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Experiences with Extensions of Auditing Procedure for Inventories

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By C. Oliver Wellington

Auditing procedures regarding inventories have been under discussion by accountants and others for many years. This subject was considered at one session of the International Congress on Accounting held in New York in 1929. For many years prior to 1939 a number of accountants in confirmation of inventories on individual engagements applied auditing procedures which included tests of physical stocks. However, it was not until 1939 that there was general, widespread adoption of an extended auditing procedure for examination of inventories.

Following the newspaper publicity on the McKesson & Robbins case, many individuals expressed their opinions as to what accountants should do in connection with inventories. Many business executives, bankers, politicians, lawyers, controllers, and certified public accountants made statements which indicated clearly that the matter had not been thought through to its logical conclusion. The suggestions as to the work that auditors should do in connection with inventories ran all the way from accountants assuming full responsibility, and in effect guaranteeing the accuracy and value of inventories included in financial statements, to the other extreme where the independent accountants would assume no responsibility for inventories and leave such responsibility entirely in the hands of others, such as engineers or appraisers.

The special committee on auditing procedure of the American Institute of Accountants gave very careful and full consideration to the subject of examination of inventories and rendered its report, which was adopted by the council on May 9, 1939, and, with slight modifications, was approved at the annual meeting of the Institute on October 18, 1939. The New York Stock Exchange in August, 1939, issued a report of its subcommittee on audits and audit procedure, approved by the committee on stock list, and adopted by the board of governors, which commented very sanely on the whole question of audits in the light of the McKesson & Robbins case, and pointed out the economic waste to investors and to the public that would be involved if auditing procedures in general should be extended so far as to make probable the detection of every possible irregularity.

Since the report of the special committee on auditing procedure was rendered to the council of the Institute the profession as a whole has had many opportunities to test in practice the recommendations of the special committee. We are now considering in the light of experience of the last twelve months the effect of carrying out such recommendations.

As an aid in presenting this summary, I have written to leading accountants in all parts of the country requesting data as to their experiences with extensions of auditing procedure as applied to inventories. I take this opportunity to express my appreciation of the very helpful comments and suggestions, and in some cases rather detailed statements of fact, that have been sent me. While no such evidence is needed, the number of replies, their length, and the

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value of the material submitted indicate clearly the interest of members of the profession in this important phase of the work of independent accountants, and the desire of all to make this work most effective.

In considering auditing procedure for inventories, we should not lose sight of the fact that inventories have always been an important part of the assets of most companies, and that accountants have always given considerable attention to the examination of inventories. The bulletin, *Examination of Financial Statements*, dated January, 1936, devotes three and one-half pages to the subject of inventories. The report adopted May 9, 1939, recommended, as an additional procedure, physical contact by the auditor with the inventories.

Experiences with extensions of auditing procedure may well be considered under the following headings:

(a) Application to all engagements.
(b) Attitude of clients.
   1. Toward having the auditors undertake the work.
   2. Toward paying additional fees for the extra work required.
(c) Work of the auditor.
   1. Planning in advance.
   2. Attendance at inventory taking.
   3. Physical hazards.
   4. Control of inventory quantities.
   5. Employment of outside specialists.
   6. Difficulties encountered.
   7. Errors detected.
(d) Variations in tests by auditors.

(a) Application to all Engagements

While inventories for some businesses represent a very small proportion of the total assets, the cases which we are now considering are those in which inventories are a material factor. These may be classified generally into the following groups:

1. Companies whose securities are listed on an exchange.
2. Other companies not listed, but in which there are numerous stockholders.
3. Closely held companies submitting reports to banks or others outside the business.
4. Closely held companies submitting no reports outside the business.

For convenience in later discussion I will refer to these groups by number. I may say at this time, however, that there has been less difference in opinion and practice as between the foregoing groups than might have been expected. Individual concerns and the groups as a whole have accepted extensions of auditing procedures for reasons that have varied in importance and emphasis, but it is a source of great satisfaction that these extensions have generally been accepted and that clients appear to be pleased with the results of such extensions, based on the work done during the past twelve months.

(b) Attitude of Clients

Under this heading we will consider both the attitude of the clients toward having the auditors undertake the additional work in confirmation of inventories and their attitude toward paying additional fees for the extra work required.

