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Inventory valuations

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Inventory Valuations

REPRESENTATIVES of a certain large "industrial" recently appeared before the Inventory Committee of the Internal Revenue Department, and submitted an argument in favor of being permitted, in stating its accounts for income tax purposes for the year 1918, to use in valuing its inventory prices as of December 31, 1916.

The counsel for the company submitted that the present level of prices is abnormally high, and that to use the prices in force December 31, 1918, would have the effect of inflating the profits for the year. Counsel for the company further argued that the company desires to be conservative and does not wish to include in its profits for the year 1918 any amount arising from a valuation of its stock in hand at an inflated price.

While the case has not been settled, it is understood that the Inventory Committee looks with some tolerance upon the argument of the company, and it seems quite possible that a decision favorable to the company will be rendered.

This case brings to mind a somewhat similar attempt on the part of certain English companies to obtain relief from the burden imposed by the high prices incident to the war.

The substance of the request is well stated in the following letter which appears in the London "Accountant," Vol. 52, page 567:

"THE VALUATION OF STOCK."

To the Editor of The Accountant:

Sir:—At the present time the values of some commodities are much above the normal. Is there any obligation on the part of a trader, or company, to value stock at cost or market price instead of prudently taking a much lower figure and omitting all reference to this reduction in the Balance Sheet?

To illustrate my meaning, a company owning a flour mill took stock on 31st of March last. Calculating the value of wheat and flour on hand in the usual way (cost price or market price, whichever is lower) the amount came to (say) £50,000. Wheat was at that time about 60s. a quarter and is now higher. The managing director proposes to reduce the value of the stock by a round sum of £7,500. on the ground that present prices are excessive, and that at any time changed circumstances may result in a sudden and heavy fall in market values. The mill usually carries about ten week's requirements in wheat and flour, so that at the present time, when the accounts are being made up, about half the stock on hand at 31st March will have been sold at prices well above the market prices on that date. The directors anticipate a very difficult time when the inevitable fall in prices does occur, and they prefer to make such 'secret reserve' as I have indicated to disclosing a larger profit and transferring a similar sum to Reserve Account in the usual way.

Yours faithfully,

24th April, 1915. MILLER.

(We see no objection to the proposed course.—Ed. Acct.)"

A discussion which took place between the Association of Controlled Owners and the Board of Inland Revenue, as set forth in Sanders's "The Law and Practice of Excess Profits Duty," pages 54-62, appears below:

"It is necessary with Excess Profits Duty that the same basis of arriving at stock be followed throughout all pre-war and accounting periods, so as to ensure a fair comparison between the pre-war and war periods. It is not permissible to write down stock against a possible future loss on the termination of war producing a fall in prices, but any actual loss on stock held at the end of the last accounting period covered by the Duty will be allowed under the following official scheme:

The Board of Inland Revenue are prepared to adopt the following modifications of the general principle that stocks should be valued at cost price or market value, whichever is the lower.

1. A period of two years will be allowed after the termination of the war in which to ascertain by actual realization the value of the stock appearing in the account at the end of the last accounting period, and an allowance made from the profits of that period for any difference between the valuation and the sum realized.

The loss (if any) on only such stocks as were in hand at the end of the last accounting period will be brought into the adjustment, but the whole of such stocks not individual parcels selected by the taxpayer, must be considered.

The necessary sanction for this modification of general principles will be given by a regulation under Section 40, Sub-section 3, of the Finance (No. 2) Act, 1915.

2. Certain classes of industry require to keep stocks of raw or semi-manufactured goods for the purposes of manufacturing processes, and these goods are frequently of such an imperishable character that a minimum quantity required for a business could be held untouched for a long period.

Accordingly any class of trade—

(a) which requires for its manufacturing processes to keep such stocks, and

(b) in which a recognized practice has obtained of valuing a constant quantity at a fixed price,

the Board of Inland Revenue are prepared to recognize the practice.

The Board of Inland Revenue would regard goods as imperishable which are of sufficient durability to last without deterioration during a period equal to the length of the war.

Any individual member of the class who has not adopted the method in his business may be allowed to do so for the purposes of Excess Profits Duty, but may not claim as the constant quantity of stock so valued a greater quantity than the minimum amount held at any stocktaking in the three pre-war trade years.

Where a claim is made that an industry should be brought within this concession, the Board of Inland Revenue are prepared to receive representations and to consider evidence as to the existence of a material body of such practice in the industry and as to the character of the stocks to which it is claimed the method should be applied, with a view to securing the uniform treatment of all members of the industry.

