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Volume Title: Taxable and Business Income

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Volume Publisher: UMI

Volume ISBN: 0-870-14118-X

Volume URL: http://www.nber.org/books/smit49-1

Publication Date: 1949

Chapter Title: Inventory Accounting

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Chapter URL: http://www.nber.org/chapters/c3242

Chapter pages in book: (p. 87 - 103)

CHAPTER 4

Inventory Accounting

WITH FEW EXCEPTIONS ALL MANUFACTURING, PROCESSING, AND trade companies—indeed almost all companies selling tangible products—must take specific account of changes in the size and value of their inventories in order to present their net income adequately. Inventories are usually taken into account in the course of calculating the cost of goods sold. To the book figure for beginning inventory are added all expenditures for purchases and for processing or manufacturing to give a total, sometimes referred to as the cost of goods handled. From this total is deducted the book figure for the ending inventory, the difference representing the cost of goods sold. Thus, purchases or manufacturing outlays do not constitute an expense to the extent that they are represented by larger inventories. Conversely, to the extent that inventory is reduced by sales, there is an expense in the form of a decrease in inventory.

When prices fluctuate substantially, different methods of accounting for inventories may cause big variations in income because the same inventory will have markedly different values. To determine the value of the inventory on hand at either the beginning or end of an accounting period, both the goods that will be included in it and the values that will be placed on them must be determined. The next section is concerned primarily with these two problems. The effect of tax requirements for inventory accounting on income as well as the requirements themselves are briefly explained. In Section B the objectives of

inventory accounting for business purposes are discussed in general terms.

A Tax Requirements for Inventory Accounting

The main provision of the Code dealing with inventories is extremely general, delegating almost complete authority to the Commissioner. Section 22(c) reads:

"Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The wording of this provision has remained unchanged since the provision was first incorporated in the 1918 Act. For many years—until the 1938 Act was passed—this provision was the only statement regarding inventory accounting in the statutes. The Code now has a second provision, introduced in the 1938 Act and greatly broadened in the 1939 and subsequent Acts, dealing with the use of the last-in first-out method. This provision, in contrast to the general terms of the main provision, is extremely detailed.

The taxpayer does not have a free choice in deciding whether to use inventories in determining his taxable income. To reflect net income correctly, inventory accounting is required whenever production, purchase, or sale of merchandise is an income-producing factor.[1] On the other hand, in certain businesses in which inventories are neither necessary to reflect income clearly nor in accordance with the usual accounting practice in the business, the law neither requires nor permits their use. An example is the business of buying and selling real estate in which inventories are not permitted.

When an inventory is required, the statute and the regulations lay down two broad rules concerning the basis for taking

[1] Regulations 111, Sec. 29.22(c)-1.

it. The method must conform "as nearly as may be to the best accounting practice in the trade or business" and be such as to "clearly reflect the income".[2] The first test is phrased in the familiar wording of the tax law, but as occurs in other instances it does not mean that all inventory practices in fairly common usage will be accepted by the Commissioner or the courts in determining taxable income.

According to Regulations 111, Section 29.22(c)-1, 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 will physically become a part of merchandise intended for sale. The taxpayer must be carrying on business before he can inventory merchandise; a mere holder of goods cannot use inventory accounting methods. Further, merchandise can be included in the inventory only when it is held for sale at a profit; goods held for sale at cost merely to win goodwill from purchasers cannot be inventoried. Although an accountant might include such goods in an inventory, the tax law does not permit the inclusion because 'sale' is interpreted to mean a sale that brings in income. Raw materials and supplies may be included if they have been acquired for sale or, in the words of the regulation, if they "will physically become a part of merchandise intended for sale".

The general rule is that only merchandise to which the taxpayer has title may be inventoried. Sales law therefore solves many of the problems that arise. Goods, title to which has passed to the buyer, should be included in the inventory of the buyer even though they have not yet come into his possession physically, while goods not yet appropriated to the contract should be inventoried by the seller. Similarly, merchandise shipped on approval should be inventoried by the seller if it has not yet been accepted by the buyer.

