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The theory of the base-stock inventory is that regardless of the particular particles making up the normal stock the combined whole is always on hand unchanged as a whole. When first accumulated it is taken at cost and being essentially identical from year to year is continued from year to year at that original cost.

Such a theory necessarily presupposes a product or material constant in quantity and interchangeable in its particles. It is likened to a river: the stream is always there although the drops of water composing it change from moment to moment. The base-stock inventory stream is not for sale and although the particles composing it are constantly supplanted the stream itself remains unchanged. It is this stream which is priced at the constant figure of original cost—not the particles composing it.

In stressing the fact that the method is not of general application and ignoring the other fact that in the comparatively few cases where it does apply it is the correct method, many writings on the subject fall into the way of condemning a sound principle on the ground that it does not reach beyond its legitimate scope.

The treasury department is on record on the subject in T. B. R. 65 (1 C. B. 51), the pertinent portions of which are:

"The facts before the advisory tax board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an 'accounting practice,' or that it has had any considerable recognition as the 'best' accounting practice. On the contrary, it is certain that the method has not been widely adopted. . . . Probably more than 95 per cent of the manufacturers and dealers in this country—certainly a very large majority of them—keep their books in accordance with methods other than the base-stock method. . . . The 'best accounting practice' set up in Sec. 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been 'regularly employed,' presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a 'practice' must be widely used and must have withstood the changing tests of time. In particular, the fact that so few business concerns use these base-stock methods is strongly suggestive of the truth that it does not truly reflect the income. . . . The effect of the base-stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. . . . In some cases highly conservative business concerns reckon trading profits by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains; but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic stock method is a mere counsel of conservatism, which ignores quasi-capital gains from motives of prudence. . . . The advisory tax board, therefore, concludes that the base-stock inventory method does not 'most clearly' reflect income. . . . The fundamental theory underlying this method is unsound. . . . The usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises, not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. . . . A distinguished British commission—the committee on financial risk attaching to the holding of trading stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1918. (Cd. 9224, 1919.) 'Accountants,' the committee found in Great Britain, 'with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.) misrepresent the facts.' . . . And again, referring to the fact that the British board of inland revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds 'And it appears that in the absence of a statutory definition the board of inland revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which government and the majority of this committee hold as to the correct system of accounting . . . this concession has not been extended beyond the point of obligation.' . . . The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the revenue act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method."

Thus the T. B. R. expresses disapproval of the base-stock principle and in the cost method (the whole purpose of base-stock is to use true cost) and in the inventorying of specified items at the known cost of those identical items, regardless of length of time on hand, approves its use.

Article 102 of regulations 74 reads, in part: "Inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . . Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased or produced" and prohibits using a constant price for so-called normal quantity as not in accord with the regulations.

The latest example of such reasoning is the recent decision of the supreme court in the *Kansas City Structural Steel Co.* case.

The board of tax appeals in that case (11 B. T. A. 877) said:

"The . . . base-stock method of inventory . . . does not conform to the best accounting practice in trade or business, . . . has not been widely adopted and to sanction it in the case of the very small minority of taxpayers who have used it, . . . only for a period of a few years, would work an unjustifiable discrimination against the great majority of manufacturers and dealers who have not. . . . The effect of the minimum inventory method is to assign all profits and losses to the year in which this minimum inventory is liquidated. In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income. . . . It is taxable when realized. The practical result of the use of this method of inventory is to offset an inventory gain of one year against an inventory loss of another year rather than to assign to each year its true gain or loss. Its use arises from a desire to play safe and provide reserves against possible future losses. . . . Some undeterminable part of the steel on hand in 1916 remained during the taxable years. All material of like dimensions was piled piece upon piece in perpendicular piles with the result that the material most recently purchased was in fact first used. If petitioner had used some means to identify the material so that its inventory could have been priced at cost, it might have obtained a more favorable result. . . . The material in the inventory, however, is unidentifiable and there has been offered no basis upon which we can determine cost of the inventory."

Further on this subject the board says in *Hug & Sarachek Art Co.* (14 B. T. A. 990):

. . . "These items had been in stock for a number of years, were on hand in 1919, and as the witness . . . testified 'were in the same condition in 1919 as they were at the end of 1920.' This being the case, any loss in respect thereto was sustained in a prior taxable year." . . .

And in *Francisco Sugar Co.* (14 B. T. A. 1062):

"Under the income-tax laws it is generally true that gains are not to be included in income until some transaction takes place by which such gain is realized and, conversely, losses are not deductible until sustained in a like manner. Fluctuations in value ordinarily play no part in the computation of taxable income. In this respect, as in many others, the computation of net income for tax purposes may differ from the computation of net income for other purposes. For this reason that which constitutes good accounting for certain purposes may not be proper accounting in computing taxable net income."