Those companies falling in group 1, with securities listed on an exchange, with few exceptions approved the additional work and paid the additional fees necessary to cover such work. Even if the management itself was not favorably disposed toward the extension of auditing procedures there was a realization that, if the auditor's certificate included any qualifications or reservations there would be critical comment by minority stockholders at the annual meeting. There has been a growing realization on the part of directors as to their responsibility and liability for the acts of the management, and directors generally advocated the additional work. Most attorneys in advising management and directors emphasized its importance.

In some cases the management felt that their own organization had a satisfactory control over inventories, and were interested in the additional work merely to obtain an unqualified certificate from the auditors. In many cases, however, the management felt that a review by the auditors of methods of inventory taking and control would have a good moral effect and might develop places where improvements could be made. The reports I have received from various accountants give numerous instances of disclosure of weaknesses, which disclosures were of distinct advantage to the management and often by themselves worth more than the additional cost of the auditors' work.

It was recognized in some cases by the companies and the auditors that additional work in confirmation of inventories was not practicable and reasonable. The extension of procedure in such cases might be possible, but not reasonable or sensible in the light of the surrounding circumstances. The committee on auditing procedure of the Institute considered the problem of inventories of department stores, instalment houses, chain stores, and other retailers, and issued a statement which was printed in the February, 1940, issue of THE JOURNAL OF ACCOUNTANCY. In practice the auditing procedure for this class of companies varied with individual cases. In some the auditors made sufficient tests to satisfy themselves and gave a certificate without qualification, and in others the auditors did not make physical tests of inventories and said so in their certificate.

Further consideration should be given by the profession and its clients to the practicability and reasonableness of tests of physical inventories in those cases where the product is of a highly technical nature. The additional work of the auditors must be of sufficient value to justify its cost. The auditor must do more than merely spend time and go through motions and must, as a result of this additional work, substantially increase his professional satisfaction as to the accuracy of the inventory amount included in the financial statements. If he cannot obtain such additional satisfaction to a reasonable extent by the additional procedures he is well advised to omit them and to qualify his report accordingly.

Companies falling in group 2, those not listed but in which there are numerous stockholders, followed in general the experiences already noted for group 1. While there was not the same direct or implied pressure from a stock exchange or the Securities and Exchange Commission to approve the extension of auditing procedures, the reasons already noted for such approval by the listed companies appealed to most of the companies in the second group.

As might be expected, there were in group 2 relatively more than in group 1 that refused to have the additional work undertaken and accepted a report or certificate with qualifications or reservations, but most companies in the second group were willing to accept the additional procedures and pay for their necessary cost.

In group 3 there has been a marked difference in practice. In some cases clients have recognized the value to them of tests by the auditors in checking the honesty and accuracy of their own employees, and have approved such additional work and paid the cost thereof because of the expected benefits to them. The reports from other accountants included numerous cases where the additional procedures followed disclosed shortages or the necessity for improvements in methods and records. Many of the clients expressed themselves as feeling that the additional work was worth several times its cost.

On the other hand, the management of many companies in group 3 felt that they had such close control of the business and such accurate personal knowledge of the situation regarding inventories that they were better able to determine the total value of the inventory than any auditors, that the additional work would not result in any value, and therefore that they did not wish it undertaken. In some cases they went so far as to refuse to have the work undertaken even if no additional fee were to be charged, and in other cases they were willing that the auditor should do what he pleased to satisfy himself, but refused to pay any additional fee because of probable lack of any value to the management.

If the accountants were unable to persuade the management as to the value of the additional procedures they then were faced with the alternative (1) of otherwise satisfying themselves as to the substantial accuracy of inventories and giving a certificate including the explanation that they were otherwise satisfied but had not applied the generally accepted auditing procedures in testing physical inventories, or (2) if they could not satisfy themselves as to inventories, of merely rendering a report with no opinion.