The determination of title is particularly significant when a buyer who values his inventory at the lower of cost or market

[2] Regulations 111, Sec. 29.22(c)-2.

has contracted to purchase goods at a cost higher than the market at the time of taking inventory. If title has passed to him, even though he has not received delivery, his loss will be reflected immediately in the lower value of the closing inventory. If title has not passed, the goods are not inventoried and the realization of the loss is postponed to a later year.

In many cases, however, the law of sales concerning the passage of title is not controlling in fixing income tax liability. In industries in which the trade usage or custom runs contrary to the established rules of title, it will be followed for tax purposes if supported by a sound accounting practice consistently adhered to. Trade usage may be consulted to determine when the parties to the sale regarded title as passing and that time may determine the goods to be inventoried. The theory has been expressed in a concurring opinion in a Board case:

"I am satisfied, however, that the taxpayer has established an accounting practice which was consistent and reflected its income. Where such is the case, legal theories should not be applied to a point where . . . it becomes necessary for the taxpayer to determine at his peril when legal title passes under each contract into which he may have entered. The refinements of the law must sometimes give way to practical considerations. . . ." [3]

As far as the quantitative effect on income is concerned, the method of valuing inventory is ordinarily much more significant than is the precise line of demarcation between goods that can, or cannot, be inventoried. Originally the only basis allowed was cost, though this was not stated in any Treasury decision.[4] In 1917 the Treasury ruled that inventories could be valued at either cost or the lower of cost or market.[5] Both bases were therefore clearly established for income tax purposes

[3] Appeal of The Amalgamated Sugar Company, 4 B.T.A. 568 (1926); appeal dismissed 31 F(2d) 1008 (CCA-8th, 1928); U.S. v. Amalgamated Sugar Company, 72 F(2d) 755 (CCA 10th, 1934); see also Appeal of Rockwood Malleable Iron Works, 2 B.T.A. 817 (1925).

[4] See A. A. Ballantine, Inventories, in *The Federal Income Tax* (Columbia University Press, 1921), pp. 161-86.

[5] T.D. 2609, *Treasury Decisions*, Vol. 19, p. 401 (1917).

by 1918, when the inventory provision was first enacted in statutory form.

Once the basis of valuation has been established, the taxpayer may change it for tax purposes only with the Commissioner's permission.[6] In 1920 the Commissioner issued a ruling allowing taxpayers generally to adopt a basis of cost or market whichever is lower regardless of their previous practice in order that they might take advantage of the sharp decline in prices.[7] But the basis adopted at that time, or in a later year, constitutes a binding election that may now be changed only with the Commissioner's permission.

The regulations specify with some care the meaning of cost and market for inventory purposes. In general, the cost of merchandise purchased is the invoice price minus 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, plus transportation or other charges incurred in acquiring possession of the goods. In the case of merchandise produced, the cost is the cost of raw materials and supplies entering into or consumed in connection with it plus expenditures for direct labor plus indirect expenses incident to production; a reasonable proportion of management expenses may be included, but selling costs and return on capital, whether by way of interest or profit, cannot be.[8] In general, market price means the current bid price at the date of the inventory for the merchandise in the volume in which it is usually purchased by the taxpayer.[9] Special treatment has been provided in the regulations and developed through litigation to deal with unusual situations where standard rules are inapplicable.

6 Regulations 111, Sec. 29.22(c)-2.
7 T.D. 3108, Cumulative Bulletin 4, p. 49 (1921).
8 Regulations 111, Sec. 29.22(c)-3.
9 Regulations 111, Sec. 29.22(c)-4.

First-in First-out Presumption

Fungible inventory goods are frequently so intermingled that it would be impossible, or highly inconvenient, to identify the particular goods that are on hand at the time the inventory is taken. Some assumption must be made concerning their identity. For many years the regulations required that the goods most recently purchased or produced prior to the date of the inventory be deemed to constitute the inventory, up to the quantity of such goods actually in the inventory. This first-in first-out presumption still applies except when taxpayers have taken advantage of the privilege of electing to use the last-in first-out presumption under the terms of the 1938 and 1939 Acts.[10]

Though some presumption is necessary in situations involving fungible goods where identification would be very difficult or impossible, the first-in first-out presumption has been employed generally even when goods on hand could be identified and related to specific invoices. The actual cost of identifiable parts of a homogeneous inventory remains at all times an acceptable alternative method to any presumption of identity.

