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Inventories

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INVENTORIES*

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The importance of inventories has been recognized for centuries. Initially, they were significant primarily for property tax purposes; however, they are also essential in accounting for results of operations during any stated period representing only a portion of the life of an enterprise. More recently, the emphasis has been upon their effect in the determination of income for tax purposes.

There are many aspects of the subject, and there is an observable tendency in the literature to use loose terminology, except as regards the specific points being developed. When the subject is approached from the technical standpoint of inventory determinations to be used in establishing liabilities for income taxes, care in the use of words is particularly important. The keynote might be "Watch your language!"

Meaning of the Term "Inventory"

The word "inventory" has many different meanings. It can be used to refer to the stock on hand at a particular time of raw materials, goods in process of manufacture, finished products, merchandise purchased for resale, and other tangible assets which can be seen, weighed, and counted. As a verb, the term refers to the acts of weighing and counting and preparing a list with appropriate descriptions. An itemized list of any type of property can itself be referred to as an inventory. In connection with financial statements and accounting records, the term is used to refer to the amount assigned to the aggregate stock of goods owned by an enterprise at a stated time.

The physical aspects of an inventory are more significant than the financial aspects to the majority of the employees in a business organization. Production departments are concerned about having material available when needed. Salesmen need the assurance that merchandise will be available to fill orders. At inventory taking time, almost every employee may be pressed into service. Some will recall working on weekends or holidays, whenever the word "inventory" is mentioned.

The importance to over-all profitability of maintaining the optimum quantity of the numerous items needed in the conduct of the business cannot be overemphasized. It has been found in some cases that savings

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can be effected equal to fifteen per cent or more of the cost of excess quantities by reducing the physical volume of the inventory.

Regardless of the procedure followed in allocating a particular amount to the inventory for financial purposes, the quantity of goods on hand is the starting point. The cause and effect relationship flows from the physical quantities to the dollar amounts and not vice versa.

Not every item thought of as part of the inventory from the standpoint of business operations or from the standpoint of financial statements is technically so considered for federal income tax purposes. The federal income tax regulations provide that the inventory should include

> all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein.[1]

On the basis of this statement, the contention has been made that the general rules applicable to inventories cannot be applied to materials and supplies consumed in manufacturing operations, but which do not physically go into the articles to be sold. When the inventory regulations are next revised, it is hoped that the scope of the definition will be broadened so as to conform to generally accepted accounting practice. Prior to 1933, the income tax regulations provided for including in inventories "raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes together with all finished or partly finished goods." In *Aluminum Co. of America v. United States*,[2] a case involving the determination of tax for the calendar year 1920, the earlier regulations were construed to permit the statement of inventories of supplies at the lower of cost or market.

In talking of the financial aspects of an inventory, it is common to use the term "valuation." The general use of this term has contributed to a great deal of confusion. In the majority of instances, the amount assigned to a particular inventory is fundamentally a determination of *cost*, consistent with an accounting concept for deferring expenditures, rather than a determination of *value*.

There are times when the value of an inventory is of primary significance. For example, where there is to be a forced bulk sale when liquidation of a business is contemplated, the value is the only significant figure. This value will be the amount that a purchaser will pay for all of the goods on hand. Value is also significant when a sale of a continuing business is contemplated. For this purpose, the value of the inventory is normally the aggregate of the replacement cost for

[1] Treas. Reg. §1.471-1 (1958).
[2] 24 F. Supp. 811 (W.D. Pa. 1938).

the individual items on hand which will be useful to the purchaser, plus the scrap value of excess quantities and obsolete items.

Just as there are various concepts of value, there are various concepts of cost. For purposes of establishing selling prices, all amounts expended in the conduct of the business must be recovered in the proceeds of sale in order to make a profit. It is unimportant for this purpose whether expenditures are technically a cost or an expense, but the word cost is frequently used to embrace the total. Categorizing expenditures is important, however, when the cost of an inventory is being established for the purpose of determining income derived from business operations during a stated period. This is the task most commonly involved with respect to inventories, and a great deal of confusion could be avoided if habit could be changed to always refer to the cost of the inventory rather than its value. In applying the generally accepted practice of assigning an amount to an inventory which represents the lower of cost or market, there is a combination of two concepts. Even in the application of this rule of conservatism, however, a cost for the preponderance of the items will be included in the compilation rather than value.

