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The merchandise inventory, one of the more significant balance-sheet items, is important, not only because of its value and its effect on the current ratio, but also because of its direct relation to the profit or loss for the period under review. As a preliminary to a discussion of this asset, it may be well to present several generally accepted principles of inventory valuation. Although there are exceptions, the basic rule is valuation at "cost or market whichever is lower." In line with the principle of providing for all losses but anticipating no profits, the inventory should not be valued at more than its probable realization value. In other words, it is agreed that slow-moving or unsalable merchandise should be written down to a price at which no loss should result in the succeeding period, thus taking up the loss as it becomes ascertainable. Continuing the above reasoning, profit should not be taken on any unsold merchandise. It is also a generally accepted fact that the inventory at the beginning and end of the period should be valued on the same basis, although in times of fluctuating prices and costs it may be difficult to agree upon the true meaning of the words "same basis."

Declines in the value of the merchandise inventory may be briefly explained and classified, as follows:

I. A drop in the purchase price of the raw materials which a concern purchases for use in manufacturing a finished product or in the price of goods purchased for resale:
   (a) Before the inventory date.
   (b) Subsequent to the inventory date.

II. A drop in the selling price of the finished or in process inventory:
   (a) Before the inventory date.
   (b) Subsequent to the inventory date.

I. DECLINES IN PURCHASE OR REPLACEMENT PRICE OF THE INVENTORY

(a) A drop, prior to the inventory date, in the purchase price of items making up the inventory should be given effect to in the pricing. This requires no journal entries, the inventory being placed on the books of account at the lower value resulting from reductions made in the pricing of its component parts.

(b) However, when subsequent to the balance-sheet date a decline of any size takes place in the price at which the materials making up an inventory may be purchased in the open market, a different situation exists. In order to conduct profitable operations in the ensuing period, the raw materials inventory at the beginning of that period (or at the end of the present period) must be valued at a price which gives effect to the lower prices which will prevail and will probably reduce the price of the respective finished products. The same line of reasoning holds true for a trading business, whose inventory consists of goods already in a salable state. Another reason for giving effect to a price decline is the principle of providing for all ascertainable losses as they are discovered. The balance-sheet should set forth as a current asset an inventory which will be realized, or turned into cash, at the proportionate value shown, plus the usual gross profit. It is evident that if the purchase or replacement price of the inventory decreases, the selling prices of this concern as well as those of its competitors in the same field will probably be adversely affected within a short time. Provision should be made for this.

Since the price decline has taken place subsequent to the inventory (and balance-sheet) date, it may not be quite orthodox to give effect to it in the detailed inventory pricing. However, it is agreed by conservative accountants that some provision should be made. In my opinion, it is best handled by an inventory reserve. However, it may also be done merely by a reduction of the total figure shown on the inventory sheets. In that case, the inventory figure on the balance-sheet will, of course, be shown net. If a reserve is created, the balance-sheet will either state "inventory, net of reserve," or it may disclose the amount of the reserve.

I believe that since the price decline has occurred after the inventory date, and since the decline is probably unusual, unexpected or perhaps not permanent, the best method of showing the provision for it in the profit-and-loss statement is to arrive at the gross profit using the gross inventory at cost (calling this figure "gross profit before giving effect to reduction in inventory values"); then setting forth the provision for inventory reserve, thus arriving at the gross profit after adjustment. The main argument in favor of this treatment is that, to obtain a true gross profit for comparative purposes and to facilitate gross profit comparisons, the inventory at the beginning and end of the period should be valued on a cost basis. The first gross profit figure arrived at above is based on opening and closing inventories on the same basis; the gross profit after adjustment is after giving effect to market declines.

When a provision for inventory price decrease has been created out of this period's profit-and-loss, the accountant should use the inventory figure before reserve, in the profit-and-loss statement; otherwise he will be charging profit-and-loss twice with the amount of the reserve. Those accountants who do not set up a reserve but handle the price drop by a direct reduction of the inventory do not encounter this problem; they merely show a net inventory figure on both the balance-sheet and profit-and-loss statement.

