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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

VALUATION OF INVENTORY OF PUBLISHER OF RELIGIOUS BOOKS

Question: Among our clients we include a religious organization which conducts a publishing house which publishes Bibles, books on theology and other religious subjects, semi-religious books as well as short stories, sheet music and pamphlets for sale to clergymen, instructors and students of the seminaries, churches, Sunday schools, members of their congregations and others. Some are edited at the insistence of the religious governing body without any guaranty as to sales.

In order to obtain a lower unit cost, the prospective sales are estimated for a five-year period and the books are then printed to meet this anticipated five-year demand. However, if the public demand does not materialize, the books remain in the inventory year after year, because, owing to their religious nature, certain publications are subject to an irregular demand over a long period of time. For example, 5,000 books of one title may be printed with the expectation of selling within five years, but, actually, the sales may be 800 the first year, then 550, 200, 300 and 150, leaving 3,000 in the inventory at the end of five years.

It has been the policy of the publishing house to carry these books in its inventory year after year at cost and it is our opinion the inventory is consequently inflated. (Using the axiom of cost or market, whichever is lower.)

From past experience, a decline in selling price does not materially stimulate sales, but the books must be carried in stock to meet whatever demand materializes.

What is a practical basis for valuing the slow-moving inventory at the close of each of the five years, using as an example the figures cited above and assuming a unit cost of publication of $3.00?

When actual sales approximate the anticipated sales volume, is it satisfactory to value the books in the inventory, at the close of each year, at unit cost?

Answer No. 1: It appears to me that the better policy to pursue in valuing the inventory of such books would be to credit the entire amount of sales to publishing cost until it is clearly demonstrated that the publishing cost will be exceeded. At the end of the first year, if the remaining cost exceeds the estimated sales for the next period of four years, I believe that the inventory should be written down to a still lower figure representing a value substantially under the estimated remaining sales.

If the publication of the book occurred only a short time before the end of the fiscal year, I would merely carry as inventory the difference between the publishing cost and the sales. If, on the other hand, a period of practically a year had elapsed I would estimate the remaining sales on the basis of the sales already effected.

Using the example mentioned in your letter, if 5,000 books of one title had been printed with the expectation of selling them within five years and only 800 copies had been sold in the first year, I would use the experience gained in selling other books to determine the probable ratio between the first year's sales and sales for a five-year period. Assuming that experience to be as indicated in your letter, it would mean that 1,200 copies would be the probable sales in the ensuing four years. In such a case I would establish the value of my inventory at the end of the first year at twelve-fiftieths of the total cost of printing, that is, I would absorb the proportionate cost for the books sold plus a proportionate cost of what was now estimated to be surplus production.

I do not think the policy of carrying the inventory year after year at cost is justified—certainly not unless it is considered that eventually all of the books carried will be sold at a price in excess of cost.

Answer No. 2: In the case of text books, religious books, medical books, etc., which have theoretically a fairly long life as compared with popular fiction, it is usual for the publisher to print an edition based upon an estimate of five years' sales. Generally, however, he will have them bound in comparatively small lots, the bulk of the stock being carried in the form of unbound sheets. For example, in the illustration cited, of the 3,000 copies on hand, it is probable that perhaps 500 are bound and 2,500 are sheets. Where excess stocks exist, the greater part will normally be found in the form of unbound sheets.

There is no uniformity in the methods used by publishers in valuing excess stocks, except a general tendency to be optimistic as to the probability of converting them into cash either through regular sales, special deals or sales as remainders at inventory values or more. The commonest method is to carry the excess in the inventory at "no value." For example, in the case cited and assuming that, of the 3,000 copies on hand, 500 are bound and 2,500 are sheets, the 500 bound copies might be considered, on the basis of recent years' sales, as being probably salable and allowed to stand in the inventory at cost, the 2,500 sheets being carried at no value.

There is no generally accepted mathematical formula for determining the reasonable quantity which may be inventoried, but I know of two cases where

an analysis of a generally similar inventory was made under the following plan:

Book published in	Maximum quantity to be valued
1935 (current year)	Full inventory.
1934	200% of 1934 and 1935 sales.
1933	133⅓% of 1933 to 1935 sales.
1932	100% of 1932 to 1935 sales.
1931	80% of 1931 to 1935 sales.
Prior	80% of last 5 years' sales.

