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Unsold Goods and the Income Account

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Since December, 1917, we have been required by the treasury regulations in ascertaining the net income of a given year to value all inventories of supplies, materials, finished or partly finished goods, unsold merchandise, etc., on one or other of two alternative bases, namely, (a) at cost or (b) at cost or market price, whichever is the lower. The far-reaching character of this requirement and the many questions involved in accepting it as sound accounting doctrine merit more attention than they have received so far.

It is intended to restrict the discussion to accounts which are kept on the basis of accruals of cost and income, and to disregard those which are kept on the basis of actual cash receipts and expenditures. Most businesses which handle commodities keep their accounts on an accrued basis, and the accounting scheme centres around the ascertainment of accrued net revenue in terms of distinct periods. One of the important phases of this question of net revenue is the inventory of commodities. It is recognized that the necessity for taking stock of such commodities at the close of each accounting period extends beyond the mere ascertainment of quantity, for unless a value is placed upon the commodities the net revenue figure for the period cannot be determined.

It is equally well recognized that a logical and consistent basis for this valuation of inventories of goods must be adopted. This is necessary even during accounting periods when inventory quantities exhibit only slight variations and when prices and values are static. The necessity is accentuated, however, during those accounting periods in which extensive accumulations or diminutions occur in stocks on hand and during those periods in which price changes and fluctuations take place, or during which there is an abnormal spread between cost prices and selling prices. In recent years, those conditions have prevailed in many industries.

For its bearing upon the problem of inventory valuation we
may classify commodities, broadly, into four or five main subdivisions, namely:

(a) Commodities purchased for resale in their original forms by merchants, traders and dealers.

(b) Goods acquired for consumption in manufacturing and productive processes, for maintenance and repairs of plant and facilities (not purchased for resale in their original forms).

(c) Goods manufactured or in process of manufacture for the general market.

(d) Goods manufactured or in process of manufacture on specific contracts.

(e) The natural products of the soil or natural resources extracted from mines, oil wells, timber lands, etc., produced in marketable form by owners engaged in operating on their own premises.

In years gone by, before the incidence of heavy taxation upon net revenue, it cannot be said that universal custom prescribed any uniform basis of valuation for the commodity classes named above, either separately or in their entirety. Custom varied according to the inclination of the owners or executives of each business enterprise, but it may be said that they usually selected one or other of the following bases of valuation: (1) original cost; (2) original cost, reduced by any shrinkage in value indicated by current market prices; (3) liquidating value, or selling prices; (4) estimated cost of replacement; and (5) value to the going concern.

This freedom in the selection of a valuation basis for inventories of commodities which existed in practice prior to the year 1917 was not encouraged or endorsed or taught by the accounting text writers. On the contrary, except for an occasional advocate for values more or less current, the text writers exhibited decided partiality for the second of the valuation rules named above—a rule which has been concisely described as "cost or market price, whichever is the lower." Nor do the text writers recognize any different valuation rule applicable to any of the classes of goods which we have noted. All are confounded in the same valuation rule, with an occasional reservation, however, as
to goods manufactured or in process of manufacture on specific contracts.

The position was stated officially in London on June 14, 1917, in an opinion expressed by members of certain eminent firms of accountants constituting a committee of consulting accountants, in a report to the board of inland revenue, which contained the following paragraph, afterward adopted verbatim by that board:

"All stocks of every sort or kind should be valued at the end of each accounting period on the basis of cost price or market value, whichever is the lower. The 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 in value unaccompanied by a sale."

The thought underlying the somewhat loose phraseology of the committee’s opinion is sufficiently evident, but is not likely to be accepted among accountants generally for several reasons.

First: it considers as a principle, and as a perfectly sound theory, the inconsistent idea that the acquirement and retention of property may imply a contemporaneous loss, but cannot imply a contemporaneous profit.

Second: it defends on grounds of principle and theory a valuation rule which rests on an illogical foundation, which originated as a practical measure to combat the formerly prevailing tendency to over-estimate profits and was adopted as an accounting expedient solely from motives of prudence and caution.

Third: it assumes that the invariable effect of this valuation rule is to prevent registration of any profit in the annual income account in regard to unsold goods. There is no such invariable effect, however, when goods are carried over during more than two consecutive years.

Fourth: it declares that a uniform valuation rule is applicable, necessarily, alike to the business of merchandising, to the business of manufacturing and to the business of producing commodities from the soil or from natural resources; applicable alike to commodities of all classes, whether acquired by purchase, by manufacture or by natural production; applicable alike whether or not the original cost of commodities has any present meaning or significance or represents more or less current values. Apparently, nothing is exempt from the rule, not even the many indus-
tries in which it is impossible to ascertain the original cost of commodities produced and the rule cannot be applied.

