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## Accounting Questions: Retail Method of Inventory

American Institute of Accountants. Bureau of Information

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## ACCOUNTING QUESTIONS

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### RETAIL METHOD OF INVENTORY

#### Question

Would you be good enough to obtain an expression of opinion upon the following matters relating to a department store whose accounts are kept upon the retail method?

1. Should cash, as well as trade discounts, be deducted from inventory at end of year?
2. The company reduces its inventory from retail to cost in the usual manner by eliminating the mark-on. Should an additional reserve then be deducted from the inventory at the end of the year to provide for subsequent mark-downs which must in the ordinary course of business be taken before the merchandise then on hand is sold?

#### Answer No. 1

In response to your letter containing an inquiry concerning certain matters of procedure where the retail method of inventory is used by a department store, we reply:

1. The reserve provided for the purpose of excluding discounts from inventory should include both trade and cash discounts. For the purpose of arriving at the amount of the reserve the percentages of discounts to cost of merchandise purchases received in the season immediately prior to the date of the inventory should be applied by departments to the physical inventory at cost. The computation should be made by departments because of the variations which exist in the rates allowed in respect of different types of merchandise.
2. After reduction of the inventory from retail to cost or market no reserve is required for the subsequent mark-downs which will be taken in disposing of the merchandise, assuming that the inventory is in

good condition and does not include an undue proportion of prior seasons' stock. Provision is automatically made for these by the use of the complement of the original percentage of marking to arrive at the cost or market figure. Generally speaking, the cost or market figure of an inventory would be one which would provide the normal rate of gross profit, or margin, upon sale. The complement of the original percentage of marking provides a larger spread between cost or market and selling prices than does the complement of the percentage of gross profit and therefore allows for the normal losses from mark-downs and shortages which may be expected to be suffered in disposing of the inventory at a normal gross profit. As previously indicated, this all applies to an inventory in good condition. Should the composition of the inventory be unsatisfactory due to the presence of an undue amount of old merchandise, particularly in the fashion departments, or to purchases in excess of requirements, consideration should be given to the provision of a reserve for mark-downs in excess of normal which will result. The percentage of such a reserve to the inventory should be determined in light of conditions existing.

#### Answer No. 2

Replying to your inquiry, in our opinion cash as well as trade discount should be deducted from the inventory at the end of the year through a reserve for discount.

In our opinion the proper method would be to value the inventory generally at the lower of cost or market, anticipating all mark-downs which it was believed at the time of the inventorying would have to be taken prior to the sale of the merchandise.