Such reports without opinions in many cases appear to have been satisfactory to the banks or others outside the business who received them. This may have been due in some cases to ignorance of the third parties as to the importance of the additional procedures, or in other cases to an understanding of their importance but a sufficient knowledge of the details of the business by such third parties so that they were satisfied to accept the inventories without approval by the auditors, and were interested in receiving merely the auditor's approval or comments on other items in the financial statements. There is no objection to such a report where the third parties thoroughly understand the situation and are still satisfied, and where the auditor makes absolutely clear what he has or has not done and how far he has departed from accepted auditing procedures. However, there may develop enough cases of closely held companies wherein carelessness or dishonesty of client's employees, or of the management itself, results in losses to the banks or others outside the business so that such third parties will appreciate the value of the additional safeguard of tests of physical inventories by the auditors, and will use their influence to see that such work is done and the necessary additional fees paid.

In the fourth group, of closely held companies submitting no reports outside the business, there were naturally the smallest proportion of clients approving extensions of auditing procedure for inventories. For clients in group 4 most accountants merely render a report without a certificate or opinion, and state in that report what has been done or not done in confirmation of inventories. Such a report has usually been satisfactory to the client. However, even in group 4 a number of cases have been reported by other accountants, and we have had several cases in the practice of our firm, where the client has been persuaded as to the value to him of having tests of physical inventories made. I suggest that accountants make further efforts in this direction, as additional services and fees which result in real benefit to the management are always regarded with greater favor than additional services and fees forced on the management for work which is of benefit primarily to third parties.

(c) Work of the Auditor

1. Planning in Advance

All accountants were somewhat worried about their ability to carry out the extended auditing procedures regarding inventories because so many clients close their books at the end of the calendar year. However, this difficulty seems to have been overcome by careful planning of the work.

Study of the conditions affecting each client indicated that in many cases clients were operating a system of perpetual control of inventories through adequate records, tests of which could be made at odd times prior to the close of the year that would justify the auditor in relying upon the stores records so tested as a basis for determination of the inventories total at the close of the fiscal year.

In cases where it seemed necessary or desirable to take complete physical inventories, arrangement was made in many cases to take such inventories prior to the close of the year, the auditor making sufficient tests of the inventory taking and then supplementing these by tests of the transactions between the date of the inventory taking and the close of the fiscal year.

In our own firm, at staff conferences in each office we reviewed the situation affecting each important client, decided what steps were desirable, and then endeavored, in coöperation with the client's employees, to undertake the work necessary at various dates prior to December 31st. As the result of such planning there was actually very little inventory work remaining to be done on that date.

Incidentally, for some of the clients of our firm, and for those of a number of other accountants who have given me the benefit of their experiences, consideration of the whole problem of inventories resulted in developing methods which were of distinct value to the clients. By careful planning it was possible in many cases to reduce the time when the plant had to be shut down, thus minimizing loss of production and the corresponding loss of profits.

While planning for the physical inventory well in advance of inventory taking has proved helpful to clients, it has been especially valuable to the auditors. I am including some suggestions as to steps to be taken in such planning.

Obtain a copy of the previous physical inventory to ascertain the distribution of inventory values, and determine what portion of the total is made up of raw materials, work-in-process, finished products, and supplies. If there are several different products using different raw materials, a grouping by principal raw materials may be helpful. Determine the physical location of inventories at one or several plants, or warehouses. After completing this analysis, review the facts with company officials and inquire whether any material changes in operations or inventories have occurred since the last inventory.

Study the client's inventory instructions to determine whether they are likely to result in an inventory that is reasonably accurate. Note especially precautions for careful and thorough records of moving items, such as receipts, shipments, and materials in process during the inventory taking.

After such review of the previous inventory and of the instructions for taking the one to be tested, visit those warehouses, plants, or departments where will be found the largest values in the inventory. Size up the physical condition and location of inventories as they are likely to be at time of inventory taking. Ascertain what units of weight or measurement are customarily used in the several departments and to what extent materials can be grouped in units, such as boxes, bales, bins, truck loads, carloads, or grouped by machines, furnaces, tanks, etc.; processing similar materials and having more or less definite capacities. Inquiry should also be made as to what stores or production records are kept in the departments, from which a test check can be made of the movement of products and the quantities that should be on hand.

The purpose of contact by the auditor with the physical stocks is to enable him to confirm the existence of the inventory and whether it appears to be current. The procedures just noted should enable the auditor to grasp the problem as a whole, determine where the bulk of the values in the inventory will be located, the conditions under which it will be taken, and plan his testing so that he can give principal attention to the bulk of the values.