Meaning of the Term "Market"

There is no single concept of "cost" which will be the most meaningful in all situations. Similarly, there is no universally accepted basis for determining "market." A recent pronouncement by the English Chartered Accountants recommends that the use of the term "market value" be discontinued.[3] The most commonly used terms when elaborating on the concept of market are "replacement price," "net realizable value," and "net realizable value less normal profit."

"Replacement price" or "replacement cost" is the amount for which in the ordinary course of business, the inventory items could have been acquired or produced either at the inventory date or during the last operating period. Recognition is to be given to the volume in which the company usually purchases the various inventory items and to the normal sources of supply.[4]

"Net realizable value" represents the amount at which the inventory items are offered for sale in the regular course of business less any direct expenses of disposition. This determination requires giving recognition to all available information, including changes in selling prices subsequent to the inventory date. Consideration must be given to future prospects for disposing of the inventory, having regard to the quantity and condition of the goods on hand.

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[3] Council of the Institute of Chartered Accountants in England and Wales, Recommendation No. 22, Treatment of Stock-in-Trade and Work in Progress in Financial Accounts.

[4] Treas. Reg. §1.471-4(a) (1958).

"Net realizable value less normal profit" represents the amount remaining after allowing for the profit which the particular business can generally be expected to realize from the sale of the items included in its inventory.

The general rule in the regulations that, under ordinary circumstances and for normal goods in an inventory, cost is to be compared with replacement price has been the subject of recent litigation. The case of *D. Loveman & Son Export Corp.*[5] involved a warehouser who had purchased steel from a premium mill during a period of steel shortage. The major producing mills were selling their production to larger customers. The warehouser valued steel on hand at the posted prices of the major producing mills, which were lower than its cost. Where the steel was ultimately sold at a price in excess of the amount paid to the premium mill, the posted prices of the major producers were held not to represent "market." This case also considers the appropriate treatment of "freight-in" expenditures. The Tax Court held that transportation expense had to be added to the cost of the steel to reflect income clearly. The inventory volume had fluctuated widely in this case, so the decision should not be applied to a situation involving an established accounting practice of consistently considering "freight-in" as a current expense where there are only normal fluctuations in annual inventories.

The federal income tax regulations recognize that net realizable value may be the appropriate amount to be assigned to an inventory item.[6] Replacement cost of work in process and finished goods (or articles bought for resale) does not constitute market where it exceeds what can be realized upon sale in the ordinary course of business.

Recently, in the case of *Space Controls, Inc. v. Commissioner,*[7] the Internal Revenue Service forced a manufacturer to litigate its right to use net realizable value in applying the lower of cost or market rule to raw materials and work in process. A government contract was awarded the company during June 1956 for 382 military light cargo trailers. The trailers were of a special military design and were not suitable for commercial or civilian use. Apart from the contract, their market value would be as scrap. At the end of the year, only ninety-six units had been completed and shipped, but substantially all of the material for the completion of the contract had either been acquired or ordered. The material was not suitable for use on other contracts. The court of appeals emphasized that the expenditures which caused the inventory to have a cost greater than the contract sale price were made

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[5] 34 T.C. 776 (1960), *aff'd,* 296 F. 2d 732 (6th Cir. 1961), *cert. denied,* 369 U.S. 860 (1962).
[6] Treas. Reg. §1.471-4(b) (1958).
[7] 322 F. 2d 144 (5th Cir. 1963), *reversing and remanding* 31 P-H Tax Ct. Mem. 336 (1962).

during the taxable year. This is not a case of an allowance of a tax advantage for amounts neither spent nor incurred until the following year.