The balance of stock above the minimum quantity in cases falling under this modification of the general principle is to be treated as in (1).

3. Profits derived from sales which reduce stock below the particular minimum or constant quantity adopted for any business are not the less trading profits. Where, however, a raw material is associated with plant in a manufacturing process (e. g., metal kept to a constant level in galvanizing baths), the Board of Inland Revenue will consider a claim under Section 40 (3) of the Finance (No. 2) Act, 1915, that it is akin to a capital asset, like plant, which has been exceptionally depreciated (by depletion) or of which the renewal has been postponed.

4. Where in an industry, or as respects a class of stock to which the foregoing (2) does not apply, the owner of a business has taken a quantity of stock at a base price, the stock will fall to be valued during the periods of liability at cost or market value, whichever is the lower; but from the final valuation (on that basis) there will be allowed a deduction of a sum (in pounds sterling) equal to the original difference (at the end of the standard period) between the valuation on the base method and a valuation on the cost or market value method. Alternatively, the first stock valuation may be revised and put upon the

general basis of cost or market value, when the modification outlined in (1) will apply."

The following opinion of a Committee of Consulting Accountants in connection with Munitions Levy advances the above practice:

"We have considered the proposal made by the Association of Controlled Owners to the Inland Revenue Department at the meeting of 8th June, 1917, for the basis to be adopted in the valuation of stocks on hand, which is set forth in the attached statement.

These proposals would—

(a) Deprive the Treasury of a considerable sum which it would otherwise receive either under Munitions Levy or under Excess Profits Duty, and

(b) Leave the owners with stocks at the end of the last accounting period considerably below market values prevailing or likely to prevail for many years after that date.

We consider that there is only one sound general principle of valuing stocks for the purposes of these Acts, and that is:

That all stocks of every sort or kind should be valued at the end of the accounting period on the basis of cost price or market value, whichever is the lower. This principle rests upon the theory (which is perfectly sound) that profits can only be realized by the sale of commodities and that no profits can arise by mere increase of value unaccompanied by a sale. To follow this out consistently, stocks therefore should be carried at their cost price until they are sold and the profit is ascertained. Where, however, the market price is lower than the cost, a precautionary reserve is permissible for the difference between the cost and the market value.

We are of opinion that this principle should be adopted in determining profits. whether for the purposes of Munitions Levy or Excess Profits Duty, with, however, the following qualifications:

In certain base-metal manufacturing trades, such as copper, pig iron, lead, spelter, etc., it has been the custom for a long period in the past to adopt what is known as a 'base value' for part of these materials, on the theory that it is necessary for the undertakings using them to keep a reserve stock to protect themselves against results of strikes and adverse fluctuations in market value, etc., and for this purpose they have adopted a value which represents what may be called a minimum cost over a series of years for a minimum quantity; in theory, keeping this minimum quantity untouched and unused, although in practice no actual reserve stock may be kept which could be identified at any time; any excess over this amount is valued at cost or market value, whichever is the lower.

It appears to have been the practice of the Inland Revenue to admit for income tax purposes stock valuations of this character in the case of base metals, provided that it is the general custom of the particular trade, and has also been the practice in the individual case, and it will be difficult now to disturb this practice. The conditions, however, during the war period are so abnormal, and the effect upon Excess Profits Duty and Munitions Levy of this practise is so important, that a modification thereof would seem to be necessary. The prices of these base metals have risen continuously and to levels which have hardly been known in the past. If any owner adopting this method of valuation is allowed to continue it throughout the period to which Excess Profits Duty applies, he will in effect, be making an increasingly large reserve during each year of rising prices to the extent of the increase in the cost price of the base stock which may have been used and replaced during that year, and will, as a result, pay considerably less Excess Profits Duty than would be paid by an exactly similar concern which values its stocks on the usual basis of cost or market.

We think that, in cases where base stock valuations are accepted, the same reserve (i. e. amount sterling) should be permitted at the close of the last period of assessment as at the beginning of the first period of assessment, viz., an amount equivalent to the margin between the base price and the market price on the minimum quantity at the beginning of the first period of assessment. In effect this will mean that those concerns in which the base price has been admitted in the past will, during the accounting period, be put back on to a cost or market price basis, and will be on a par with other concerns which have throughout valued on that basis. If this principle be adopted the Association's claim under (c) does not arise, and any possible hardship to the owner is met by the recommendation made later in respect of losses made on realization of stock after the end of the last period of assessment.

