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Inventory reserves; Accounting Research Bulletin, no. 31

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No. 31

Inventory Reserves

1. Reserves designed to set aside a part of current profits to absorb losses feared or anticipated in respect to inventories on hand, or in connection with future purchases, are the subject of this bulletin. Charges to provide, either directly or by use of a reserve, for obsolescence, deterioration, or similar losses, or for reducing an inventory to market, or for reducing an inventory to a recognized basis such as last-in first-out or its equivalent in accordance with an announced change in policy to be consistently followed thereafter, are regarded as proper charges to income, and are not under consideration in this bulletin. The committee has already dealt with reserves arising out of the war,[1] and with general purpose contingency reserves.[2]

2. The committee has previously[3] recognized the character of the income statement as a tentative installment in the long-time financial results, and is aware of the tendency to exaggerate the significance of the net income for a single year. Nevertheless, there still exists the responsibility for determining net income as fairly as possible by sound methods consistently applied, and the duty to show it clearly.

3. In accomplishing this objective, it has been deemed desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.[4] In applying this rule, inventories on hand or contracted for should be priced in accordance with principles recently stated by the committee.[5] When

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[1] Accounting Research Bulletins Nos. 13 and 26.
[2] Accounting Research Bulletin No. 28.
[3] Accounting Research Bulletin No. 8, p. 64.
[4] Accounting Research Bulletin No. 13, p. 111.
[5] Accounting Research Bulletin No. 29.

such an inventory which has been priced in accordance with those principles is further written down by a charge to income, either directly or through the use of a reserve, current costs are not properly matched with applicable revenues and future charges are correspondingly reduced. This process may result in the shifting of profits from one period to another without accounting justification. The committee is on record that reserves should not be created for the purpose of equalizing reported income.[6]

4. It has been argued that losses which will have to be taken in periods of receding price levels have their origins in periods of rising prices, and that, therefore, reserves to provide for future price declines should be created in periods of rising prices by charges against the operations of those periods. Computations of reserves of this kind have to be made on the basis of assumptions as to what future price levels will be, what quantities will be on hand if and when a major price decline takes place, and finally, whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. When estimates of this character are charged to current costs, amounts representing mere conjecture are combined with others determined with a reasonable degree of accuracy.[7]

5. The committee is therefore of the opinion that inventory reserves, such as those created:

(a) for possible future inventory losses on inventories not on hand or contracted for, or

(b) without regard to any specific loss reasonably related to the operations of the current period, or

(c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles.[8]

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year.

6. The committee is also of the opinion that if a reserve of the

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[6] Accounting Research Bulletin No. 13, p. 112.

[7] Accounting Research Bulletin No. 13, p. 113.

[8] See particularly Accounting Research Bulletin No. 29.

type described in paragraph 5 is set up: (1) it should be created preferably by a segregation or appropriation of surplus, (2) no costs or losses should be charged to it and no part of it should be transferred to income or in any way used to affect the determination of net income for any year, and (3) the reserve should be restored to surplus when it is no longer considered necessary. The committee recognizes as proper, though less desirable, the alternative procedure of (a) setting up such a reserve by an appropriation of net income so reported in the income statement that the final figure would clearly indicate that it is not the entire net income, and (b) of showing the subsequent return of such a reserve at the foot of the income statement after the determination of net income for the period in such a way as to clearly indicate that it is not income.

The statement entitled "Inventory Reserves" was adopted by the assenting votes of nineteen members of the committee. Two members, Messrs. Dohr and Knight, dissented.

Mr. Dohr dissents for the following reasons: "(1) The position taken by the committee in this bulletin cannot be reconciled with its approval of the last-in first-out method of inventory accounting. (2) The committee characterizes the reserves in question as 'speculative guesses,' 'mere conjecture,' and 'future' inventory losses," and in his opinion "this precludes any argument." He believes "there may be cases where reserves, objectively determined, may be appropriate despite the fact that they would not come within the ambit of Bulletin No. 29." (3) He "can think of no circumstances in which it would be appropriate to bring an unused reserve into the disposition section at the foot of the income statement."

Mr. Knight dissents because he believes "traditional accounting practices are clearly inadequate to cope with existing extraordinary price inflation and subsequent substantial deflation that appears inevitable based on past experience. Obviously reserve provisions made capriciously to equalize profits between years must be condemned. It seems equally plain, however, that accounting rules should not force business to report inventory profits as unqualifiedly realized in the face of conviction that such profits will never be realized. Neither should business be forced to adopt the involved last-in first-out method as the only means of eliminating such profits. This extraordinary price situation requires sensible tolerance in making objective tests of business judgments exercised in good faith and a realistic consideration of substance rather than technical adherence to form."

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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