II. Decline in Selling Price of the Inventory

A decrease in the selling price which will be obtained for the goods on hand will probably exert an adverse effect on the profits. The accountant completing his audit several weeks after the balance-sheet date can readily observe any fluctuations in the selling prices of the stock in trade. He may, for statement purposes, disregard minor declines either before, or subsequent to, the date of his audit. However, when the selling price drops to a point where the resulting percentage of realizable gross profit is too low to cover the expense of doing business, a reserve should be provided. Since the main aim of business activity is to earn a profit, if a balance-sheet sets forth an inventory valued at a price on which no profit can be realized, the reader or analyst is deceived, because, unless mention is made to the contrary, he may assume that the inventory shown on the balance-sheet will be liquidated within a year at prices sufficient to realize approximately the gross profit usual in the particular industry.

(a) Provision to reduce the inventory to give effect to a large decline in selling price, which has occurred before the date of taking inventory and will continue for a time to come, can best be made by a direct credit to the inventory. In other words, the inventory items should be priced at a figure which will allow the realization of a sufficient gross profit.

(b) It is difficult for the auditor to determine whether a severe reduction in the selling price of the inventory, which occurs within a few weeks after the balance-sheet date or just prior to the time he submits his report, will be permanent or have a serious effect on his client's business. However, a prudent auditor provides for all contingencies brought to his attention; therefore, I would advise the creation of a reserve for this price decline, to the extent needed to reduce the value of the inventory to sales price less the expense of doing business. This reserve should be set up out of profit-and-loss, as previously described under section I, part b.

Conclusions

Several controversial points arise out of the foregoing dissertation. The first questions to consider are: Should a reserve be set up or should the credit be made directly to the inventory? And, when setting up an inventory reserve, should it be set up out of surplus or profit-and-loss? The question of whether to provide for these price declines by means of a reserve or by a direct credit to the inventory is often a matter of individual preference. However, I would advocate the following general rules:

When the decline (either in the purchase or sales price) takes place before the balance-sheet or inventory date, reduce the pricing of the inventory or its component parts.

When the price reduction in the purchase price of the inventory or a part thereof takes place subsequent to the inventory date, either set up a reserve or credit inventory.

When the drop occurs in the sales price of the finished inventory subsequent to the balance-sheet date, set up a reserve.

In my opinion, an inventory reserve when employed, should be created by a charge to profit-and-loss, in the manner previously discussed in section I, under part (b), and not out of surplus. The reasons for this are as follows:

1. An inventory loss is a profit-and-loss charge.
2. The operations (profit and loss) of the current period should be affected by any decrease in inventory value.
3. As a general practice, where an item may be correctly debited to profit-and-loss or surplus, I favor the entry to profit-and-loss both as resulting in a more conservative presentation of the period's operations and as a means of avoiding numerous surplus adjustments.

In some cases, the management may wish to provide for some event which has not yet taken place but may adversely affect the future price of the inventory. In a case of this kind, since the reserve is more in the nature of a contingency reserve than an inventory reserve, it is proper to segregate a portion of surplus for this purpose.

Another important point in a discussion of inventory reserves is the method of handling a reserve which has been set up in the prior period and is still on the books. If, when making an audit, it is discovered that the management or a previous auditor has segregated a reserve for future inventory fluctuations from surplus, the auditor should credit this reserve back into surplus. There are two reasons for this: first, if the decline has already taken place, the auditor will give effect to it in the present inventory pricing, and, second, if the price drop has not materialized, there is no longer any need for this reserve.

However, if, when preparing the financial statements, the accountant comes upon an inventory reserve which had been set up in the prior period out of profit-and-loss, for obsolete merchandise or decreases in the replacement value or selling prices of the inventory, there are several courses he may follow. The treatment of this reserve on the balance-sheet presents no difficulties. If the condition necessitating its creation has been corrected and the reserve is no longer required, it should be written off. If a part of the reserve is still required, the company should write off the unneeded portion and allow the necessary portion to remain on the balance-sheet. For purposes of the profit-and-loss statement, however, I would advocate the use of the following general rule:

Allow the method used in the creation of an inventory reserve to govern its disposition.

Expanding this reasoning, when the reserve has been set up in the prior period through the gross-profit section of the profit-and-loss account, as recommended under section I, it should be reduced through the gross-profit section of this period's profit-and-loss account, as an adjustment of the opening inventory. If the reserve has been created by a profit-and-loss charge under "other charges," it should be closed out or reduced by a credit to a profit-and-loss caption not affecting gross profit, such as "other credits." When the reserve set up in the prior period remains unchanged, this period's profit-and-loss statement is not affected, since the reserve applicable to both opening and closing inventories is the same and has already been created out of prior operations. The balance-sheet, in this case, will, of course, carry the reserve in the same manner and amount as at the close of the preceding period.