

# Suggested Inventory Procedures on Interim Audit Engagements

By KERMIT J. BERYLSON, C.P.A.

**D**URING the year 1947 and for the first quarter of 1948, profits of small businesses have shown a constantly decreasing trend, while their bigger brothers show constantly increasing profits. Perhaps this is the surest index that small business is actually marginal business, and that only during those periods of exceptionally great demand—as in a war—can it produce profits beyond the modest living requirements of its owners. Credit-grantors are well aware of this.

Inventory is the turning point of liquidity. It is classified as a current asset, and the reader of a balance sheet assumes that it will become cash within a reasonably short time—even if he realizes that the report which he is

reading is an “interim” report, in which the inventory is stated as “submitted by the management”, or “estimated in accordance with current gross profit ratios”, or even a “break-even” inventory.

Modern accounting procedure, ever since the McKesson-Robbins case, has laid increasingly heavy stress on inventory examinations. In a so-called “certified” report, the independent public accountant indicates exactly what he has done to confirm the existence of each asset and liability, and is thus able to express an opinion on the reasonableness of the balance sheet. Now, with the promulgation of Auditing Procedure Statement No. 23, which is not yet generally accepted, he may have to state, perhaps with resulting credit injury to his client, that he has no opinion with respect to the assets and liabilities if he has not carried out all generally accepted auditing procedures.

Statement No. 23 hits hard at the interim audit report, but it also performs the valuable service of once again pointing up what can be done if public accountants engaged in interim work are to become more than “arithmeticians” to their clients. Any bookkeeper can draw off a trial balance and prepare reports therefrom. The accountant can go further into the substance of the figures, and be in a position to assure his client and credit-grantors that the figures represent reality.

In his book, “Auditing Theory and Practice,” Mr. R. H. Montgomery states:

“The auditor cannot assume the same responsibility with respect to the item inventory which appears among the current assets as he does with respect to other items of current assets, such as cash, but he should arrive at a well-founded

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opinion as to whether the inventory is fairly stated on the basis of constantly applied and generally accepted principles of accounting".

On an interim, as on a complete examination, an inventory review should comprise examinations of quantity, quality and pricing. However, the fee for an end-of-year examination usually permits the auditor to spend sufficient time on each phase of the audit, so that at its conclusion the public accountant is in a position to make a statement with respect to each of the items which he has examined. Not so on an interim engagement—the client's budget for professional services is limited to the greatest extent possible, and correctly so.

The usual interim engagement is either a general ledger review, with the barest possible examination of the underlying records, or a detailed audit of transactions. In an interim report, the inventory is usually stated as submitted. While it may be argued that these examinations are of value to the client in the sense that he is given assurances, etc., how does he profit in an active sense? Nothing goes into the report which can assure a credit-grantor. No analyses of operations can be presented of which the auditor can be certain, because the inventory figure has not been thoroughly investigated.

I have in mind a situation like this: an organization engaged in manufacturing a textile product, had shown a consistent gross profit of 25%. In January, 1948, based on the inventory *as submitted*, and not examined by the auditor, the gross profit jumped to 36%. Questions led to the assurance that January had been a spectacularly good month, and that the increased gross profit was reasonable. The gross profit, for February, again based on an inventory *as submitted*, dropped to 6%. The March gross profit returned to the norm of 25%. Obviously, the February 1st inventory was grossly overstated. In error, the client proceeded on the assumption that certain of his operations were more profitable than they actually

were, and was misled by incorrect guideposts. Had the audit program provided for a monthly examination of inventory content, the error would have been avoided.

Much has been said, in and out of this committee, about sampling methods as applied to auditing. Current uncertainties in the business world have now indicated a need for a more serious consideration of their application. Fee considerations will always prevent the application of a complete audit program to interim engagements. If an engagement must be limited, the client will profit more if some audit operations are eliminated from time to time, where internal control permits, and inventory steps are substituted. For example, the audit of purchases and sales may be made on a bi-monthly basis. Accounts receivable may be reviewed by sections.