The first-in first-out presumption was applied without exception for the entire period covered by our data. Subsequent modifications have brought the taxable income concept more into accord with that of business income and may be presumed to have reduced the differences in reported income arising from differences in inventory accounting. Certain differences still exist, however, and the two income concepts have by no means become identical in this respect.

Authorization for Use of Last-in First-out Method

Until the 1938 Act, the statutory inventory provisions were merely a broad delegation of power to the Commissioner to determine the bases upon which inventories should be taken for tax purposes. In 1919 a Treasury ruling which prohibited

10 See Regulations 111, Sec. 29.22(c)-2.

the base stock method for tax purposes impliedly prohibited all other techniques tending to minimize the effect of fluctuations in inventory prices on taxable income.[11] The pressure for the allowance of some inventory method that would lessen the effect upon income of gains and losses due to price changes was intensified by the undistributed profits tax but still did not alter the long standing position of the Treasury.[12]

As a result, the interested tax-paying groups applied directly to Congress for a statutory provision that would afford an alternative to the first-in first-out presumption of the Commissioner's regulations. The Senate passed a floor amendment to the 1938 Bill permitting taxpayers to use the last-in first-out method, provided it was commonly applied in the industry. In Conference Committee the amendment was modified to apply, with certain restrictions, only to the leather and nonferrous metal industries.

In the 1939 Act this inventory provision was replaced by a greatly broadened provision, the terms of which are substantially unchanged in the present Code. The main changes were to permit the adoption of the last-in first-out basis by all taxpayers, irrespective of the type of business; to remove the restriction limiting the method to inventories of raw materials; and to authorize the method even though there was no lack of identity through commingling of goods. Two subsequent amendments were passed. One partly removed a restriction that had prohibited the last-in first-out method if any alternative method was used by the taxpayer for other than tax purposes. The other made available an optional relief provision to taxpayers who on account of wartime shortages had involuntarily liquidated inventories carried on a last-in first-out basis.

The Code provision for the last-in first-out method of inven-

[11] T.B.R. 65, Cumulative Bulletin 1, p. 51 (1919).

[12] See discussion in editorial note, Base Stock Inventories and Federal Income Taxation, *Harvard Law Review*, Vol. 51, p. 1431 (1938). Cf. Lucas v. Kansas City Structural Steel Co. 281 U.S. 264 (1930) which, though it involved base stock inventory accounting, has been noted by one reader of this manuscript as a principal reason for the Treasury's refusal to allow last-in first-out accounting.

torying is too long for full quotation here. The first, and general, subsection, 22(d)(1), reads:

"A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2);

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: first, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method."

The inventory method as set out by the Code and the regulations, called in the regulations 'the elective method', is to treat the goods on hand at the close of the taxable year as being, first, those included in the opening inventory of the taxable year in the order of acquisition, and second, those acquired during the taxable year. The inventory must be taken at cost, not at cost or market. Because of this requirement, to avoid loss of revenue when a shift is made to the elective method, the income for the year preceding the shift must be computed by taking the closing inventory at cost [Section 22(d)(4)].

The goods included in the opening inventory of the first year in which the method is applied are treated as though they had been acquired at the same time; in other words, their unit cost is an average cost [Section 22(d)(1)]. The cost of goods on hand at the close of the year in excess of the opening inventory may be determined by an average cost method, by the cost of goods most recently purchased or produced, or by the cost of the goods first purchased or produced in the taxable year in the order of their acquisition [Section 29.22(d)-2].

The general effects of the last-in first-out method may be described briefly. When prices are rising, the most recently ac-

quired and hence the most costly items purchased or manufactured are presumed to be those first sold. Consequently, if the quantity of a given category of inventory goods remains the same, it will be stated at the same figure as in the beginning inventory; the cost of goods sold will therefore reflect fully the rising costs of the period. On the first-in first-out basis, on the other hand, the original lower cost inventory would be presumed to be sold and replaced by the higher cost inventory acquired towards the end of the period, thereby decreasing the cost of goods sold and increasing the net income.

In a subsequent period of price decline, on the last-in first-out basis, current acquisitions are presumed to be sold currently. Just as the beginning inventory was not previously revised upwards when prices increased, it does not have to be revised downwards when prices fall, as in first-in first-out procedures. Any exact comparison of the effects of the two inventory accounting systems will be influenced by the phase of price movements when the system was put into effect and by fluctuations in inventory quantities.

