders.

Book Inventories other than Stock-in-Trade and Bulk Material

Book inventories other than stock-in-trade and bulk material would include current assets, chiefly represented by materials and supplies of all kinds, and fixed assets such as live-stock, wagons, automobiles, stable or garage equipment, furniture and fixtures or any items the book value and quantity of which it is usual and advisable to verify from time to time by physical inspection and count.

If actual inventories of current assets have been taken reasonably close to, but not on the balance-sheet date, the auditor is usually justified in assuming the book inventories to be correct, after routine audit of current book entries, provided the last inventory adjustment was not relatively large in amount; but if an important adjustment is necessary that fact should put the auditor on his guard against carelessness or errors of principle.

The same rule would apply as to fixed assets except that, the items usually being much smaller in number and much larger in amount, the auditor is almost invariably held responsible for the verification of each item of acquisition and disposition as reflected not only by book entries, but by the underlying records available, and he must exercise great care to see that the items are properly capitalized from the evidence at his disposal.

The auditor should see that proper reserves for depreciation have been provided against the book values of fixed assets or that the book or inventory figures reflect depreciated values, but further discussion of this important subject does not come within the scope of this paper.

Book Inventories of Bulk Material

Book inventories of bulk material will consist of such items as ore, pig iron, sand, coal, coke, logs and scrap metal, and it is usual not to attempt a physical inventory and frequently impracticable so to do, until the piles or other units of storage are practically exhausted, which may take several years.

The usual practice is to add a small percentage to the weight or number consumed to cover waste or loss, and if the auditor ascertains that the usual allowance incident to the particular business has been made, he cannot be held responsible for shortages brought to light when the units are finally exhausted.

In the case of some stocks, a close estimate can be made of the contents of a pile—e. g., there are formulas for ascertaining the weight of coal of various sizes stored in bins—and an auditor should in these cases make inquiry as to how recently a test had been made and how the result multiplied by the average unit cost compared with the book value at the time.

Estimated Inventory of Stock-in-Trade

It occasionally happens that an auditor is called upon to report as to the estimated profits of a concern for a period at the end of which no inventory was taken. A vital element of gross profits being missing, the auditor has to supply it by a process of deduction, assuming a certain ratio of gross profit to sales to have existed for the period under review (usually the same as for the preceding period) and the inventory at beginning, purchases and sales being known.

In cases such as these the auditor should state clearly in his report that no inventory was taken and the means adopted to supply the deficiency.

It is most desirable that the auditor take the opinion of some one else as to the estimated ratio of gross profit to sales and state in his report whose opinion has been followed, thus placing the responsibility where it belongs, in the event of a misinterpretation or misuse of the figures submitted.

Conclusion

As will be noted, an auditor's responsibilities in regard to verification of inventories are frequently onerous. Certain points may be covered by him in an unequivocal manner, while certain others must be accepted upon information and belief. He must exercise due diligence and care at all times and satisfy himself, to the best of his ability, from the evidence available, that the total amount is substantially correct. If he has conducted his work conscientiously and accurately and with a clear conception and an intelligent treatment of the many points involved, he has done his duty and the responsibility to his clients has been met.