Interim engagements are usually carried on at a date subsequent to the inventory date. An auditor will not normally be present at the taking of a complete physical inventory. However, provision may be made for the auditor to make progressive physical quantity checks as at the date at which the interim audit is done. The auditor may prepare a schedule of all inventory items, and may then select certain items to be counted at different times during the year. As he secures his counts at the actual date of the audit, he may then reconcile back to the inventory as submitted by the management. The adjustment to his own physical count will be made by adding sales and deducting production or purchases.

The selection of items to be physically counted by the auditor should be a careful one. Since the inventory examination must of necessity be limited, only the more important items, in terms of quantity and value, should be selected. The method employed in taking a selective count should be as carefully applied as a client's inventory instructions at the end of an accounting period. A date and hour of cut-off with respect to sales and purchases should be established and care should be taken that

shipments and receipts of the particular items are excluded from the inventory count. Time may be saved in the actual counting of physical inventory by providing for counts in groups rather than by items. If boxes of canned food which are stacked in easily available counting units are to be counted, the stacks themselves may be counted and multiplied by the number of boxes in each stack. Checks may then be made to determine that each stack does contain the number of boxes which it is supposed to contain, and spot checks may also be made to determine that the boxes do contain the actual cans of food.

References should be made also to the receiving and shipping records which play so great a part in internal control. The auditor should review receiving records to determine that all items which have been received up to the actual date of his physical count are included in the goods which he is counting. Specific items should be traced from the receiving records to the inventory.

With respect to shipping records, the auditor should make tests to determine that goods which have been billed out in the period immediately preceding the count have actually been shipped out and that they are not included in the physical inventory.

Further reference can be made to production records in cases where the client is a manufacturer. On a selective basis, raw materials should be traced into production and the items produced traced in turn to inventory or to shipping records. Purchase bills during the period immediately preceding the count may be traced to receiving records. While engaged in this operation, the auditor should make sufficient tests to assure himself that all purchase invoices, particularly those involving stock included in the inventory, have been entered in the books. The auditor should look for post-dated invoices. If he finds that there are goods in transit under such invoices, the aggregate

should be included in the inventory and entered as accounts payable.

A somewhat more difficult situation exists with respect to inventory held in warehouses, mills, on consignment, etc. Normally, on an end-of-year engagement, the existence of such goods would be substantiated by direct confirmation in writing. A complete, direct confirmation is not always practicable on an interim audit, although there is no reason why confirmations cannot be sent out periodically. Normally, the auditor may satisfy himself with the examination of negotiable warehouse receipts or statements or goods on memorandum. He may check these by reviewing correspondence with the warehouses and with consignees, to determine whether any change has taken place in the inventory amounts. He may also review sales invoices to assure himself that identifiable items included in the "out-of-house" points have not been sold and that they are still the property of the client.

Some textile concerns maintain actual consignment accounts, either in memorandum books or in the general books, of goods sent to converters. These may be reviewed as a check on inventory.

Where the client maintains a perpetual inventory, the auditor's job is simplified in that he has only to compare opening inventories per the perpetual record with the physical inventory figures submitted by the management, and the perpetual figures at the audit date with his own count. If major discrepancies arise, a review of the entire inventory may be indicated. Of course, all physical inventory checks based on perpetual inventory should follow the procedures outlined above to the greatest extent possible.

Valuation of inventories on an interim engagement should not be too difficult, especially in those engagements where a detailed audit of purchase vouchers is made, where the auditor should have a continuing schedule of material, labor and overhead costs. On a progressive basis, the checking of a

submitted inventory should be a simple matter. Also, the audit program should provide for a continuing review of cost cards. Where cost reviews are included in the audit program, it goes without saying that an auditor familiar with cost procedures should be assigned to the engagement.

The valuation procedures to be followed in detail or an interim engagement should follow closely, on a selective basis, the procedures followed at the end of the year. For the most part, clients who require interim engagements will be found to price their inventories on a basis of first-in, first-out, in combination with the rule of cost or market, whichever is lower. However, LIFO may be followed in some instances, as may other methods of inventory valuation. The auditor should determine which method is followed and assure himself that it is being followed consistently.