The last-in first-out option was of great significance for many companies during and immediately after the war. Rising prices created substantial inventory profits for taxpayers not using the last-in first-out method. High war and postwar tax rates levied against such noncash and nondisposable inventory profits caused serious cash drains for many such taxpayers.

Inasmuch as the trend of prices was steadily upwards after 1939, companies that elected the last-in first-out option benefited greatly. These benefits will, of course, be partly or conceivably even wholly, offset by any future price declines. Therefore future price changes and future tax rates should be considered before the last-in first-out method is adopted. These considerations, together with many others, such as the typical relation between cost and selling prices and the expected stability of the amount of inventory goods on hand, render the analysis of the effect of the last-in first-out method

much more complex than is suggested by the preceding simplified discussion.

Perhaps the greatest difficulty thus far encountered in administering the last-in first-out method has been to determine the categories into which inventory goods must be grouped in applying the method. Frequently, decisions made with respect to these categories will have a great effect on the results yielded by the method and may even determine its practicability for many taxpayers. After long deliberations with interested taxpayers the Treasury issued regulations for some industries, particularly cotton textiles and pork packers.[13] Even these regulations are phrased in such general terms that they leave many basic questions unanswered. Specific applications of the regulation have, however, been worked out with taxpayers who use the elective method. Department stores posed perhaps the most difficult problem. Abandoning all efforts to apply the method in the traditional manner to narrowly defined categories of homogeneous inventory goods, they constructed price indexes designed to eliminate the effect of price changes from entire departments. The Treasury contested the legitimacy of this procedure, but in January 1947, the Tax Court in a test case upheld the taxpayer, a large Baltimore department store.[14] The Treasury has since issued regulations governing the use of the elective method by stores valuing their inventories according to the retail method. These regulations permit the use of specially prepared government price indexes in the application of the last-in first-out basis to department store inventories.[15]

Inventory Methods Prohibited for Tax Purposes

Certain inventory methods are specifically disapproved for tax purposes: [16]

[13] Regulations 111, Sec. 29.22(d)-1, as amended by T.D. 5407, Cumulative Bulletin, 1944, p. 83.

[14] Hutzler Brothers Company v. Commissioner, 8 T.C. 14 (1947).

[15] T.D. 5605, Internal Revenue Bulletin 1948-6, p. 1, and Mimeo. 6244, Internal Revenue Bulletin 1948-7, p. 2.

[16] Regulations 111, Sec. 29.22(c)-2.

1) Deducting a reserve for price changes or for an estimated depreciation of the inventory.
2) Valuing parts of the inventory at a nominal price or at less than their proper value.
3) Omitting portions of the stock on hand.
4) Using a constant price or nominal value for a so-called normal quantity of goods.
5) Including in the inventory stock in transit, title to which is not vested in the taxpayer.

Only two items of this group can be dignified by the term 'method'—the base stock method (4) and the inventory reserve (1).

1 *The base stock method*

The base stock method has been applied most commonly by extractive and processing industries that always maintain a certain minimum quantity of raw materials. The argument has been that since a minimum quantity—the so-called normal quantity—of stock must be kept on hand at all times to carry on the business, changes in its value should not be reflected in income any more than changes in the value of fixed assets.

Very early in income tax history the question whether the base stock method could be used for income tax purposes was raised. The Advisory Tax Board ruled in 1917 that the method was not in conformity with the revenue acts on the ground that it did not conform to the best accounting practice regularly used by a majority of taxpayers; that, on the contrary, it had not been widely adopted; that it disregarded the annual accounting period of the tax law by overstating or understating the profits of the period; and that it ordinarily tended to understate profits since the usual practice was to value the base stock at a figure well below cost.[17]

In a case arising in the Court of Claims, a variation of the base stock method was disallowed. The Court held that although the method may have been sound financial manage-

[17] T.B.R. 65, Cumulative Bulletin 1, p. 51 (1919).

ment because it was conservative, "Questions of management and questions of taxation should not be confused." [18]

The next year the Supreme Court disapproved the base stock method in a case in which the taxpayer valued his 'normal' stock at a base price.[19] It held that the method did not fulfill the tax necessity of an annual accounting of gains and losses since it ignored gains actually realized through liquidation of low price stock on a high price market, and ignored losses resulting from the consumption of high price stock. It compared the base stock method with the "many reserves which businessmen set up on their books for their own purposes". The reserves as well as the base stock method were stated to be inconsistent with an annual accounting as they offset inventory gains of one year against inventory losses of another, obscuring the 'true' gain or loss of the year.

