

ANNUAL STOCK VALUATION- SMALL BUSINESSES

References

Figures in brackets refer to the section in the Income Tax Act.

Definitions

A "small" business for tax purposes is one (combined with its associated persons) which has a turnover of less than \$3million per year.

Associated persons rules apply. This means, for example, a person having an interest in two companies must add the turnovers to see whether the total is still less than \$3million. A company is associated when this person owns 50% or more of the shares.

Trading Stock

In general it is anything bought for resale. It includes work in progress and the yet unprocessed raw materials. For example, to a cardboard box maker the partly completed boxes are stock and are subject to these rules. Stock purchased but not yet delivered forms part of your end of year stock and must be included in your stock take. However the value of such stock, not paid for by year end, should be included in the amount owing in your accounts payable (Sundry Creditors)

These rules do not apply to:

- Livestock, except when used in dealing operations
- Nursery plants (special rules apply and there are new ones for the 2002 year)
- Consumable aids such as lubrication oil
- Spare parts unless they are your trading stock
- Land (including crops in the ground)

The following expenses are neither stock nor form part of the trading stock:

- Stationery
- Wrapping paper
- General administration
- Marketing costs
- Distribution costs

Way To Value Stock

- 1. Discounted Selling Price**
- 2. Cost (Retailer/ Manufacture)**
- 3. Selling Price (Above Cost/ Below Cost)**

4. Replacement

You must basically value stock in accordance with the Financial Reporting Standard No4. These standards are developed by the Institute of Chartered Accountants.

- If by using FRS4 it is materially different to cost then you must use cost.
- You are no longer permitted to value stock on one basis for the bank and another for tax purposes. The bases you choose for tax must be the same as for your business's annual accounts.
- You may, however, value different stock lines using different bases. Some stock can be valued at selling price and others at cost.
- You must keep a record of your valuation methods and how you have applied them as well as records of your stock take. Records have to be retained for seven years.
- You may only reduce the price of obsolete and slow moving stock in accordance with these rules.
- There are consistency requirements in respect of the cost valuation method, the basis i.e. FIFO or WAC, the method of calculating discounted selling price, and the use of market selling price versus cost unless there are sound commercial reasons.

1. Discounted selling Price (EE8)

You may use method if use this method in your financial statements or you do not compile financial statements (Financial Statements means general financial statements not specific ones).

- You start by valuing your trading stock at retail.
- You are expected to divide it into departments, grouping stock of similar profit margins together.
- Determine the gross profit margin for each department and discount the selling price of the stock to bring it back to cost.
- Retailers (only) with annual sales of \$1million or less, do not have to separate the stock into departments but may apply the discount across the entire stock. (EE9)
- You must recalculate the normal gross profit margin each year
- When calculating the gross profit margin, take into account all the costs listed below under the heading Cost Reseller and Cost Manufacturer.

2. Cost- Retailer (EE7[3])

Comprises:

- Purchase price
- Freight of goods in shop

- Insurance cost relating to getting the stock on the shelf
- Import duty and any other related costs

Whether you use FIFO or weighted average cost, you must continue to use it from year to year.

3. Cost- Manufacturer

Costs to a manufacturer include:

- Direct Material and labour costs
- Indirect materials and labour costs
- Utilities like power and water but not telephone
- Repairs to factory plant
- Factory plant depreciation or rental

Also:

- Costs of production included in your financial statements, which are additional to the above list, must also be included in stock valuation.
- You are permitted to value stock at cost even though selling price may be lower.
- If you bought the trading stock rather than manufactured it must include the costs above for a retailer.
- Paradoxically, a major repair to factory plant has the effect of increasing the value of your stock and consequently your profit!

4. Market Selling Price– Above Cost (EE 16(3)(e))

- Choose this option and you must use it for that line of stock every year unless you have a good commercial reason to change other than tax advantages. (EE16(4))
- There could be some tax planning advantages in choosing this option. It would probably be best applied to stock you are not expecting to continue with in future years.
- Once sales exceed \$3million you will go into the big league and selling price above cost is not an allowable option.

5. Market Selling Price –below cost (EE 12)

You must have reasonable evidence of market selling price. If you cannot get reasonable evidence use cost. (EE 12(3))

In arriving at selling price you may deduct:

- Transportation
- Insurance
- Sales Commissions
- Discounts to buyers

6. Replacement

- To use this option you must use it in your financial statements

- You may either choose the last price you paid (EE11(4)) or the amount you would have to pay to replace the stock item at balance date. (EE11(2))

Very Small Stock

At the time of writing these notes a bill was passed by parliament proposing that businesses having less than \$1.3million sales may dispense with valuing their stock "If the taxpayer reasonably estimates that the stock's value is less than \$5,000." This change is effective from the start of the 2003 Financial year.

WARNING: The information supplied here is simplified and condensed. It is only a guide and should not be relied upon as a substitute for professional advice.