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# Accounting Research BULLETINS

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## Inventory Pricing

### INTRODUCTION

Whenever the operation of a business includes the ownership of a stock of goods, it is necessary for adequate financial accounting purposes that inventories be properly compiled periodically and recorded in the accounts.<sup>1</sup> Such inventories are required for the statement of financial position and for the periodic measurement of income.

This bulletin deals with the general principles applicable to the pricing of inventories of mercantile and manufacturing enterprises. Its conclusions are not directed to or necessarily applicable to non-commercial businesses or to regulated utilities.

### STATEMENT 1

The term "inventory" is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in the process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

#### *Discussion*

The term "inventory" embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process) and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes the long-term assets subject to depreciation accounting, or any goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item be classified as part of the inventory. Raw materials and

<sup>1</sup> Prudent reliance upon perpetual inventory records is not precluded. Cf. Statements on Auditing Procedure No. 1, p. 6, American Institute of Accountants.

supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of oil-producing companies are usually treated as inventory.

### STATEMENT 2

A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.

#### **Discussion**

An inventory has financial significance because revenues may be obtained from its sale, or from the sale of the goods or services in the production of which it is used. Normally such revenues arise in a continuous repetitive process or cycle of operations by which goods are acquired and sold, and further goods are acquired for additional sales. In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is in effect a residual amount remaining after the matching of absorbed costs with concurrent revenues. This residual is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. In practice, this residual amount is determined by the process of pricing the articles comprising the inventory.

### STATEMENT 3

The primary basis of accounting for inventories is cost, which has been defined<sup>2</sup> generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

#### **Discussion**

In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. The definition of cost as applied to inventories is understood to

<sup>2</sup> *Accounting Research Bulletin* No. 24, Summary Statement (1).

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mean acquisition and production cost,<sup>3</sup> and its determination involves many problems. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, except for the portion of general and administrative expenses that may be clearly related to production, it is generally accepted accounting practice to include such items as period charges and to exclude them from inventory costs (product charges). Selling expenses constitute no part of inventory costs. It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

#### **STATEMENT 4**

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as "first-in first out," "average," and "last-in first-out"); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.

#### ***Discussion***

The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in cases in which similar goods are purchased at different times and at different prices. Ordinarily, under those circumstances, the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development and general acceptance of several assumptions with respect to the flow of cost factors to provide practical bases for the measurement of periodic income. These methods recognize the variations which exist in the relationships of costs to sales prices

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<sup>3</sup> In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.

under different economic conditions. Thus, where sales prices are promptly influenced by changes in reproductive costs, an assumption of the "last-in first-out" flow of cost factors may be the more appropriate. Where no such cost-price relationship exists, the "first-in first-out" or an "average" method may be more properly utilized. In other situations a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. Standard costs, if adjusted at reasonable intervals to reflect current conditions, are acceptable. In some cases, the business operations may be such as to make it desirable to apply one of the acceptable methods of determining cost to one portion of the inventory or components thereof and another of the acceptable methods to other portions of the inventory.

Although selection of the method should be made on the basis of the individual circumstances, it is obvious that financial statements will be more useful if uniform methods of inventory pricing are adopted by all companies within a given industry.

#### STATEMENT 5

A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market."

#### ***Discussion***

Although the cost basis ordinarily achieves the objective of a proper matching of costs and revenues, under certain circumstances cost may not be the amount properly chargeable against the revenues of future periods. A departure from cost is required in these circumstances because cost is satisfactory only if the utility of the goods has not diminished since their acquisition; a loss of utility is to be reflected as a charge against the revenues of the period in which it occurs. Thus, in accounting for inventories, a loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses is accomplished by applying the rule of pricing inventories at "cost or market, whichever is lower." This provides a practical means of measuring utility, and thereby determining the amount of the loss to be recognized and accounted for in the current period.

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### STATEMENT 6

As used in the phrase "lower of cost or market,"<sup>4</sup> the term "market" means current replacement cost (by purchase or by reproduction, as the case may be) except that:

- (1) Market *should not exceed* the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and
- (2) Market *should not be less than* net realizable value reduced by an allowance for an approximately normal profit margin.

#### **Discussion**

The rule "cost or market, whichever is lower" is intended to provide a means of measuring the residual usefulness of an inventory expenditure. The term "market" is therefore to be interpreted as indicating utility on the inventory date and may be thought of in terms of the equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction. In applying the rule, however, judgment must always be exercised and no loss should be recognized unless the evidence indicates clearly that a loss has been sustained. There are therefore exceptions to such a standard. Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

Because of the many variations of circumstances encountered in inventory pricing, Statement 6 is intended as a guide rather than a literal rule. It should be applied realistically in the light of the objectives expressed in this bulletin and with due regard to the form, content and composition of the inventory. The committee considers, for example, that the retail inventory method, if adequate markdowns

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<sup>4</sup> The terms "cost or market, whichever is lower" and "lower of cost or market" are used synonymously in general practice and in this bulletin. The committee does not express any preference for either one of the two alternatives.

are currently taken, accomplishes the objectives herein. It also recognizes that, if a business is expected to lose money for a sustained period, the inventory should not be written down to offset a loss inherent in the subsequent operations.