Under the present law, although the base stock method as such is prohibited, closely similar results can be achieved by the last-in first-out method. Under it, the base price cannot be fixed at an arbitrary low figure, but an important objective of the base stock method—the elimination of purely inventory gains and losses from taxable income—can be achieved.

2 *Inventory reserves*

Regulations 111, Section 29.22(c)-2, specifically prohibits deducting from the inventory a reserve for price changes or an estimated depreciation in the value of the inventory. Nor can a taxpayer, by transfers from a reserve previously established, add to gross income an estimated appreciation in the value of inventories. When through a reserve, gross income is decreased or increased according as the closing inventory is estimated to have depreciated or appreciated, the effect is the same as though the inventories were given an estimated value rather than being valued at cost or at the lower of cost or market. From the viewpoint of the tax law, an appreciation in the inventory

[18] Chicago Frog and Switch Company v. U.S., 68 Ct. Cls. 186 (1929).

[19] Lucas v. Kansas City Structural Steel Company, 281 U.S. 264 (1930).

over cost or market is not income since it has not been realized; likewise, an estimated depreciation below cost or market is not a loss for that year since it has not yet been sustained.

The inventory reserve is a device to smooth annual gains and losses by removing the fluctuations caused by price changes. The prohibition of this reserve is consistent with the basic philosophy of the tax law, namely, that gains or losses are a part of income in the year in which they are realized. Though the income may be largely fictitious because inventories have to be replaced at a higher price level, and the inventory gain may be entirely lost in a subsequent year of falling prices, the income has nevertheless been received. From the traditional tax viewpoint, liability is determined by the receipt or accrual of income in a given year, although a large part of the income must be reinvested in higher priced inventory. The gains and losses of each year stand alone. The gain of one year cannot be offset by the loss of another by means of an inventory reserve even when it is perfectly clear that the gain is purely an inventory gain which will almost certainly be balanced by a later loss. The allowance of last-in first-out accounting has gone a long way towards achieving the objectives of inventory reserves.

The restriction against the deduction of an inventory reserve is merely one specific example of the general policy not to allow reserves to be deducted from income. The statutory allowance of a reserve for bad debts is an unusual exception. In an early case, in which a reserve was set up to cover a collateral obligation almost certain to arise, the Board stated the position of the law against the deduction of reserves: "In this instance good accounting and the statute may not be in strict accord, since Congress may with entire fairness tax what a conservative and prudent businessman may wish to hold in reserve." [20]

In view of this heavy emphasis on the realization criterion and of the traditional antipathy of tax authorities to reserves of all kinds, recent interpretations of the last-in first-out method

[20] Appeal of Consolidated Asphalt Company, 1 B.T.A. 82 (1924).

are especially interesting. The Hutzler Brothers decision authorizes a procedure scarcely distinguishable from a refined application of at least one kind of inventory reserve for price fluctuations.

B Changing Concepts of Inventory Accounting for Business Purposes

The accounting treatment of inventories has been much discussed and considerably modified during the last decade; it is still a subject of lively controversy among professional accountants. The increasing interest in inventory accounting manifests the growing importance of the income statement. The technical significance of the last-in first-out method and of various special types of inventory accounting has already been described. These new forms of inventory accounting should, however, be recognized as merely one manifestation of a general change in accounting objectives.

The traditional method of valuing inventories at the lower of cost or market on a first-in first-out presumption was appropriate for the period in which it developed. A creditor, especially a short-term creditor, wants statements to reflect a conservative valuation of current assets, because it is to the current assets that he looks for the repayment of the loan. Thus when prices are falling, he desires to have the full impact shown for balance sheet purposes. The simplest way is to include inventories at the end of a period at the lower of cost or market, a procedure that at the same time reflects the full effects of price declines in the income of the period in which the declines took place.