The regulations also provide that whether cost or the lower of cost or market basis is used, the amount assigned to goods which are "unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange"[8] should not exceed net realizable value. It is further stated that if the inventory items unusable in the normal way "consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value."[9] Therefore, in applying the rule of lower of cost or market, the scrap value of the particular items included in the inventory constitutes a minimum amount.

Meaning of the Term "Cost"

Although many volumes have been written dealing with the subject of cost accounting and the appropriate amount to be assigned to inventories for financial statement purposes, the federal income tax regulations contain only a few general paragraphs to state the meaning of the term "cost."[10] In the case of merchandise on hand at the beginning of the taxable year, cost means the inventory price for such goods. In the case of merchandise purchased since the beginning of the taxable year, cost means the invoice price less trade or other discounts (except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed) *plus* transportation or other necessary charges incurred in acquiring possession of the goods. In the case of merchandise produced by the taxpayer since the beginning of the year, the general rule is that cost means the aggregate of

> (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.[11]

Recognition is given to trade practices of industries in which the general rules are inapplicable. Among these exceptions are farmers and raisers of livestock; miners and manufacturers who by a single process or

8 Treas. Reg. §1.471-2(c) (1958).
9 *Ibid.*
10 Treas. Reg. §1.471-3 (1958).
11 Treas. Reg. §1.471-3(c) (1958).

uniform series of processes derive a product of two or more kinds, sizes, or grades; and retail merchants who use what is known as the "retail method" in ascertaining approximate cost.

Use of general language in the income tax regulations is a recognition of the fact that there is no single concept of cost which is appropriate in all businesses. Although somewhat more detailed, the pronouncements on this subject by the professional accounting organizations are also stated in general terms.[12]

Whether items are purchased or manufactured, it is not uncommon to begin with a single average based on the total cost for the lot, but to make redeterminations of the cost allocable to units on hand at inventory time. For example, a retailer may have purchased three dozen novelty toys at six dollars per dozen and sold thirty at one dollar each before the demand slackened. The six remaining at inventory time will have to be sold at thirty-five cents apiece, and the profit realized from the thirty units will be overstated if a cost of fifty cents per unit is allocated to the inventory. When a shipment of merchandise is received (or a production order is completed), it may be expected that some units will be unsalable at normal prices or unsalable in the normal way. Which or how many units will be ultimately involved in an adjustment at inventory time is unpredictable. For convenience, all units are commonly assigned the same cost. Such a cost allocation is a tentative expediency. After the major portion of the lot has been disposed of in the normal manner, a correction must be made. The correct cost for the units on hand at the inventory date cannot exceed net realizable value, and any difference is an adjustment of the cost tentatively assigned the units which have been sold. Usually, the sales will have occurred during the period ending with the inventory date, so there is no occasion to consider an amended tax return or other retroactive changes. Even if some of the sales were made in prior periods, the adjustments would normally fall within the category of lap-over items and not distort income. In this type of situation, net realizable value is not technically being used to state the inventory at the lower of cost or market, but rather to state properly the cost of the various units.

Applying this same principle, if second-hand units cannot be sold for an amount equal to the credit allowed on a trade-in, there is no writedown to market involved when the cost of those in an inventory is restated at the net realizable value. There is actually an adjustment of the originally computed profit on the earlier sale which resulted in the acquisition of the used merchandise.

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[12] See COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 43, ch. 4: *Inventory Pricing*; COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES, *op. cit. supra* note 3.

Inventory Amounts Represent Deferment of Expenditures

The basic accounting principle in the measurement of net income involves the assignment or "matching" of costs against related revenues. There is carried forward the unabsorbed costs properly chargeable against future sales. This point has been succinctly stated in the following terms:

> The primary objective in accounting for those items which are subject to inventory accounting is to assure a proper charge against revenue in the determination of periodic income in accordance with the concept of income by which the accounting is governed. This involves (a) a proper matching of costs against the revenues that are attributed to the period and (b) the elimination of such part, if any, of the remaining costs as is found to be in excess of the useful costs properly chargeable against future periods.[13]