2. Attendance at Inventory Taking

I have already commented upon the fact that, with proper planning, much of the work of inventory taking was done prior to December 31st, and that it was possible to have members of the auditor's staff on hand at the time of inventory taking. This was true whether there was a complete physical inventory at one time or testing at various times of continuous stock records.

In general, accountants found less difficulty than expected in accomplishing practical results in obtaining satisfactory confirmations that the physical inventory was actually in existence, and that it appeared to be in quantities useful in the normal course of business.

The reports from other accountants indicate considerable differences of opinion and of practice as to the way attendance at inventory taking should be carried out, how many staff men are needed in proportion to client's employees, and how far the auditor should go in verifying the checking or merely observing the work of the client's employees. Undoubtedly mere attendance and observation has its value in giving the auditor a better knowledge and understanding of the business, and in exercising a moral effect upon the client's employees toward greater care and accuracy in their work. In many cases accountants have felt it necessary to go far beyond such minimum requirements. Our profession may well give further consideration to what is reasonable procedure under various sets of circumstances to give the auditor the added assurance that he should get, from contact with physical inventories, that the inventory amount appearing in the financial statements may be accepted by him as substantially correct.

3. Physical Hazards

Statements received from other accountants indicate that auditors making contact with physical stocks have been exposed to conditions quite different from those encountered in clients' offices.

A crew of men is reported to have arrived for testing an inventory in a steel plant dressed in usual office clothes and to have suffered severely from cold and exposure. Another crew spent New Year's Eve observing the inventory taking in 20-minute shifts in some cold storage coolers where the temperature was 25° below zero.

Other cases were reported of auditors having narrow escapes from being hit by falling materials, from operations of cranes, or from various manufacturing processes, and it was often necessary to explore locations that were dirty if not dangerous.

Undoubtedly auditors will profit by the experiences during the past twelve months and will in the future dress more in keeping for the work required and make their way more surely and carefully around the plants and warehouses. However, no matter how carefully the work may be planned and carried out, contacts with physical inventories are more hazardous than work merely in an office, and auditors and their staffs should carry suitable insurance against such hazards, such insurance being one of the costs of these additional procedures.

4. Control of Inventory Quantities

In a paper I presented on the subject, "The Mechanics of Confirmation of Inventories," I made some observations as to the control of inventory quantitites which I believe are of sufficient importance to justify repetition at this time:

> One of the most important matters to keep in mind is the necessary control of inventory quantities between the time of inventory taking and the time when the final total inventory expressed in dollars and cents is produced for the final statement. While errors in the basis of prices or computation may result in important differences in the final inventory total, if any attempt is made to change the inventory total, it is most likely to be accomplished by increasing the actual quantity on hand when the report is made of physical quantity in the final inventory.
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> Accordingly, the accountant, when testing at the time of inventory taking or as drawn from perpetual inventory records confirmed by suitable physical tests, should keep control of such quantities through obtaining duplicate tickets, duplicate sheets, or otherwise so that he may be satisfied that the final inventory total does not contain quantities substantially different from those taken or drawn from perpetual stock records as at the end of the fiscal period. This control of quantities during the period between the taking of inventory and production by the client of the final total may be considered as equivalent to control that auditors usually take over securities, cash, and other negotiable items by sealing up those items that cannot be completely verified at one time and keeping all such items under seal until the total has been verified, in order to prevent substitution or change. The control over inventory is not a control of the physical items but a control of the records of the physical items on hand at the time of inventory, so that the auditor can satisfy himself that those items and no more and no less are included in the final inventory.

Although the practice outlined in the foregoing paragraphs is desirable it is not possible in every case, and I gather from the statements received from other accountants that it is not generally followed. I am repeating the suggestion at this time for the purpose of stimulating further discussion of the matter so that at least it will be given consideration in each case where it is possible or practical to keep such control. We should compare the additional trouble and expense involved with the possible danger from changing of quantities between the time the auditor observes the taking or checking of such quantities and the time when the total inventory is determined for inclusion in the financial statements.