Item valuations may be compared with purchase invoices, and also with current sales for that item. The valuation reflected on the inventory should not be greater than the purchase price, and in no case should it exceed the sales price for the item less a reasonable allowance for distribution expense. Tests should be made to ascertain that normal cash discounts are not deducted from the cost of inventory items and, at the same time, tests should be made to assure the auditor that trade discounts are deducted from inventory valuations. Any rebates for quantity purchases should be applied to the adjustment of inventory prices.

If any method of standard costs is employed, the auditor should make it his business to review the application of material, labor and overhead to the item costs. This requires familiarity with production and time study methods employed by the client. Great care should be taken that any "normal" overhead rates are extremely close to actual rates. If any great difference appears, inventory valuation should be adjusted.

Further, at a time when inventories are declining in value, adequate reserves should be established to provide a proper balance sheet and income picture.

An accountant engaged in an interim audit should be able to arrange for a brief but intensive analyses of material, labor and overhead which go into the manufacture of specific products. This may require more familiarity with production and time study methods than the accountant normally has. However, one so close to the operations of the client as the accountant engaged on interim audits should be able to qualify.

A review of quality and obsolescence in inventory is often peculiarly within the province of the interim auditor. The client's products and methods of sale should be so familiar to him as to preclude any necessity for instruction on the salability of products. A supplementary procedure in connection with the visual review of inventory should consist of an analysis of sales by items, from month to month, in order to determine which are slow-moving items, and which items therefore should be marked down in value for inventory purposes because of their presumptive obsolescence.

Many accountants have submitted to their clients, from time to time, monthly reports on a "break-even" basis. That is, a figure is presented at the end of a report which represents the minimum amount of inventory which the client must have on hand in order to "break even" for the period. Any excess over this "break-even" amount, of which the client will be aware, represents profit. Any shortage represents a loss. It has been suggested that supplementary procedures be developed to test these "break-even" figures. This suggestion appears to be something of a paradox. Audit procedures on interim engagements are normally confined to assets other than inventory, to liabilities, and to capital investment. The "break-even" figure is derived from these figures. It appears to be impossible to test something which may be present or may

not, and in connection with which the accountant can take no responsibility. It must be recognized that the "break-even" figure is purely for management purposes and can be of value only if inventory is known. Any tests of a "break-even" figure will revert naturally to the procedures suggested for normal inventory auditing. The "break-even" figure must remain perched forever on its own precarious limb.

Where an "estimated" inventory is submitted to an auditor, he may find it possible to check its accuracy by a review of statistical records of production (purchases) and sales which may be maintained by the client. If the auditor

will make the necessary effort to introduce these records, he will find that information can be developed which will produce very feasible checks on estimated inventories. For example, sales and production by units; orders booked, filled and on hand; average gross profits by units; methods of determining selling prices.

To summarize, the extent to which inventory may be reviewed on interim engagements depends primarily upon the time which can be allotted to the entire audit and upon the extent to which interim control will permit normal auditing procedures to be followed on a sampling basis.



### AN ADIRONDACK VIEW

**The Adirondack Conference.** "Adirondack" is a more exciting name for this Conference than "Upstate" or "Regional"—don't you think? If you don't, that is, don't think, you shouldn't be reading this. The following is an accountant's report to accountants, an attendant's report to non-attending former-attendants. Let's go to press!

1. **Weather.** Barometric reading: 29.55 constantly; snow fall: 0; thunder showers: 1; rain: little; sunshine: some; clouds: plenty; complaints: below normal.
2. **Attendance.** A few over 200; more past, present, and future State Society officers than ever before. The up-state boys were so numerous that we had trouble keeping the Buffalonians, Rochesterians, Syracuseans, Albany-Troyans, and others distinguished from each other. We even got them mixed up with the New Yorkians. Shame on us!
3. **Speeches.** Mostly short. Talking: in great quantity; everyone pregnant with a speech—delivered.
4. **Adirondack Chapter.** Doubled membership, now have 2; after-dinner speech its spokesman wishes he had made: "Hello folks, welcome, have a good time, get acquainted, make a speech, make some friends, get hold of one good idea, drop two bum old ideas, thanks for coming, see you next year, goodbye."

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