Europa Engines – Rationalizing an Inventory Shortfall

Europa Engines was located in the Netherlands. It was a wholly owned subsidiary of a large Canadian multi-national corporation (CANCO), that manufactured diesel engines and parts. It was a very large operation – one of the largest employers in the region and a high-profile European company.

During the CANCO audit, a C$14 million inventory shortage was reported in Europa. This was almost material to CANCO and very material to Europa, on which the auditors were to express a separate opinion for regulatory and tax purposes. The client was keen to rationalize (i.e., explain the cause) the shortage and not book it at all if possible. Auditors were dispatched from Canada to get to the bottom of the issue and determine whether a write down was necessary. Fortunately, all the working papers and client records were in English.

Initial observations from the investigations were:

- The inventory count was completed in stages over four months and there were difficult cut-off issues at each stage. So, the possibility of errors in tabulating the physical inventory quantities was real. The local auditors (not an affiliated firm) had attended the count on each date and had not noted any differences between recorded count and actual quantities on hand.
- The system for costing the inventory was manual and very complex. Again, there was a possibility for errors in pricing the physical inventory and in the bookkeeping itself, especially in the four different roll-over periods between the count and the year end.
- The plant and the warehouse were immaculate, and everything was well labelled. Generally, operations looked excellent, but the accounting records looked very messy.
- Controls over inventory appeared to be strong upon initial review.

As the audit unfolded, a large number of small errors were found in the inventory processing and accounting, but they were not in a consistent direction, so this was not very helpful in resolving the issue.

The warehouse manager took the auditors around the plant but was puzzled why the auditors were there. They did not elaborate at the time but actually met him by chance in a cafe one evening. They said there appeared to be an inventory shortage and he asked what the books said the inventory was. When they told him he thought for a moment and said “that much inventory would not fit in the warehouse”! The auditors regarded this as probably the most persuasive evidence gathered to date.

The auditors were reaching the opinion that the physical count was probably reasonably accurate and therefore that a write down would be necessary, when two very persuasive pieces of evidence came to light that indicated that the inventory shrinkage might have been caused by theft:

- First, in conducting an internal control review of the shipping system it was discovered that, while trucks leaving the plant were inspected to ensure their contents matched the documentation, there was an exception for shipments transferring items from the plant to an off-site warehouse about fifty kilometers away. No checks were made on these trucks.
- Second, and very luckily, a few days later the auditors had a meeting scheduled with the plant manager to update him on progress. When they arrived, his secretary said he was busy in an urgent meeting with his sales manager, but that if they wished they could sit in on the meeting. They did. The sales manager was talking about an unexplained decline in sales to wholesalers because they in turn were reporting declines in customer sales. When the sales manager learned about the weakness in inter-location shipments, he was astounded, and they all concluded that the declines in sales could be because customers were buying the engines or parts on the black market obtained from guess where.

However, that did not solve the whole problem. Skepticism still reigned regarding the cause of the problem. For example, why did the warehouse manager not notice large quantities of stock missing? He kept his own record in quantities.

Nevertheless, it was resolved that the only way to get at the problem would be an expensive forensic audit and there was no enthusiasm for that because it was clear beyond reasonable doubt that the inventory should be written down. So the auditors accepted that for the CANCO statements but withheld their opinion on the Europa statements because of the uncertainties. A major systems overhaul was commissioned, and the shipping weakness plugged. Given the poor accounting system, the auditors had to worry about what other errors may have been lurking. But, based on their audit findings of offsetting small inventory processing and accounting errors, they were it least confident that it was not a deliberate accounting fraud problem.

Questions:

1. What red flags should have been identified by an auditor demonstrating professional skepticism?
2. How important is it for auditors to hold discussions with important front-line people like a warehouse manager? Why?
3. Why is information from non-accounting sources important?
4. The big picture is an important element of a good audit – discuss.
5. How do messy accounting records change the approach to an audit? Were the auditors justified in their confidence that the inventory shortage was not a deliberate accounting fraud?
6. What was the most important step in determining that the physical inventory was reliable?

7. What further procedures could have been performed to decide how much, if any, of the shortage was through theft resulting from the internal control weakness?
8. When serendipity turns up a possible issue should auditors ignore it or pursue it?
9. How important were materiality issues in this situation?
10. What are the potential problems involved with accepting a client's rationalization of an inventory shortfall without fully investigating it?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.