From the board the case went to the circuit court of appeals and the decision there (33 F–2nd–53) was not based on whether or not the base-stock method of inventorying is legitimate but upon the permanence of the material in question, reading, in part:

"An Iowa farmer who owned $150 an acre land in 1916, and who sold it in 1924 for $150 an acre, can not be taxed because in 1918 or 1919 it had a market value of $300 an acre. This analogy, it is true, overlooks the specific individuality of two identical girders which may be interchanged one day with the next—'borrowed' and 'replaced.' But that is of the form rather than of the substance. The appellant derived no income during the years from the ownership of this emergency supply; it was a part of its equipment for doing business; its business was such that it was not necessary to include it in the inventory to arrive at actual income; so to consider it distorts, rather than reflects, the true income of the taxpayer. This decision is necessarily confined to the facts of this particular business. If the appellant were a merchant or a manufacturer, where inventories were necessary to arrive at income, it must take into account all of its stock, and can not set apart a 'minimum' inventory. If the appellant, a builder, used this emergency supply for tucking away profits actually made, it could not escape. If there was bad faith, or an excessive reserve, it would be otherwise. If it liquidated the pile and took its profit, it must pay. But these are not the stipulated facts."

The supreme court in reversing the lower court goes into the principle of the method, saying it "results in offsetting an inventory gain of one year against an inventory loss of another, obscures the true gain or loss of the tax year and, thus, misrepresents the facts. It does not conform with the general or best accounting methods and is apparently obsolete," speaks of "the discarded base-stock method" and refers for support to the "well reasoned" T. B. R. 65, to various prohibitory regulations and to 1 Montgomery, *Income Tax Procedure* (1926 ed.) p. 712 and Klein, *Federal Income Taxation* (1929) 14: 13 (d) p. 375, as approving such prohibitions.

Let us examine these authorities:

Klein, p. 375, states that the base-stock method is not sanctioned by good accounting practice and refers to T. B. R. 65 for a comprehensive analysis of the method.

Montgomery, p. 712, classes the base-stock method as a technical departure from good accounting practice; refers to a paper by H. B. Fernald read before the American Mining Congress (1923) for a discussion of this method; on p. 729 and 730 states the treasury has gone on record as being opposed to the 'so-called base-stock' method and for a full discussion refers to Montgomery's *Auditing, Theory and Practice*, vol. 1 (1921 ed.) p. 117 to 172. Turning to that book we find on p. 124: "The selection of a low, fixed price for raw materials is a practice which was adopted many years ago by some of the most successful and far-seeing business men." Continuing, p. 125 states objections to the base-stock method but says, "On the other hand, the method has much to recommend it," and "In the opinion of the author, the method was adopted by enough concerns to justify calling it good accounting practice."

Mr. Montgomery, therefore, is one of the few writers recognizing an essential distinction, condemning the method for general use and approving it for specific cases; making it clear that in any particular case the question is not the legitimacy of the base-stock principle but its applicability to the particular case. It is probable that the attitude of the treasury led many to discontinue the practice. On the other hand the previous use of the method by oustanding successful concerns justifies the conjecture that if it had not been for the war the practice would have spread.

Mr. Fernald's paper reads, in part:

"We all know that no manufacturer would consider that he really made any profits in 1917 unless he sold his product at a price more than sufficient to cover the cost of replacing at 1917 prices the raw materials which he had consumed in manufacturing that product. The department would, however, hold that his profits for the year 1917 are to be measured on the basis of low-priced materials he may have bought in previous years and that high-priced materials purchased in 1917 are, to the extent of any quantity remaining on hand at the end of the year, to be carried forward by inventory against future years' operations. Probably no decision of the department has worked greater hardship on the business interests of the country than has this decision, which denies to the taxpayer the right to charge off against his sales or production for the year the cost of the raw materials purchased during that year to replace consumption."

Mr. Fernald makes this comment after having pointed out that the department adheres to a general principle of "first in, first out" except that "if goods sold or used can be identified with specific purchases these specific amounts may be charged off as the cost of goods sold, or if the goods remaining on hand at the date of inventory can be identified with specific purchases the actual purchase price may be used in pricing the inventory."

The severe criticisms of the base-stock theory quoted above are more apparent than real, for they evidently refer to the use of that method where circumstances do not warrant its use. The point is that such criticism overlooks the fact that there are situations where it does properly reflect the income; where it is exactly the opposite of the writing down of buildings and accumulating secret reserves; where it is the only way to represent facts; where it is the best accounting practice; where it has been in use for years and not discarded; where the fundamental underlying theory is sound and where the sole purpose of its use is to measure income accurately.

The office of the year-end inventory in the operating statement is elimination, not valuation. The purpose of the inventory entry is to remove from the profit-and-loss calculation something that never went into the sales' cost—to leave it as if the inventory had never been purchased or produced. Reduction of an inventory below cost is rather a balance-sheet matter affecting surplus, not income. To hold that operating income can be truly stated by taking out left-over goods or material at less than they went in at and by taking out "constant" goods or material at a different price than they went in at is illogical. If the base-stock is the same stock at the beginning as it is at the end it clearly, even under the above apparently adverse authorities, should be taken at original cost.

For obvious reasons the accountant can not blindly accept decisions of the courts and taxing authorities as decisive of accounting questions from a purely accounting viewpoint. The much cited *Eisner* v. *Macomber* case is an example. The treasury department in regulations 33 (art. 106) *considered* stock dividends to be income and in regulations 45 (preliminary ed. art. 1544 and 1919 ed. art. 1545) went further and stated that they *are* income. The court did not decide they are not income; it decided that congress has not power to tax them without apportionment *as* income.