The general effect upon the income account which arises from applying to unsold goods the valuation rule of cost or market price, whichever is the lower, is essentially discriminatory; for it allows the registration of unrealized losses, while refusing to allow the registration of profits similarly unrealized, the basis of the figures in each case being market values. Obviously, if this market price is admitted to be an element in the situation and may be adopted to register an unrealized loss, then consistency demands that it should be adopted to register an unrealized profit. If uncertainty as to the price which will be realized ultimately for unsold goods is a valid reason against adopting the higher market value, the same uncertainty is an equally valid reason against adopting the lower market value. Uncertainty as to the ultimate price to be realized for unsold goods furnishes no more and no less justification, in logic and in practice, for registering an estimated loss in the income of a given period than it does for registering an estimated profit.

Formerly, the apologists of this valuation rule, while admitting its fundamental inconsistency and lack of sound basis, defended it solely on grounds of expediency, declaring it a precautionary measure against the danger of over-estimating profits. The valuation rule arose in times when the practice was quite prevalent of over-estimating the value of the assets, thereby over-estimating the profits; in times when the fear of profit inflation exercised a powerful influence upon the teachings and practice of accountants; in times when courts of law, desiring to protect investors, were inclined to limit the concept of commercial profits to profits which had been actually realized or to profits which were available for dividends. It was not foreseen that the time would come when the opposite tendency would involve greater and more serious abuses, through under-statement of assets and profits. In these days of high rates of taxation upon annual net income, there is not the same need for accounting expedients designed solely to prevent over-statement of profits.

The London committee, as we have seen, claims to have discovered a “principle” and a “perfectly sound theory” by which to explain the discrimination which pervades this valuation rule.
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Unfortunately, the committee's theory is itself of dubious validity; and, further, whether valid or not, it furnishes no ground whatever for the discrimination.

For if, as the committee says, "profits can only be realized by the sale of commodities," then the converse of the proposition is equally true: "losses can only be sustained by the sale of commodities." Again, if "no profits can arise by mere increase in value unaccompanied by a sale," then it is equally correct to add: "no losses can arise by mere decrease in value unaccompanied by a sale." (Of course, we assume that no physical deterioration has occurred.) To expand the committee's theory by these logical additions is to destroy it as an explanation of the valuation rule. Incidentally, it is surprising to find the committee clinging to the old idea that a profit must be "realized" before it may be taken in the income account.

Further, the working of this valuation rule does not prevent, necessarily, the registration of profits in the income account of a given period in regard to unsold goods nor prevent the registration of "mere increase in value unaccompanied by a sale" in the income account, which the committee finds so obnoxious. For both these events would take place, in the case of goods which had been on hand for some time, when a rise in quoted prices occurred after a previous fall in quoted prices had been registered in the income account of a former period as a loss.

Having disposed of the theory of the London committee as a defense of the illogical discrimination which results from adopting the valuation rule of cost or market price, whichever is the lower, it is time to examine the merits of the theory itself. The first dictum is that, in the case of commodities, "profits can only be realized by sale." As we are not dealing with realized profits but accruals of income, we may give this phrase the benefit of amendment to read "in the case of commodities no profit may be taken into the income account until they are sold or otherwise disposed of." Even in this amended form, the doctrine is denied by high accounting authority, notably by Professors Paton and Stevenson in their exhaustive review of the subject contained in Principles of Accounting, edition of 1919, chapters X and XX. Further, in the case of commodities produced from the soil by cultivators and natural resources extracted from mines, oil wells,
timber lands, etc., by operators, the dictum of the committee is against the weight of custom and common opinion. Nor, in the case of manufactured goods which have reached their marketable form, is the dictum free from serious objection.

In regard to the second observation of the London committee—that no profits may be implied from increase in value of unsold commodities—we must assume that it refers to commodities which have not changed their original form, for the increase must refer to definite unchanged articles. Within this limitation, and so far as it involves any appreciation in value of commodities acquired and retained in their original form over the value which existed at the date of acquisition, there is no doubt that the weight of legal opinion sustains the view that accrued appreciation of property in its unchanged form should not be taken into the income account prior to its realization.

It seems to us, however, that both the advocates and the opponents of the idea that no profits or losses may be implied in respect of undeteriorated goods which have not been marketed (in other words, the advocates and the opponents of the valuation rule of original cost) are alike mistaken in seeking uniform rules for unsold goods of every sort and kind, regardless of the conditions under which the goods are acquired. It does not follow, necessarily, that the same basis of income reckoning and, consequently, the same valuation rule are applicable to (a) goods purchased for resale in their original form, or for use in manufacturing and productive processes and facilities, and (b) natural products or natural resources put into marketable form by cultivators and operators.