The general rule is that in assigning amounts to an inventory, recognition should be given to the cost of the particular goods on hand. In practice, however, numerous exceptions have developed as a consequence of practical considerations, as well as a result of applying differing principles of income determination. The first exception, the use of average costs, is so common that it is frequently not thought of as constituting an exception. Actually, there are many different ways in which an average can be computed; *e.g.*, weighted average, moving average, and averages for a particular period. Specific identification of cost with each individual unit is time consuming even where it is feasible. It is most commonly used with respect to high-value, low-quantity items. There may be unique items, or items required for a particular job or customer. Where there is a large quantity of similar units having different costs, a business is no better or worse off, depending on which of the units were taken to fill a particular order. Differing profit amounts should result from real economic differences and not from arbitrary decisions by management.

Another type of exception to the general rule about identifying individual costs with specific items is reflected in the use of an assumption as to the flow of goods. During recent years, there has been an increasing emphasis placed upon the last-in, first-out assumption. Although this will differ from the actual fact in many cases, it is no more arbitrary than the assumption that the flow of goods follows a first-in, first-out pattern.

In thinking of the deferment of expenditures by allocation of amounts to inventories, the commitments represented by liabilities are treated the same as actual payments. This is necessary not only in order

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13 May, *Inventory Pricing and Contingency Reserves: Comment on New Accounting Research Bulletins*, J. Accountancy, Nov. 1947, p. 366.

to reflect the true financial position of the business, but also to give recognition to all expenses which have been incurred during the period.

Inasmuch as the allocation of a dollar amount to an inventory reflects a deferment of an expenditure, it is basic that an actual expenditure or a commitment resulting in an accrued liability is a prerequisite to the allocation. From the standpoint of the determination of the cost of an inventory for federal income tax purposes, no amount should be included which does not constitute at least an accrued obligation under the federal income tax rules. For example, it would be inappropriate to include any portion of a provision for vacation pay not recognized as an accrued liability for tax purposes in determining the cost of goods included in an inventory.

Subject to the adoption of an acceptable practice as to the averaging of costs and a stated assumption as to the flow of goods, there is generally little difficulty encountered in determining the appropriate amount to be allocated to an inventory for the cost of materials purchased and expenditures for direct labor. Greater differences of opinion exist with respect to overhead.

Expenditures which do not aid in a productive activity are never part of overhead includable in cost computations; and the extent that other expenses are included in any particular instance will depend upon such factors as the complexity of the organization, the attitude and sophistication of the individuals compiling and using the economic data, and the availability of information. Not every business has electronic data processing equipment to analyze its expenditures. Costs are computed to meet a situation, and no one amount can be said to be "correct" to the exclusion of all others.

Although many types of classifications of business expenditures are in use, it has been found that a clearer concept of the factors affecting the operating results of a particular period can often be obtained if all expenditures are classified as (a) prime costs, (b) controllable expenses, (c) recurring expenses, and (d) continuing expenses. In this type of analysis, if the entire amount expended for an asset consumed, lost, or disposed of is deductible from revenues of a period, it would be denominated a prime cost; but if only a portion of the cost of an asset is allocable to the period (*e.g.*, a provision for depreciation), the deductible amount would be classified into one of the three types of expenses. Controllable expenses are those incurred as a result of a current (or continuing) decision of management; recurring expenses are those necessary to keep the business operating, even on a minimum basis; and continuing expenses are those which have resulted from a decision of management in a prior period.[14]

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[14] This approach to the classification of business expenditures is developed in

There are several viewpoints as to the extent to which the expenses relating to production should be included in cost as a matter of principle. At a risk of oversimplification, the alternatives for inclusion of overhead in production costs may be grouped broadly in four classes:

1. Prime costing, under which no overhead is included.
2. Direct costing, under which controllable expenses directly attributable to production are included, but no fixed overhead is included.
3. Analytical costing, under which overhead expenses attributable to production are included, except for the portion not taken into account because of the production facilities not being fully utilized.
4. All-inclusive costing, under which the entire amount of overhead expense attributable to production is included.