5. Employment of Outside Specialists

The experiences of accountants in different parts of the country as reported to me indicate fewer cases where the employment of outside specialists seemed necessary than had been expected when the extensions of auditing procedure regarding inventories were under consideration. Apparently accountants found that a study of the business, the materials used, the manufacturing processes, and the nature of the finished products, gave them sufficient knowledge in most cases so that the contacts which they had with the inventories, supplemented by their tests of the records, satisfied them that the values shown were reasonable.

In many cases reported, the accountants were forced by the nature of the inventory to place rather heavy reliance upon the company's records and the technical knowledge of the company's employees, but even in those cases it was usually possible to develop a method of internal check whereby the work of those preparing the inventory was checked by others in the organization who could express an independent opinion.

This question of the employment of outside specialists to assist the auditor in passing upon materials requiring a technical knowledge to determine quality and condition, will undoubtedly be given further consideration by individual accountants in individual cases. We can merely observe at this time that the experience thus far indicates less difficulty than had been anticipated.

6. Difficulties Encountered

I am merely including a few of the cases brought to my attention by other accountants that appear to be typical or most significant.

Materials in bulk such as coal, oil, fertilizer, and lumber presented many practical difficulties. In some cases there were available careful engineering surveys and calculations, while in others the estimates of quantities made by the client's employees were rather casual guesses. There was often an absence of standards as to weight per unit of cubic content, and sometimes little or no attention had been given to such factors as the moisture content. In some plants the practice was followed of storing bulk materials in separate piles small enough to be exhausted within a reasonable time, keeping separate records by piles, and making adjustments when each pile was exhausted. In other cases all of the material was mixed together and reliance as to quantities depended solely upon an engineering survey.

For some businesses the auditors found difficulty in distinguishing between materials similar in general appearance which differed greatly in price. Here physical inspection was of little value unless supplemented at the time of inspection by questioning various employees accustomed to handle and use the materials, and making comparisons with production records, and stock records if kept, to indicate the relative quantities of each of the materials on hand.

A different type of problem rose with companies manufacturing machinery involving hundreds of parts for each machine. In such cases the inventory values were spread over so many items of raw materials, stores, and work-in-process that it was not possible to test the bulk of the value through checking any small proportion of the items. The auditors, however, were able to supplement their physical impressions of quantities in stock and in process with the stock records, and especially with the production orders, and to obtain a rather clear idea as to the volume in process by a discussion of production orders with the plant manager and department foremen. With this kind of business there may be excess quantities of parts for discontinued models of machines. It is necessary to carry a stock of parts to service customers' requirements for repairs, but the quantities carried should be compared with records of sales of such parts to see what quantities have a real value.

Inventories of chemicals or other technical products could only be tested by auditors in company with experts familiar with the business, but independent of the inventory taking, who could help in the identification of materials and their approximate values.

7. Errors Detected

In the experiences of our own firm and of those reported by other accountants, there were several instances of errors detected through tests of physical inventories. I am including only those which may be of general interest.

In a department store, a number of errors were found in the furniture department, arising mostly from failure of the company to take account of piece sales from special furniture; for instance, a bedroom suite comprising one bed, four chairs, a chest of drawers, etc., would be short two chairs which had been delivered on another sale. Also, it was found that mattresses stored in the basement had been returned by customers and under the state law could not be resold.

In the course of reprocessing oleomargarine, a certain amount of weight is lost. The bookkeeper in charge of the inventory record was inexperienced, and was unaware of this loss in processing. On finding that the physical inventory did not agree with the books, he changed the physical inventory. This change was discovered by the auditors' test of the physical inventory.

In a shoe company the auditors found that several thousand dollars' worth of samples held at one division of the company over the year-end had been omitted from the inventory. The reason these samples were not on the inventory when presented to the auditors was that it was an unusual situation for samples to be held at this particular division; the clerk in preparing the final inventory followed the procedure of previous years, and in consequence omitted these samples. Except for checking the physical quantities back to the inventory, these samples would have been entirely overlooked.