Applying this formula to the example cited, the sales during the last 5 years were 2,000 copies, and 80% or 1,600 copies, would be the maximum allowable inventory. Assuming again that, of the actual inventory, 500 copies were bound and 2,500 were sheets, the 500 bound copies would be deducted from the allowable total of 1,600, leaving 1,100 sheets to be inventoried and 1,400 sheets to be carried at no value.

The foregoing formula is presented for what it is worth and without any claim that it is perfect or has had any general acceptance. It has been tried, however, and while on some individual titles the results can easily be criticized, as applied to the valuation of a complete inventory it appears to produce fairly reasonable values. Certainly its use would result in substantially more conservative inventories than are commonly found on publishers' balance-sheets.

When actual sales have approximated the anticipated sales volume, it is satisfactory, in the absence of any known special circumstances which would adversely affect future sales, to value the books at unit cost.

The unit cost, however, should represent the cost of paper, printing and binding only. The $3.00 unit cost mentioned (presumably for bound copies) is extremely high, as the paper, printing and binding cost usually runs not more than 20% to 25% of the net sales, which would indicate a list price of the book of about $15.00. This raises the suspicion that the unit cost may include plates.

Plates are a fixed asset, to be depreciated separately, and the inclusion of them in the inventory cost of the book results in carrying the undepreciated balance of a fixed asset in the current assets as a part of the inventory. This is neither good accounting nor common practice among publishers. If the plate costs (which include composition, editorial expense, art work and the actual cost of the electrotypes) have been included in the inventory unit prices, these prices should be corrected and the inventory recalculated.

LOSSES ON COMMODITY INVENTORIES AND CONTRACTS

Question: We have a client dealing in a commodity which is traded in on recognized commodity exchanges. Our client sells the actual commodity to users and trades in the commodity on the exchange as a hedge against inventory on hand and also for speculation.

At the close of the fiscal year, our client has realized losses on contracts closed out on the exchanges but has not yet disposed of the inventory on hand, so that there is a profit in the inventory at present market values. The custom of this particular client in the past has been to value its inventory at the lower of cost or market and to take into its operating accounts for the year the profits or

losses realized on closed contracts on the exchanges. It now desires to defer the loss on closed contracts on the exchange until the period in which the profit is taken on the actual merchandise to be sold.

Will you please advise us what other accounting firms consider the proper practice in the treatment of losses on contracts of this nature? If your answer could cover the following questions which have arisen in this matter, it would be very helpful:

1. Should the loss on closed hedge contracts be added to the inventory value of the merchandise on hand? If so, must the inventory be stated on the balance-sheet as at "cost or market, whichever is lower, plus loss on commodity exchange contracts"?

2. Should the loss on closed hedge contracts be treated as a deferred expense to be written off in the future period against profits realized on the inventory now on hand?

3. Could the inventory be carried on the balance-sheet at market values, less a reserve which would be sufficient to bring the net inventory down to cost plus the loss on closed contracts on the exchange? If this is good accounting practice, how should the item be expressed?

4. Is there any other way in which this matter is handled by representative accounting firms?

Answer No. 1: It is assumed from the question that:

(a) A commodity, let us say, cotton, was bought and physically delivered some time prior to the end of the year, at 11¼¢.

(b) At about the date of the purchase, the same quantity was sold short, at the same price.

(c) Prior to the end of the year, the short was filled at the then market of 11½¢.

We are of the opinion that it would be good practice to value the cotton on hand at 11½¢ (or market, whichever is lower).

The reason for hedging is to eliminate the speculation incidental to carrying a stock of merchandise. The hedge in question was for the purpose of selling the original purchase, and, although the purchase to fill the short was not taken into stock physically, the price of it should be used for inventory purposes.

Answer No. 2: It is our opinion that where there is a definite relation between a commodity on hand and the commodity contracts, the profit or loss on commodity inventory may be offset against losses or gains on contracts. In that event, we see no objection to adding the loss on such closed hedge contracts to the inventory value of the merchandise on hand. We believe that it should then be stated that the inventory is at "cost or market whichever is lower, plus loss on commodity exchange contracts applicable thereto."

We prefer this treatment to that mentioned in the second and third specific questions raised by your correspondent.

Where the commodity contracts, either open or closed, are speculative rather than hedges against inventory or sales contracts, we believe that any profit or loss on such contracts should be reflected in the accounts at the year-end.