Circumstances may make it appropriate and useful to apply procedures falling into any of these four categories in preparing statements and reports for management purposes; and management should understand what procedures have been followed. If the computed costs are utilized in determining selling prices, this is particularly important. The business will show a profit only if the revenues realized are adequate to cover the aggregate of all costs and expenses regardless of how individual expenditures are classified.

Prime costing is applied most frequently where the magnitude of the overhead expenses makes them of little relative importance. It has the advantage of simplicity.

Direct costing and analytical costing procedures are premised, in part, upon a recognition of the fact that in addition to controllable expenses, the items of overhead include recurring expenses which are necessary to provide the capacity to carry on production activities, and continuing expenses resulting from decisions previously made to secure the production facilities which are available for use. Assumption of a certain level of recurring and continuing expenses is essential to being in a position to carry on any production activities. During a particular period, however, production may be all or only a part of the total possible with the available capacity. The question is: how much of the expenses required to provide the existing capacity to produce should be considered as part of the cost of the actual production?

Under a direct costing procedure, none of the recurring and continuing expenses is included in cost. The reasoning is that the expenses were incurred as a consequence of decisions which had nothing to do with any particular units of production, that they would have been incurred whether or not any specific units had been produced, and that corresponding amounts of expense will be incurred in subsequent

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HOFFMAN, INVENTORIES: A GUIDE TO THEIR CONTROL, COSTING AND EFFECT UPON INCOME AND TAXES (1962).

periods regardless of the quantity of the current production. The practice of not including in overhead certain items considered to be period expenses is a partial application of the direct costing principle.

Under an analytical costing procedure, the recurring and continuing expenses are included in the computations of cost on the basis of a comparison between the actual rate of activity and a predetermined norm. Expenses for a particular period are included in cost to the extent they are allocable to the fraction of the available capacity which was actually utilized. The portion of the expenses allocable to the unused capacity is considered to represent a loss. This is an economic loss attributable to the level of production set by management during the period and is not part of the cost of the units actually produced.

All-inclusive costing is most frequently applied in smaller enterprises where detailed analyses of the various expense accounts are not available. It may also be appropriate where a plant is consistently operated at a capacity rate or where the aggregate amount of overhead is relatively small. It shares with prime costing the advantage of simplicity. There are almost always some elements of overhead attributable to events which are not customarily a part of plant operations, and the all-inclusive costing concept will not be literally applied where the amount of expense resulting from such events can be identified. Examples of events which could justify special recognition in determining the overhead expenses to be included in cost computations are: shortages of materials; receipt of defective materials; labor slowdowns and strikes; and interruptions of production caused by a flood, fire or other casualty. In a business which does not have a regular program for model or product changes, special recognition might also be given, even under an all-inclusive costing concept, to the effect upon expenses of disruptions caused by such factors as the introduction of a new product, the training of an expanded labor force, and the realignment of facilities incident to equipping a plant to manufacture a different product.

Principles of Inventory Costing

Except for additions and revisions necessitated by recognition of the last-in, first-out (LIFO) method, there have been no substantive changes for many years in the sections of the Internal Revenue Code and income tax regulations pertaining to inventories.[15]

The Internal Revenue Code contains the general requirement that "whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer."[16] This section of the law concludes with the requirement that the inventories be taken on the basis which is prescribed by regulations "as conforming as nearly

[15] INT. REV. CODE OF 1954, §§471, 72; Treas. Reg. §§1.471-1 to -9, 1.472-1 to -8.
[16] INT. REV. CODE OF 1954, §471.

as may be to the best accounting practice in the trade or business and as most clearly reflecting income."[17] This statutory provision is recognized in the regulations by the conclusions that (1) inventory rules cannot be uniform and (2) an inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

All of the authoritative pronouncements on the subject of accounting for inventories uniformly emphasize that greater weight is to be given to consistency than to the use of any particular method. However, when the use of an inventory practice is questioned and the defense is consistency in application, as in the cases of *Birmingham Elec. Battery Co. v. United States*[18] and *E. W. Bliss Co. v. United States*,[19] the taxpayer must also show that recognized accounting principles have been applied.