In making tests of inventories of a branch of a manufacturing concern the auditors found that good stock records were maintained and that monthly statements of quantities on hand as shown by the stock records, supposed to have been checked by physical inventories, were forwarded to the home office. It happened that when the auditors called to inspect the merchandise the manager was out of town. Using the stock records as a guide they made a rather comprehensive test check against the stocks and discovered considerable shortages. The manager was advised to return immediately for an explanation, which was that all or substantially all of the shortages developed represented merchandise which had been regularly shipped to a customer whose credit had become so impaired that the home office had instructed that no further sales be made. The manager nevertheless had continued to make shipments. He informed the auditors that he viewed these shipments as sales to himself for resale to the customer in question, immediately prepared an invoice to himself covering all of these shipments, and reported it to the home office with his check to cover.

While we are considering extensions of auditing procedures involving tests of inventory quantities, another case which involved prices may be significant. Prior to 1939 auditors in some cases accepted inventories in total and failed to make tests not only of quantities, but also of prices. The following case would probably not have been brought to light if the extension of auditing procedures approved in 1939 had not been applied.

This was a manufacturing company in which no adequate cost system was maintained. The auditors not only tested physical quantities but calculated approximate costs for the finished products which sold in largest volume and which made up the bulk of the inventory. Such costs were based on quantities of materials used at the prices being paid for such materials, labor tickets showing quantities produced for the different operations and the cost thereof, and the corresponding application of overhead expenses or burden. These calculated costs disclosed that many of the items had been priced substantially above cost in the previous inventory and would have been so priced in the current inventory if the cost calculations had not been made by the auditors who followed the procedures now generally accepted.

(d) Variations in Tests by Auditors

It is clear from the experiences reported to me by accountants in various parts of the country that, while accountants generally have followed the recommendations in the report of the special committee on auditing procedure, there have been great variations in the quantity and quality of tests made.

We all know that no two cases are exactly alike, that the accountant must apply his personal judgment to the conditions, both of the physical stocks and of the records, as he finds them, and that he is entitled to rely upon a system of internal check and control if it is properly designed and effectively operated. Procedures regarding confirmation of inventories would be expected to vary greatly as between companies with an adequate system of stock control and those which have no such system but depend upon the taking of a complete physical inventory. However, for tests in each of these general groups there seem to be differences in opinion and practice.

I have already mentioned the importance of the control of inventory quantities between the time of inventory taking and the time that the final total inventory expressed in dollars and cents is produced for the financial statements. Practice as to such control differs. Another difference is in the procedure adopted in making tests of physical quantities. While it is not necessary that members of the accountant's staff in making tests actually touch the stock, they must be sufficiently close to the physical items to have a real knowledge that the tests being made represent real tests. Observation of the inventory tests being made by client's employees will have little practical value unless it represents intelligent observation, by which the auditor can satisfy himself that the tests were actually made and that they were made in a manner that would be likely to determine the accuracy of the reported quantity, quality, and condition of the item, or disclose any substantial inaccuracy in such reporting.

The relation of the independent accountant to inventories of a client may vary all the way from complete supervision of the taking or checking of the inventory, followed by full control of the quantities by the auditor until the final inventory in dollars and cents is completed, through testing of inventory taking and the control of quantities, down to mere observations of inventory taking or checking by client's employees, and no control of quantities between the time of such observation and the time when the final inventory in dollars is presented.

How extensive tests should be in each individual case can be determined only by judgment and experience, but this is a subject which is worthy of further discussion by accountants to see if agreement can be reached as to suitable tests under several given sets of circumstances.

Summary

The experiences of independent certified public accountants with extensions of auditing procedure for inventories, emphasizing physical contact by the auditors with the inventories, may be summarized as follows:

There has been less resistance from clients than might have been expected toward having the auditors undertake the additional work and paying the additional fees therefor. Acceptance of the additional procedures has been general among those companies whose securities are listed on a stock exchange or which have many stockholders. However, approval has not been limited to the larger companies, but has been given by a number of smaller clients, both those presenting financial statements to bankers or other third parties and those keeping the auditor's reports for the management alone.

Due to proper planning of the work it has been possible for accountants to undertake much of the work prior to December 31st and to complete the necessary work without placing unreasonable burdens on the accountants' staffs.

There have been differences of opinion and of practice as to the work done and the responsibility assumed by the accountants' staffs at time of inventory taking. This is a subject which should be given further consideration by all accountants, in the hope of developing the most practical procedure under different circumstances.

