An Empirical Test Of The View Of Inventory As A Liability In Explaining Financial Distress: A Reply

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The authors of the comment (see pages 31-34 of this issue) concerning our article published in volume 14 number 2 of this journal make some points with which we cannot argue. Perhaps our wording to emphasize that some writers and managers actually view inventory as a liability led to criticism of the paper overall. However, just in time (JIT) inventory and Theory of Constraints (TOC) concepts certainly indicate that high inventory levels may be a symptom of a problem, and low inventories may indicate a strength. Inventory itself is not necessarily a liability, but holding inventory levels that differ from successful competitors is a symptom of underlying problems and/or inefficiencies. These underlying factors will result in future costs. Therefore, inventory may represent a liability because it is indicative of future costs.

Our study examined whether the view of inventory as a liability could help in distinguishing between healthy and distressed firms. Our inventory variables therefore serve as proxies for underlying problems associated with inventories. Most external users cannot have intimate knowledge of a company’s internal processes. Consequently, information about symptoms of potential problems or strengths (proxies), may be the best we can expect from financial reporting.

Theory of Constraints proponents would disagree with the Comment’s assertion that TOC performance metrics are only short-term performance measures. TOC is a strategic management philosophy for long-term management of the company. The five focusing steps of TOC are geared toward continuous improvement of all the company’s processes, much like the Kaizen concept. Definitely, the fourth focusing step, “Elevate the constraint” can entail strategic, long-term decisions. Examples include (1) building a new plant to elevate a production capacity constraint, and (2) entering a new market, and/or developing or acquiring a new product line or distribution system to elevate a market demand constraint.

The Comment attacks our call for including more inventory information in financial reports due to an alleged lack of relevance. The Comment claims that the possibility that users might interpret information from TOC out of its intended decision context limits its relevance to external users. Even if the Comment’s assertion that TOC metrics are short-term performance measures, are valid, they may have relevance to some users. Given the frequent ups and downs in the equity markets, some investors may pur-

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chase and sell shares of stock on a short-term basis. Also, many credit decisions are short-term decisions such as extending credit to customers and short-term bank loans.

TOC and activity-based costing (ABC) proponents have advocated new performance measures because they viewed traditional accounting measures as not beneficial, or perhaps even harmful, to management of a company. Many managers have attested to the superiority of the new measures over traditional accounting information. Consequently, TOC performance measures might be incrementally beneficial to financial statement users as well as managers.

In fact, our results indicated that viewing inventory differently than the traditional accounting view may produce more useful information in distinguishing healthy from distressed companies. We are not suggesting new reporting system. Only that companies show a breakdown of materials, direct labor, and manufacturing overhead, in work-in-process and finished goods inventories. Then, users could decide for themselves whether constructing TOC measures was beneficial. Because the cost of reporting this information should be low, we say let users decide what is useful – not traditional accountants. Who are accountants to deny users access to information because we say it is not relevant?

The last two sentences of the Comment’s conclusion appear to reiterate what we stated in our study. The Comment requests further research to examine insights from the other managerial accounting information in financial distress prediction. However, as we stated, such research is not possible without more information reported in the financial statements.

References