Even where there is doubt as to the current acceptability of the practice, consistency will be a particularly strong defense if the Commissioner has granted permission to the taxpayer to use a certain method of accounting.

Permission may be implied by approval of the accounting method by field representatives of the Internal Revenue Service. Among cases so holding are: *Geometric Stamping Co.*,[20] involving the recognition of only prime costs for inventory purposes; *Klein Chocolate Co.*,[21] involving the use of a single LIFO pool prior to the natural business unit philosophy being incorporated in the regulations; and *APCO Valve Co.*,[22] involving the use of standard costs which had not been changed for approximately fifteen years. The last of these cases is also significant for the fact that the Tax Court implied that either of two computations would be acceptable as clearly reflecting income for 1954, even though there was a difference of $32,415. This is a relatively important difference, since the income was only $119,878.82 as disclosed by the return and only $157,684.38 as adjusted in the deficiency notice.

The strength of the defense of consistency is shown in the case of *Fruehauf Trailer Co.*,[23] recently decided by the Tax Court, and which may be appealed. The calendar years 1954-1956 are under review in this proceeding, and the major issue is whether the inventory basis can be changed from a one-dollar-per-unit to a lower-of-cost-or-market method. Since 1918, the company has been primarily engaged in the manufac-

[17] *Ibid.*
[18] 11 Am. Fed. Tax R. 2d 1036 (N.D. Ala. 1963).
[19] 224 F. Supp. 374 (N.D. Ohio 1963).
[20] 26 T.C. 301 (1956), *acq.*, 1958-1 CUM. BULL. 4.
[21] 32 T.C. 437, 36 T.C. 142, *acq.*, 1961-2 CUM. BULL. 4.
[22] 31 P-H Tax Ct. Mem. 1800 (1962), *appeal dismissed per stipulation*, P-H 1963 FED. TAXES ¶56,446 (7th Cir. Aug. 9, 1963).
[23] P-H 1964 TAX CT. REP. & MEM. DEC. ¶42.6 (T.C. April 13, 1964).

ture and sale of commercial truck-trailers. In about 1926, it first began to acquire used trailers by trade-in and repossession. At that time and for several years thereafter, it was not feasible to establish either the cost or the market value for used trailers, and the taxpayer adopted the practice of inventorying them at one dollar each. This practice was accepted by Internal Revenue agents for all years prior to 1942. When the returns for the years 1942 through 1945 were audited, it was determined that used trailers should be inventoried at the lower of cost or market value. The company acceded to this, but in 1950 the office of the Commissioner of Internal Revenue decided that the taxes should be recomputed using the one-dollar-per-unit method. The Tax Court held that while a change in inventory method must be made, beginning with the calendar year 1954, section 481 of the Code is to be applied so that no tax will be payable on the amount of the increase resulting from the restatement of the inventory on December 31, 1953.

The *Fruehauf Trailer Co.* decision is particularly significant because it reaffirms the well-established principle that where the closing inventory of a particular taxable year is determined on a certain basis, the opening inventory for that year must be determined on the same basis to clearly reflect income.

The argument of consistency was of no avail in the case of *Frank G. Wikstrom & Sons, Inc.*[24] where the first year of the taxpayer's operations was involved in the litigation. The Commissioner of Internal Revenue was alleged to have erred by not accepting the taxpayer's consistent method of inventorying, by including overhead expenditures in the closing inventory without making the same adjustment to the opening inventory, and, in any event, by including in overhead such items as taxes and depreciation which are proper deductions from gross income. As a sole proprietor, the controlling stockholder of the taxpayer corporation had been engaged for many years in the design and fabrication, modification, servicing, and repair of special machinery, machine tools, dies, jigs, and fixtures, exclusively on specific contract, to the requirements or specifications of his customers. As of July 1, 1947, all of his business assets were transferred to the corporation in exchange for all of its stock. The business and accounting methods were continued without change. Among the accounting procedures continued by the corporation was the inclusion in cost of only direct labor and material charges attributable to specific contracts. All other charges were treated as general expenses deductible from revenues of the year in which incurred. Commencing with the calendar year 1947, the Commissioner allocated to the closing inventory a portion of the total overhead expenses (officers' salaries; rent; taxes; depreciation; repairs; light, heat, and power; insurance; employees' welfare; factory stores;