#### STATEMENT 7

Depending on the character and composition of the inventory, the rule of "cost or market, whichever is lower" may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.

#### ***Discussion***

The purpose of reducing inventory to "market" is to reflect fairly the income of the period. The most common practice is to apply the "lower of cost or market" rule separately to each item of the inventory. However, if there is only one end-product category the cost utility of the total stock—the inventory in its entirety—may have the greatest significance for accounting purposes. Accordingly, the reduction of individual items to "market" may not always lead to the most useful result if the utility of the total inventory to the business is not below its cost. This might be the case if selling prices are not affected by temporary or small fluctuations in current costs of purchase or manufacture. Similarly, where more than one major product or operational category exists, the application of the "cost or market, whichever is lower" rule to the total of the items included in such major categories may result in the most useful determination of income.

When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market equally in excess of cost, such components need not be adjusted to market to the extent that they are in balanced quantities. Thus, in such cases, the rule of "cost or market, whichever is lower" may be applied directly to the totals of the entire inventory, rather than to the individual inventory items, if they enter into the same category of finished product and if they are in balanced quantities, provided the procedure is applied consistently from year to year.

To the extent, however, that the stocks of particular materials or components are excessive in relation to others, the more widely recognized procedure of applying the "lower of cost or market" to the individual items comprising the excess should be followed. This would also apply in cases in which the items enter into the production of unrelated products or products having a material variation in the

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rate of turnover. Unless an effective method of classifying categories is practicable, the rule of "cost or market" should be applied to each item in the inventory.

When substantial and unusual losses result from the application of the rule of "cost or market, whichever is lower," it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separately identified from the consumed inventory costs described as "cost of goods sold."

#### **STATEMENT 8**

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements; whenever a significant change is made therein, there should be disclosure of the nature of the change and, if material, the effect on income.

#### ***Discussion***

While the basis of stating inventories does not affect the over-all gain or loss on the ultimate disposition of inventory items, any inconsistency in the selection or employment of a basis may improperly affect the periodic amounts of income or loss. Because of the common use and importance of periodic statements, a procedure adopted for the treatment of inventory items should be consistently applied in order that the results reported may be fairly allocated as between years. A change of such basis may have an important effect upon the interpretation of the financial statements both before and after that change, and hence, in the event of a change, a full disclosure of its nature and of its effect, if material, upon income should be made.

#### **STATEMENT 9**

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

#### ***Discussion***

It is generally recognized that income accrues only at time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordi-

narily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. In cases in which such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the fact of the use of such basis should be fully disclosed in the financial statements.

#### STATEMENT 10

Accrued net losses on firm purchase commitments of goods for inventory, measured in the same way as are inventory losses, should be recognized in the accounts. The amounts thereof should, if material, be separately disclosed in the income statement.

#### **Discussion**

The recognition in a current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable and unhedged commitments for the future purchase of inventory items. The net loss on such commitments should be measured in the same way as are inventory losses and, if material, should be separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposition of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

*The statement entitled "Inventory Pricing" was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Tilly, assented with qualification. Two members, Messrs. Paton and Peloubet, dissented.*

Mr. Tilly assents to the bulletin, but disagrees with that part of Statement 6 and the related discussion which provides for a write-down below cost in certain cases solely because replacement cost is lower, when the realizable value (selling price less cost to complete and sell) is higher. He believes that cost is a proper measure of the amount to be carried forward, irrespective of the cost to replace, provided cost does not exceed the net realizable value.

Mr. Peloubet dissents because in his opinion it is ordinarily preferable to carry inventory at not less than recoverable cost, and particularly in the case of manufactured or partially manufactured

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goods which can be sold only in finished form. He recognizes that the application of the cost or market valuation basis necessitates the shifting of income from one period to another, but objects to unnecessarily accentuating this shift by the use, even limited as it is in this bulletin, of reproduction or replacement cost as "market" when such cost is less than net selling price.

Mr. Paton opposes the issuance of this bulletin because he objects to the (1) retention of the phrase "cost or market," as confusing, and to the emphasis laid on that approach, (2) requirement that excess of actual cost over replacement cost (or a portion of this excess) be charged to current revenue even if there is no expectation that a loss will be suffered on disposition, (3) requirement that the prospective "normal profit" be estimated and used in determining inventory value in certain cases, (4) apparent acceptance of the theory that replacement cost is significant to owners and managers when prices are falling but deserves no notice in accounts or statements when prices are advancing, (5) requirement that current revenues be charged with possible future losses that may be related to outstanding purchase orders.

### NOTES

1. *Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)*

2. *Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)*

3. *It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)*

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