Contact with physical inventories increases the physical hazards of the accountant's staff, and those accountants not covering such hazards through compensation insurance are advised to do so.

Few accountants now attempt to keep in their control summaries of inventory quantities, the determination of which they have tested, between the time of inventory taking and the completion of the final inventory total which appears in the financial statements. Such control should be more generally recognized as a part of auditing procedure.

While, in some cases involving materials of a technical character, outside specialists have been employed either by the company or by the auditors, experience during this past twelve months indicates less need for the employment of specialists than had been anticipated.

Accountants have encountered numerous difficulties in making suitable tests of physical inventories, due to the physical characteristics of materials, the way they were handled and stored, the location of such materials, the lack of suitable storage facilities, lack of suitable records, or lack of planning and coöperation by the client's employees.

Some of these difficulties are inherent in the nature of the materials or the operating processes of the business, but the experiences of the past twelve months will be helpful in enabling suitable tests to be made in the next year and following years with less difficulty and effort. The work of auditors will undoubtedly be made easier and more effective because of improvements in the design and operation of stock records, and the more general adoption by clients of methods for continuous control of inventories.

In addition to greater satisfaction on the part of the auditors that the amount of inventories shown in the financial statement was supported by actual physical stocks, the extensions of auditing procedure were in many cases a distinct help to the clients, through disclosure of errors or thefts of stock, or unsatisfactory methods of handling stock or of keeping and controlling the stock records.

Both the auditors and the clients obtained increased value from the audits as a whole, because of the more practical viewpoint of the auditors towards each business resulting from contacts with the physical inventories and the operating processes.

There appears to have been great variation in the quantity and quality of tests made by different accountants, and our profession should give further consideration to an exchange of experiences and ideas in order to develop standards of performance. I realize that no two cases are exactly alike, and that the minimum of work to satisfy the auditor may be greatly expanded to meet the desires of the management, the auditing committee, or others to whom a report may be rendered.

An incidental result of the increased attention to inventories has been greater consideration by clients of the advantages of adopting as a fiscal year their natural business year rather than the calendar year.

Inventories are a very important asset for most concerns, but in thinking of the whole subject of auditing procedure, we must not give inventories greater emphasis than they deserve. There is no difference in principle between inventories and other assets, and the auditor must apply to the examination of the inventory asset those methods of inquiry and testing and checking that lie reasonably within the scope of his ability and experience. In general the most effective and economical procedure for confirmation of inventories is a combination of testing of records of the company and testing of physical stocks.

While physical contact with the inventories by the auditors was not a part of generally accepted auditing procedure prior to 1939, for many years some accountants had carried out such procedures. The experiences noted in this paper are similar to those in earlier years of accountants who then followed these procedures, and the more recent experiences simply emphasize the importance of the extension of auditing procedures and confirm the work previously done.

While there has been a considerable development of understanding on the part of the business public and members of the profession as to auditing procedures, we must keep continuously in mind the proper relationship between reasonably adequate safeguards and the cost thereof. A statement made by a prominent accountant in 1926, which was quoted in correspondence with the New York Stock Exchange, is equally applicable today. This statement is as follows:

"In any such work we must be practical; it is no use laying down counsels of perfection or attempting to extend the scope of the audit unduly. An audit is a safeguard; the maintenance of this safeguard entails an expense; and this expense can be justified only if the value of the safeguard is found to be fully commensurate with its cost. The cost of an audit so extensive as to be a complete safeguard would be enormous and far beyond any value to be derived from it. A superficial audit is dangerous because of the sense of false security which it creates. Between the two extremes there lies a mean, at which the audit abundantly justifies its cost."

The "Extensions of Auditing Procedure" adopted May 9, 1939, represent an important step forward. Experiences with additional procedures for inventories have been generally satisfactory. Our responsibility now is to continue to test the application of these procedures to individual cases and build up a body of experience which will lead to further modifications and extensions as they may be required. The final test is the economic justification for the procedures, considering their costs in relation to their value, not only to the independent accountants who must express opinions in regard to the financial statements, but also to all others affected by such statements, such as security holders, management, employees, customers, creditors, and the general public.