[24] 20 T.C. 359 (1953).

indirect factory labor; vacation, holiday, and bonus pay; freight inward; and "miscellaneous") based upon the relation of the number of production hours represented in the closing inventory to the total production hours of the year. This procedure may be characterized as "all-inclusive costing with a vengeance," but the amount of the overhead expenses could not have been great. The inventory adjustment on December 31, 1947, was only $4,932. It was only $5,982.54 on December 31, 1948, and $7,918.26 on December 31, 1949.

With reference to the consistency argument, the Tax Court held that the provisions of the law and regulations relating to a change in inventory or accounting methods have no application where the Commissioner makes adjustments in the very first year of the taxpayer's existence; further, it was stressed that the corporation took over the inventory of its predecessor in a nontaxable exchange and the basis for all the assets so acquired is the same as that of the predecessor. Since 1954, the federal income tax law has provided for the continuation of a predecessor's inventory method after certain types of nontaxable exchanges, but this section does not apply to exchanges representing transfers of assets to controlled corporations.[25]

The *Frank G. Wikstrom & Sons, Inc.* decision does not hold that all-inclusive costing is *the* inventory method. The concluding paragraph of the opinion, quoted below, expressly recognizes that there are other acceptable inventory methods:

> The Code and Regulations are somewhat elastic on the subject of inventories but where, as here, the Commissioner has made a determination in regard to inventories in the very first year of the taxpayer's existence, which determination is presumed to be correct, the taxpayer must show by the evidence that the Commissioner has gone beyond his authority under the Code and Regulations and the taxpayer's own method is a proper one thereunder. The petitioner has failed to advance any sound argument supported by evidence for disturbing the determination of the Commissioner in this case and the Court leaves the parties as it found them, without attempting to lay down any broad principles applicable to inventories generally.[26]

With reference to the contention that such items as taxes and depreciation should not be included in overhead for inventory purposes because they are "deductions from gross income," the Tax Court merely comments that if carried to its logical conclusion the argument would throw out the entire adjustment made by the Commissioner, and the petitioner did not seek such a result. Further, it is observed that the evidence does not show that the taxes and depreciation charges selected for inclusion by the Internal Revenue agent were not indirect expenses

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[25] INT. REV. CODE OF 1954, §381(c)(5).
[26] 20 T.C. at 362-63.

incident to and necessary for the production of the particular articles included in the closing inventories. The small amount of federal income tax resulting from the inventory adjustments could account for the limited extent to which evidence was submitted on behalf of the petitioner.

Related to the question of including in costs allocated to inventories amounts which are specific deductions in computing taxable income is a ruling issued in 1958 concerning amortization of emergency facilities.[27] This ruling states that a taxpayer who uses depreciation as part of inventory costs must also include that portion of the charge for amortization of emergency facilities which is equal to the depreciation that would have been included in inventory costs had the facilities not been subject to amortization. Under these circumstances, any amortization in excess of depreciation constitutes a current allowable deduction from gross income.

What Should Be Done?

Every businessman should know what he owns, and appropriately designed inventory controls will increase operating efficiency. Where accurate quantity determinations have not been made, there is a very *real* inventory problem from the standpoint of federal income taxes. This type of problem can be corrected merely by compiling accurate quantity data at the next succeeding year end. The proper recognition of inventory quantities at any year end will correct for prior errors.

Whenever an inventory procedure is determined to be inappropriate in a particular circumstance, there is a tendency to classify whatever revisions are necessary as being either a change in accounting method or a correction of an error. The attempt to classify the revisions in this manner tends to make inventory practices rigid. Most revisions are merely normal evolutionary refinements. Refinements are necessary in any dynamic business organization and should be encouraged.

