

PS LA 2003/13 - Income tax: the cost basis of valuing trading stock on hand for taxpayers in the retail and wholesale industries

⚠ This cover sheet is provided for information only. It does not form part of *PS LA 2003/13 - Income tax: the cost basis of valuing trading stock on hand for taxpayers in the retail and wholesale industries*

⚠ Amended on 30 June 2004 to include new paragraph 1, restricting application to particular entities; changing date of application from 2003 year to 2004 year and following.

⚠ This document has changed over time. This version was published on *15 December 2003*



ATO Practice Statement

Law Administration

PS LA 2003/13

Amended on 30 June 2004 to include new paragraph 1, restricting application to particular entities; changing date of application from 2003 year to 2004 year and following.

FOI status: may be released

This Practice Statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by ATO officers unless doing so creates unintended consequences. Where this occurs ATO officers must follow their Business Line's escalation process for significant issues.

SUBJECT: Income tax: the cost basis of valuing trading stock on hand for taxpayers in the retail and wholesale industries

PURPOSE: To provide guidance to staff on items of expenditure included in valuing trading stock on hand at cost under section 70-45 of the Income Tax Assessment Act 1997 (ITAA 1997).

STATEMENT

1. This practice statement applies to those taxpayers or consolidated groups where the consolidated gross operating turnover for the financial year is \$10 million or more. Taxpayers not covered by this practice statement will still be expected to use a reasonable and practical basis to correctly bring to account their trading stock.
2. This practice statement provides guidance to tax officers in determining what costs to include in valuing trading stock on hand at cost for taxpayers in the retail and wholesale industries. In valuing trading stock on hand, a full absorption costing method should be adopted. This practice statement also sets out the approach tax officers will take for income tax returns for the year ended 30 June 2004 where taxpayers have not previously used full absorption costing. The general absorption costing principles for valuing trading stock on hand at cost will also apply for the year ended 30 June 2005 and for subsequent years.
3. A number of taxpayers in the retail and wholesale industries who value their trading stock on hand at cost have not previously determined the cost under the absorption costing methodology as described below. Where this has occurred, tax officers should allow those taxpayers to include the appropriate figure as at 30 June 2004 in their income tax return for the year ended 30 June 2004. Tax office staff should not require those taxpayers to adjust the closing stock on hand in earlier year returns. This will ensure a smooth transition to full absorption costing and minimise costs of compliance.
4. Tax officers should accept a taxpayer's calculation of the cost of trading stock on hand for the purposes of section 70-45 where the cost is determined in accordance with the absorption costing principles as enunciated in Accounting Standard AASB

1019. The costs that are to be absorbed under this method include those detailed in paragraphs 7 and 8 below and may include some costs which the taxpayer does not include for accounting cost purposes.

5. Where taxpayers have not determined accounting costs separately from allowable deductions, tax officers should accept that the relevant costs for valuing trading stock are the taxpayer's allowable deductions.
6. On the basis that cost reflects accounting principles and concepts, tax officers should accept that incidental costs of a minor nature which may be time-consuming to record, and which would not result in material differences in the value of trading stock, need not be absorbed in calculating the value of trading stock on hand. For example, the cost of moving stock from the on-site storage location to the display setting need not be included.
7. In valuing trading stock under the full absorption costing method, tax officers should accept cost calculations based on the absorption of the costs of or connected with:
 - The purchasing function;
 - Operating distribution centres;
 - Operating on- or off-site warehouses or storage areas;
 - Freight from the supplier's premises to the retailer's warehouse or distribution centre; and
 - Freight from the retailer's warehouse or distribution centre to the retail outlet.
8. Typically, the costs of operating a warehouse or distribution centre include:
 - Salary and wages;
 - Light and power;
 - Cleaning;
 - Security;
 - Repairs and maintenance;
 - Freight;
 - Insurance;
 - Rent;
 - Rates and taxes;
 - Lease costs;
 - Depreciation;
 - Damaged stock;
 - Telephone;
 - Workcare premiums;
 - Superannuation; and

