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American Institute of Accountants. Committee on Auditing Procedure

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Inventories and Receivables of Department Stores, Instalment Houses, Chain Stores, and Other Retailers

A STATEMENT BY THE COMMITTEE ON AUDITING PROCEDURE OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS

Query: Is it practicable and reasonable to observe the taking of inventories and to communicate directly with debtors, as added auditing procedures in the examination of the financial statements of department stores, instalment houses, chain stores, and other retailers?

THE report of the American Institute of Accountants dealing with extensions of auditing procedure indicates that, where "practicable and reasonable," observation of the taking of inventories and direct communication with debtors are to be considered "generally accepted auditing procedures," meaning that they are normal, usual, or customary. The conjunction "and" is used; the procedures must be both practicable and reasonable. If they are both, their application cannot be avoided. Their omission under such circumstances necessitates a clear-cut exception.

On the other hand, if these procedures are not practicable and reasonable in the circumstances of a given engagement, and if the auditor has otherwise satisfied himself, he need make no exception or explanation in his report. Under such circumstances, however, if he prefers to do so, he may make any explanation he sees fit.

The primary meaning of "practicable" is:

"capable of being put into practice, done, or effected, especially with the available means or with reason or prudence."

The primary meaning of "reasonable" is:

"endowed with reason, or rational, having or exercising sound judgment, or sensible."

Rarely is a procedure impossible or incapable of being put into practice, but it seems that the auditor may view "practicable" in the light of "with the available means," or "with reason or prudence." The operations may be practicable, but they may *not* be reasonable, i.e., not "sensible" in the light of surrounding circumstances. Notwithstanding these refinements in meaning, it is believed that there will be very few cases in commerce and industry as a whole in which the procedures cannot be applied, to the extent that will afford such tests as the auditor, in the exercise of his judgment, determines to be reasonable.

In the case of the receivables of department stores, instalment houses, chain stores, and other retailers, there might be justifiable question as to the reasonableness of applying the positive form of confirmation, but it is believed that there is no question as to the practicability and reasonableness of applying the negative form of confirmation which requires no reply unless the recipient challenges the balance shown. When dealing with housewives, as is the case in department stores particularly, the negative form is more practicable than the positive, as it places the recipient definitely on notice that the creditor's books show a stated balance, and that the auditor assumes the correctness of that balance unless the debtor objects within reasonable time.

It is believed, therefore, that depart-

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ment stores, instalment houses, and others dealing with ultimate consumers are among the cases in which the application of the negative form of direct communication with debtors, when carried out in the manner suggested in the bulletin, *Examination of Financial Statements*, is to be considered as compliance with "generally accepted auditing procedure."

There is a further distinction between the larger institutions with large masses of receivables which may run into tens of thousands of items and the smaller ones, because the very mass of the accounts requires more than ordinary division of duties affording opportunity for more effective internal control. Confirmation of receivables by a selective test, where the conditions justify it, is within the contemplation of the added procedures prescribed. As a rule, the larger the mass, the smaller the average amount, and the more effective the internal control, the smaller may be the percentage of confirmation; and in unusual cases quite a small percentage may well be proper.

As to the added procedures regarding inventories of department stores, instalment houses, chain stores, and other retailers, it is likewise believed to be practicable and reasonable for the auditor to participate by suitable observation at the time inventories are determined by physical count by the client, or to require physical tests of inventories to be made under his observation. The method, extent, and time of applying this extension of auditing procedure necessarily will vary with the circumstances, and the procedures will be undertaken in addition to the usual auditing tests and checks of the inventory accounts and records, with due consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories.

Here again there is a distinction be-

tween large institutions with a great number of branches and/or departments and the more compact or simple organizations, because the volume of transactions requires more than ordinary division of duties, affording opportunity for more effective internal control. In such cases, the observation or tests of physical inventories may well be limited to a relatively small number of branches or departments, and the larger the number of branches or departments and the more effective the internal control, the smaller may be the percentage to be covered; and in unusual cases quite a small percentage may well be proper.

The auditor's purpose is to satisfy himself as to the credibility of the client's representations concerning inventories, but he does not hold himself out as an appraiser, valuer, or expert in materials. The auditor does not "take," "determine," or "supervise" the inventory. These operations are undertaken by management, antecedent to its primary representations concerning quantity, condition, and value of the inventories. The independent certified public accountant "observes" these procedures in his capacity as an auditor, for the purpose of satisfying himself as to the fairness of representations made by the client, but he does not, and should not in his ordinary capacity as auditor, make the original determination. Within these clear limitations, it is believed that observation of the taking of inventories of department stores, instalment houses, chain stores, and other retailers is "practicable and reasonable" and, therefore, to be considered "generally accepted auditing procedure."

There appears to be a question in the minds of some concerning the character of exceptions necessitated by the omission of the added procedures when their application is practicable and reasonable. When the auditor has been unable to satisfy himself concerning the *amount*

of inventories or receivables (or any other asset) stated in the accounts, he will continue, as in the past, to make a definite exception as to the amount. Moreover, where the added procedures prescribed in "Extensions of Auditing Procedure" are practicable and reasonable, if the auditor has not adopted them an exception is still required even though he may have satisfied himself by other means as to the fairness of the amount. What is the character of the exception in these circumstances?

The report, "Extensions of Auditing Procedure," clearly refers to several types of exceptions in the following language:

"Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item in the financial statements, the soundness of the company's procedure (as regards either the books or the financial statements), or the consistency of accounting practices."

This leads to the obvious conclusion that when the added procedures are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of work), without calling into question the inherent fairness of the representations. On the other hand, were the auditor not satisfied, and were his exceptions so material or the scope of his examination so limited as to negate the expression of an opinion, he would limit his report to a statement of findings, and, if appropriate, say that the limitations, or exceptions, were such as to make it impossible to express an opinion concerning the fairness of the statements as a whole.

There follows a restatement of the standard short form of independent certified public accountant's report in-

cluding a typical paragraph relating to the exception which should be made when (a) the added procedures are "practicable and reasonable," but (b) have not been applied, and (c) the auditor has otherwise satisfied himself:

"We have examined the balance-sheet of the XYZ Company as of blank date, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate, except as stated in the following paragraph.

"Auditing tests and checks of accounts and records concerning accounts receivable and inventories have been made, but upon instructions of the company we have not applied the generally accepted auditing procedures of direct communication with debtors or attendance at the physical count of inventories; nor have physical tests of inventories been made under our observation.

"In our opinion, subject to the exception stated in the foregoing paragraph relating to the limitations of the scope of our examination, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at blank date, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

It should be emphasized that the language in which the exceptions are stated above is to be regarded as typical and not as standard. Each accountant must feel free to state his exceptions in whatever form his judgment dictates.