Many of the problems in this area would be solved if there was general acceptance of guidelines of conduct somewhat as follows:

(a) Taxpayers will not effect any change in accounting method without securing advance permission to make the change, exclusive of such changes (for example, adoption to LIFO) as do not require obtaining the consent of the Commissioner.

(b) Internal Revenue Service representatives will not initiate a change in accounting method or attempt to make a correction of an error unless the resulting adjustments would be both material in amount and significant when considered in relation to the income as otherwise determined.

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[27] Rev. Rul. 58-181, 1958-1 CUM. BULL. 238, which contains a reference to Rev. Rul. 141, 1953-2 CUM. BULL. 101, concerning the use of depreciation as part of inventory costs in determining gross income.

(c) It will be conceded that the federal income tax effects of a change in accounting method will be governed by section 481 of the Internal Revenue Code.

(d) Taxpayers will be encouraged to make such refinements in their inventory practices as are motivated by the exercise of bona fide business judgment.

A program of this type could be accepted in practice without ever being stated in technical language. It would be very helpful, however, to eliminate apprehension over businesses being hamstrung in their efforts to adopt more efficient inventory control methods. The encouragement sought for taxpayers in the fourth phase of the suggested program would be provided in two ways: (1) a refinement could be made without its being characterized as a correction of an error (although the federal income tax result would be the same, there would be none of the stigma associated with admission of an error), and (2) a refinement could be made without fear of harassment by an allegation that it constituted a change in accounting method for which advance permission had to be obtained.[28]

The federal income tax regulations provide that the term "method of accounting" includes not only the overall method of accounting of the taxpayer, but also the accounting treatment of any item.[29] The fact that the consistent past treatment of the item is erroneous does not justify correction if the rules for change in accounting method would otherwise apply.[30]

A step in the direction of the guidelines of conduct suggested herein was taken by the Internal Revenue Service on February 17, 1964, when it announced a new administrative procedure under which taxpayers may request permission to change an "accounting practice" with respect to items of income or expense. The stated purpose is to permit changes to an acceptable treatment of the items *consistent* with the income tax regulations; consequently, there is an implication that practices which are *not consistent* with the regulations may be continued if they are consistently applied and result in income being clearly reflected.

This new administrative procedure is specifically not applicable to changes in an over-all method of accounting (*e.g.,* cash to accrual), in a method of depreciation, from specific charge-off to the reserve method of treating bad debts, nor from LIFO, farm price, or unit-livestock-price inventory methods. These changes are still subject to the rules for changes in accounting methods, and promulgation of specific guidelines as to what constitutes a change in method of account-

[28] This subject is also discussed in Hoffman, *Inventory Problems: Real or Imaginary?,* 40 TAXES 951 (1962).
[29] Treas. Reg. §1.446-1(a)(1) (1957), as amended, T.D. 6584.
[30] Commissioner v. O. Liquidating Corp., 292 F. 2d 225 (3d Cir. 1961); Rev. Rul. 59-285, 1959-2 CUM. BULL. 458.

ing appears to be contemplated. Meanwhile, the Service will presumably grant a taxpayer's request to change his accounting procedure with respect to particular items of income or expense to an acceptable treatment consistent with the regulations, *provided* that the taxpayer proposes and agrees to take the necessary resulting adjustment into account in computing taxable income ratably over a ten-year period.[31]

There are occasions of improprieties in inventory determinations. The danger in such an admission is that the frequency and significance of the basic facts may be exaggerated. Further, there should be no implication that all inventory determinations are to be looked at with suspicion. Nor has there been any indication that unreasonable attitudes will be adopted by Internal Revenue agents in carrying out the directives issued during recent months, but the prudent businessman will be prepared for whatever questions are raised. A review of current practices may reveal potential problems—some real, some only illusory. The problems which are *real* should be corrected, and those which are *illusory* should be put in perspective. They will disappear when the procedures can be documented as conforming with acceptable accounting practice, as having been consistently applied, and as resulting in income being clearly reflected.

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[31] Rev. Proc. 64-16, 1964 INT. REV. BULL. No. 9.