Accounting Questions

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VALUATION OF INVENTORIES

Question: We are preparing a balance-sheet as of March 1st, for one of our clients. Our report will be rendered about May 20th.

Inventories were valued at cost or (March 1st) market, whichever was lower. Between the date of the balance-sheet and the date of the submission of the report, there has been a decline in market prices of the raw materials in the inventory.

Questions:

(1) Should a reserve be provided for this decline in market prices, and if so, on what basis?

(2) If no reserve is set up, should a comment upon the decline in market prices be made in the certificate or report? or

(3) Should the decline in market prices be disregarded since it occurred after the date of the balance-sheet?

Answer: It is our opinion that the inventories, the subject of your inquiry, are properly valued in the balance-sheet at the lower of cost or market. At the same time, a reserve should be provided for the decline in market prices, the amount of such reserve being the difference between the inventory valuation and the value to which the market has declined. We are assuming a decline in prices stabilized within reasonably definite limits, since, if the downward price movement still continues, the stated reserve must be based on a consideration of the circumstances, and governed by a prudent conservatism. If, on the other hand, no reserve is made, appropriate comment should be offered in the certificate.

Answer: In reply to questions one and two, we believe that either a reserve should be set up or suitable comment made disclosing the fact of the decline of market prices and its effect on the financial position of the company. The answer to question three is, of course, that the decline in market prices should not be disregarded.

We believe, however, that the inquirer should consider other factors than those mentioned in your letter. It is quite conceivable that a substantial decline might have occurred between March 1st and May 20th without impairing the financial status as shown on the March 1st balance-sheet. That is, the entire inventory might have been liquidated before the decline in prices occurred. It is manifest that if such were the case any reference to the decline in market prices would give an unjustified impression as to the client's financial condition.

The measure of the reserve or of the qualifying comment should be the loss actually sustained and the potential loss still to be realized, in respect to the values shown as of March 1st. If the client had liquidated one half his inventory at a definite loss, such loss, together with the decline in value on the unliquidated portion, should represent the reserve requirement or amount to be embodied in the comments.

It is seldom possible to trace the liquidation of inventory satisfactorily so as to determine the exact loss incurred at a given date. It is not necessary to comment on the difficulties in establishing the actual and potential loss, but merely to state the principle which must be followed in order that no injustice be done to the client.

LEASE OF REAL ESTATE UNDER PARTNERSHIP

Question: A man who has a building on leased ground—the lease having a sixty-day notice-to-vacate clause—takes in a partner and the partnership makes an addition to the building which costs approximately $6,000.

The partnership is now being dissolved and the question arises: What portion of the cost of the addition should be paid by the partner (the original owner of the building before the extension was made) who is to occupy the premises in the future?

It should be pointed out that the building is on a main thoroughfare which is in the process of development and surrounding property is being built up and a notice to vacate may reasonably be expected at any time.

Answer: It is apparent that it is impossible to determine over what period the lessor of the land will have the benefit of the additions which cost $6,000, inasmuch as it is impossible to foresee the date when the lease will be terminated.

At the termination of the partnership, therefore, there can be no adjustment of the cost of the additional buildings which must be considered, at that time, as having no value. However, there should be an arrangement between the partners so that the partner who was the original owner of the building should pay to the other partner a fair proportion of the cost of the addition based upon the time during which the former continues to occupy the premises. In other words it would seem fair to pro-rate the $6,000 over the period of occupancy, which, at the time when the partnership was dissolved, was undeterminable but would be possible of determination in the future if the landlord took action under the sixty-day notice-to-vacate clause.

Answer: We do not see in the facts presented any definite basis for making an apportionment between partners. If notice to vacate is given and the building has to be vacated, presumably there will be a loss not only of a portion of the

$6,000 put in by the partnership but of the building previously owned by one of the partners. Considering the period during which the cost of the building and the cost of the addition should be charged against operations, you have the two extremes: one, that the total should be charged over a period of sixty days, and the other that the cost of the building and the addition should be spread over the reasonable life, taking into consideration the kind of construction. Probably a fair adjustment lies between these two extremes, but the facts given in the question offer no help in setting any exact or approximate period of life for either the building or the addition. In the circumstances we can only suggest that the two partners consider the question in the light of their own knowledge of the local situation and try to reach a friendly agreement based on a reasonable life, spreading the cost of the addition over the reasonable life from the time the addition was built up to the time when it will probably be discarded.

Answer: It might be possible to make an equitable settlement on the basis of ratio of the time during which the addition is used by the partnership to the total time from the date when the addition is completed to the date when it is necessary to vacate the building. Such an agreement, of course, would require that final settlement be made only after notice to vacate has been received, unless there is some other means of knowing when it will be necessary to vacate.