In an exceptional instance, when it can be proved that a specific quantity of metals has been lying in stock untouched throughout the period of control, we do not consider that the owner's claim to take this same parcel out of control at the price at which it was brought in can successfully be resisted; because, if the theory we have stated is accepted, profits can only be realized by the sale of commodities and no profits can arise by a mere increase in value unaccompanied by a sale.

The claim of the owners for consideration in respect of stock values arises from their fear (which is probably to some extent justified) that they may be left at the end of the last accounting period with stocks at excessively high prices and perhaps in excessive quantities and that after the war ends prices may fall rapidly, and they may consequently lose a good deal of money on the conversion and sale of these stocks.

There is no doubt some force in this contention, and it seems only reasonable that, if the Government have taken from the owners a large share of their profits when they were purchasing on a rising market, the owners should not be left the whole of the loss when the natural reaction comes and they are selling on a falling market. If the Excess Profits Duty period extends for not less than twelve months after the end of the war, it may be expected that these difficulties will have adjusted themselves within this period; that by that tim prices will have found a general 'after-the-war' level, and that the excessive quantities, if any, will have been worked off.

To meet this contention, we would strongly recommend that an undertaking should be given to the manufacturers that if the Excess Profits Duty should be repealed within a few months of the end of the war, fair compensation will be given for any loss they can prove to have arisen during the succeeding twelve months by the realization of these stocks either in their raw or manufactured condition.

The final claim (d) made by the Association of Controlled Owners does not arise if their first claim (a) is not conceded. If the stock be valued at cost, it is immaterial whether goods brought 'forward' at the beginning of control are treated as stock-in-hand at that date or as purchases when delivery takes place. We submit, however, that on general grounds this claim is unsound. In most manufacturing businesses contracts for future delivery of necessary materials are made, as a common practice, to ensure that the quantities required are received as and when they are wanted. If all manufacturers who enter into such contracts were to demand delivery on the day on which the contract was made, no one would receive more than a small quota of his contract, because sufficient materials to meet all the contracts would not be in existence in a state in which they could be delivered. Sellers, as well as buyers, make their contracts ahead to ensure delivery of their products as required, and they cannot, in a general way, deliver them at any earlier dates; consequently, there seems no reason to discriminate between purchases made under long-dated contracts and those made from 'hand to mouth,' but that both should be taken into account as and when received on the general principle indicated above—namely, cost or market, whichever is the lower.

Signed by the following Chartered Accountants:

A. Lowes Dickinson (Price, Waterhouse & Co.)
F. L. Fisher (Fuller, Wise, Kirby & Fisher.)
F. N. Keen (W. B. Keen & Co.)
L. Maltby (Deloitte, Plender, Griffiths & Co.)
R. H. Stainforth (Gray, Stainforth, Newton & Co.)

Ministry of Munitions,
28 Northumberland Avenue, W. C. 2.
14th June, 1917."

An Omission

IN an article entitled "Some Facts About Accountants," which appeared in the June number of the BULLETIN, there was inadvertently omitted reference to the society in England known as the "Society of Incorporated Accountants and Auditors."

We are indebted to Mr. A. M. Lovibond, Manager of the London office, for bringing this omission to our attention, especially in view of the fact that Mr. Holding and Mr. Williams of our staff are members of this Society; and we take pleasure in reprinting an extract from Mr. Lovibond's letter, as follows:

"The Society was organized in London in 1885. Without going into the details of its long and honorable history, we may say that at the present time its legal standing is on a par with the Institute of Chartered Accountants, as is evidenced by the fact that where reference is made thereto in Acts of Parliament, the Institute of Chartered Accountants and the Society of Incorporated Accountants and Auditors are always coupled in the Act.

"When Government departments advertise for qualified accountants, they specify Chartered or Incorporated Accountants, and in all regulations under the Defence of the Realm Act, Chartered and Incorporated Accountants are treated as having equal qualifications. In all Government appointments only members of the Institute or the Society are considered to the exclusion of all other bodies, for the reason that only the first two are considered to possess the requisite qualifications for important work.

"Mr. Sells will remember Sir James Martin, Secretary of this Society practically since its foundation, who has recently had a knighthood conferred upon him, and the American Institute of Accountants took this occasion to write a letter of congratulation to the Society of Incorporated Accountants and Auditors, under date of July 1, 1919."

Additions to the Library, September, 1919

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