- Other administration costs.
9. In applying the principles of full absorption costing, tax officers should note that the following costs need not be absorbed in calculating the value of trading stock on hand:
- General administrative costs unrelated to the operation of the warehouse or distribution centre;
 - Costs connected with the selling function;
 - Costs incurred outside the normal operations of the warehouse or distribution centre;
 - Costs of carrying obsolete stock;
 - Cost of displaying goods in the retail outlet;
 - Cost of transporting goods from the selling location to the customer's premises;
 - Interest; and
 - Advertising.
10. Note also that Simplified Tax System (STS) taxpayers who elect to participate in the STS do not need to account for changes in the value of their trading stock on hand where the difference between the value of their opening trading stock on hand and their closing trading stock on hand is not more than \$5000.

EXPLANATION

Valuation of trading stock

11. Section 70-45 provides that a taxpayer may elect to value each item of trading stock on hand at the end of an income year at cost.

Absorption costing

12. 'Cost' and 'cost price' are not defined in either the ITAA 1997 or the *Income Tax Assessment Act 1936* (the ITAA 1936). In the absence of statutory definitions the courts have held that cost, as an accounting concept, should be determined in accordance with accounting principles. Two cases on point are *Philip Morris Ltd v FC of T* 79 ATC 4355; (1979) 10 ATR 44 (*Philip Morris*) and *FC of T v Kurts Development Limited* 98 ATC 4877; (1998) 39 ATR 493 (*Kurts*). Although these cases are not directly relevant to retailers and wholesalers (*Philip Morris* deals with a manufacturer and *Kurts* deals with a land developer), they do assist in clarifying the valuation principles for taxpayers generally including taxpayers in the retail and wholesale industries.
13. The relevant accounting principles are the Australian Accounting Standards. In particular, *AASB 1019* sets out the prescribed accounting treatment of 'Production Overheads', 'Other Production Costs', 'General Administration Costs', and 'Other Costs' for valuing inventories, and requires that all such costs be absorbed. Absorption costing values trading stock by including relevant costs in bringing the trading stock to its 'present location and condition'. In the case of a retailer or a wholesaler, the relevant costs would include the costs of distribution and storage up

to and including the point that the trading stock is located in its final selling location.

14. The application of absorption costing accords with accepted industry practice, *AASB 1019*, and International Accounting Standard *IAS 2*. In particular, sections 6.1, 13.1.4, 13.1.5, and 13.1.6 of *AASB 1019* all require that particular costs 'in bringing inventories to their present location and condition' be included in determining the cost of the inventories for inventory valuation purposes.

Cost v Cost price

15. Section 70-45 of the ITAA 1997 allows a taxpayer to value 'each item' of trading stock at 'cost'. The corresponding provision in the ITAA 1936 allowed a taxpayer to value 'each article' of trading stock at its 'cost price' (subsection 31(1)). The change from 'cost price' to 'cost' was made as a simplification measure and did not intend any change in meaning: refer to section 1-3 of the ITAA 1997 and the accompanying Explanatory Memorandum. Therefore, the principles that previously applied in determining the 'cost price' of an article of trading stock for the purposes of the ITAA 1936 continue to apply in determining the 'cost' of an item of trading stock for the purposes of the ITAA 1997.

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| subject references: | Trading Stock; Accounting Standards; Absorption Costing |
| legislative references: | <i>Income Tax Assessment Act 1997</i> Part 2-25 <i>Income Tax Assessment Act 1997</i> Section 70-45 <i>Income Tax Assessment Act 1936</i> subsection 31(1) |
| related public rulings: | Taxation Ruling IT 2350 Taxation Ruling TR 98/2 |
| Case references | <i>FC of T v Kurts Development Limited</i> 98 ATC 4877; (1998) 39 ATR 493 <i>Philip Morris Ltd v FC of T</i> 79 ATC 4355; (1979) 10 ATR 44 |

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