The valuation rule of original cost when applied to the unsold goods of traders, dealers and merchants whose business it is to purchase commodities for resale in their original form is a sufficiently workable and satisfactory rule. The objection which has been made to the valuation rule of original cost, namely, that this cost has no present significance and may not measure the true economic resource at the present disposal of the owner, loses much of its force in this case, for, as these unsold goods are usually deemed to be those most recently purchased, their cost usually represents more or less current values. By adhering to this valuation rule of original cost for the unsold goods of
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traders, etc., one avoids a practice condemned by the weight of legal opinion, namely, that of taking into income an accrued appreciation in the value of property prior to its realization. Another advantage of adopting this valuation rule for this class of goods is that original cost is readily determinable in most cases; further, that it establishes a fair measure of equality and price uniformity throughout a given industry. Finally, as the spread between original cost and cost of replacement is not usually large in these cases, the argument for the latter basis of valuation becomes theoretical rather than practical.

The effect upon the income account which is reached by applying to unsold goods the valuation rule of original cost is to measure the profits or losses of a given period by the amount of sales within the period and to allot profits only to periods in which sales are consummated. In the case of traders, dealers and merchants whose business it is to purchase commodities for resale in their original form, this emphasis upon sales as the controlling factor in the accounting scheme is natural enough, for selling is the predominant feature of the merchant's business; he thinks and operates in terms of sales; his business ceases when there are no sales; and it would be unnatural for him to keep his accounts and measure his costs and profits and losses in any other terms than those of sales.

A complete antithesis to this situation is presented in the case of producers of natural products of the soil or producers of natural resources extracted from mines, oil wells, timber lands, etc., operating on their own premises. With these producers, the marketing of the product is usually a secondary and incidental matter, and the primary consideration is volume of production. The predominant feature and main effort of their business is production; they think, act and operate in terms of units and measures produced; when production ceases their business is in liquidation; and they measure their costs, their profits and their losses in terms of production.

As a rule, the producer markets his product more or less currently, at publicly quoted prices; and a normal profit or loss may be reckoned with a reasonable degree of approximation on the year's production, even though some of it may not be marketed until the following year. If the producer does not choose to
market his product currently and allows it to accumulate, it is in the nature of a speculation, usually—and the result of this speculation is a separate matter, not to be confused with the normal profit or loss on the year’s production with which the producing business was entitled to reckon.

It would involve curious economic ideas to suppose (for illustration) that during periods of wide margin between cost of production and selling prices, highly lucrative production of metals from a mining property might continue indefinitely without resulting in any earnings to the enterprise, so long as no metals were sold and they were allowed to accumulate.

It would appear, then, that in the case of these producers of natural resources, etc., profit or loss attaches during the period of production to all the product which has been put into marketable form, whether actually marketed or not. The product which has not been marketed, that is to say, the product corresponding to the unsold stocks of merchants, should be taken into the account of the period at its “fair value to the going concern.” Only by doing so is it possible to give to the period in which the main effort and service were rendered a fair and commensurate return.

By “fair value to the going concern” we mean (a), in the case of products under contract of sale for delivery in the future, the selling price after making due allowance for unpaid charges and (b), in the case of the remaining product unsold, a reasonable estimate of its fair value, based upon good judgment of market conditions and with due allowance to cover the unpaid charges and the risks intervening before it will be marketed.

Not only does the nature of these operations require that such unsold commodities should be taken into the income account of the production period at their fair value to the going concern, and not at their original cost, but practical considerations exclude the latter basis. The first of these is the difficulty, frequently the impossibility, of ascertaining the original cost. Again, this cost frequently has no present significance and varies widely from more or less current values. Finally, the use of original cost, even when it can be determined, would present an extraordinary extent of price variation for the same commodities in the same industry.

Unsold manufactured goods which have been put in market-
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able form present many analogies, frequently, to unsold commodities which have been produced from natural resources by cultivators and operators. The main effort and service which were required to bring these manufactured goods into their commercial form were expended usually during the period of production. The effort and service of the period during which goods are fabricated are entitled to commensurate reward within the period itself—this commensurate reward applied to the entire completed output, including the portion unsold. For this reason, the unsold fabricated goods which have reached complete marketable form should be valued in the income account without regard to original cost.

It is to be noted that in applying the valuation rule of "fair value to the going concern" to natural commodities which have been put into marketable form by cultivators and operators, but have not been marketed, and in applying the same rule to manufactured goods which have been fabricated in complete commercial form, we are not brought in conflict with the prohibition against taking into the income account a mere increase in value of property, for, as we have seen, this prohibition applies, necessarily, only to goods which have not changed their original form.

In conclusion: the business of merchandising and trading has its own accounting scheme, which is governed naturally by the emphasis upon selling. The business of the producer of nature's commodities has a different accounting scheme, which is governed naturally by the emphasis upon production. The business of the manufacturer occupies an intermediate position, dependent upon the particular circumstances of the case and whether the emphasis is upon selling or upon production. The rules for ascertaining the net revenue of a given period, so far as they relate to the value to be placed upon unsold goods, are not necessarily, or even naturally, alike for each of these three classes. The valuation rule to be adopted for a given class of goods should depend upon the character of the business, the nature of the controlling accounting scheme and the manner in which the unsold goods were acquired—whether by purchase in their original form, by extraction from the earth or by manufacture.