This very fact of showing in the income accounts the full influence of price declines has led to modifications of the cost or market, first-in first-out principle. The taking up of losses caused by inventory price declines gives lower incomes in years of such declines, but leads to higher incomes in years of subsequent price recovery; from both standpoints, the result is to accentuate fluctuations in income. In view of the increasing

concern given to the effects of accentuations of fluctuations in income on management policies, stockholders' reactions, stock market prices, and on the general economic welfare, it was natural that inventory accounting should receive more attention. The traditional first-in first-out concept, though logical and expedient, was not inherently more accurate than other concepts.

Emphasis on the viewpoint of a going concern and its income inevitably led to dissatisfaction with an accounting convention that accentuated income fluctuations on the unrealistic assumption that the entire inventory would in fact be liquidated. It was sometimes stated, particularly with reference to certain basic manufacturing industries, that a minimum investment in inventory was a continuing necessity, and that such an investment was in a real sense a fixed capital investment even though the actual items composing it changed. Accounting conventions that recognized this continuing investment were therefore supported as a means of treating basic inventory investments in a manner comparable with the established practice of not revaluing plant and equipment each year on the basis of current market prices.

Accountants recognize several standard conventional ways of inventory accounting.[21] No one of these inventory procedures always gives a nearer approach to a fundamental abstract 'true' income than do others; each has certain advantages. The best accounting procedure is to adopt the method most appropriate to a particular situation and to make full disclosure, perhaps with proper footnote recognition of the differences that would arise from another of the conventional treatments.

The lower of cost or market procedure, with cost determined according to the first-in first-out rule, as already stated, perforce gives a low income figure when prices are falling and income tends to be low for other reasons, and a high income figure

[21] As an example of detailed specialized discussion among accountants see National Association of Cost Accountants, *Year Book, 1940: Proceedings of the Twenty-First International Conference,* Sessions I and II, pp. 1-172.

when prices are rising. Thus, it accentuates fluctuations in income. The cost or market treatment in a sense anticipates realization by writing down inventory values to the current market price when it is lower than cost. When prices are rising, however, there is no comparable anticipation, since nothing is taken into account until low-cost inventory has been sold. Cost or market takes into account only actual decreases in price. Nevertheless, as is sometimes overlooked, when the first-in first-out rule is applied, even cost or market procedures show inventory profits when prices are rising.

Expected declines in prices are sometimes provided for by reserves intended to present more conservative estimates of the amount realizable from inventory. When set up from income they are intended also both to reduce income in peak years when prices are high and to cushion the low years when prices decrease.

The fact that inventory reserves and the base stock method of inventory accounting involve discretion and arbitrary judgment has apparently been the chief reason for their disallowance. The base stock method, once established, is almost automatic. Objective standards might be determined in advance for inventory reserves, though typically the amounts set up have been those which seemed appropriate at the time; any other practice would apparently be extremely difficult. Recent developments in department store inventory valuation can be described as an effort to develop a 'scientific' inventory reserve method based on carefully constructed price indexes.

In industries for which the last-in first-out method is appropriate, its adoption has done much to eliminate the fluctuations in income arising from the effect of price changes on inventory valuations. No additional element of discretion is introduced and income is as determinate as under the first-in first-out rule. Apart from the administrative difficulties the method raises, there seems no reason why it should not have been accepted much earlier.

Room still remains in business accounting, however, for ad-

justments in income figures to take account of peculiar circumstances arising from abnormal fluctuations in the quantity of inventory or from certain sequences of price movements. Any such adjustments are likely to be based on judgment. Acceptance of them for tax purposes would call for a much more liberal interpretation of the general rule that taxable income will be determined in accordance with the accounting method regularly used by the taxpayer (Sec. 41) than has yet been adopted.

Most differences between taxable and business income arising from inventory accounting may be expected to balance out over a period of years, though some will remain until the final liquidation of a company. In fact, the business methods not accepted by the Treasury have been and ordinarily are designed merely to smooth income, not to increase or decrease it in the aggregate. Exceptions to this statement occur in special situations where catastrophic decreases in inventory value are handled through direct surplus charges or through inventory reserves created out of surplus. Also, a permanent change in the price level would lead to continuing significant differences under some methods; this consideration is probably important in the current postwar period.