Draft Taxation Ruling TR 2005/D11

Cost Basis of Valuing Trading Stock in the Retail Industry

The Draft Ruling does not reflect a change in tax law as theoretically the closing value of stock at financial year end should always include a component of all costs that have been incurred in getting the product onto the retailers shelves ready for sale.

It's preparation, however, perhaps signals a new determination by the ATO to ensure that more businesses show a higher closing stock in their accounts (and thus a higher tax liability) than has previously been common practice.

Absorption costing means that the closing value of stock should not only include the cost price, the cost of freight and insurance in (all part of normal practice) but also an allowance for costs relating to:

- The buying function. This could include a labour cost allocation for time spent by certain employees in purchasing inventory as well as software / hardware costs relating to ordering.
- Warehousing. If a retailer holds surplus stock at a separate location then all occupancy costs re those premises plus costs relating to the movement from the warehouse to the store would need to be recognised in the stock value. Hopefully the warehousing definition would not extend to storage areas at the rear of most retailers premises.

Some of these costs may be immaterial or difficult to determine exactly, however the ruling allows for estimates for stores with a turnover of $10m pa or less. Presumably the ATO thinks that stores with a larger turnover will have more sophisticated accounting systems!

This ruling will not affect taxpayers who lodge under the Simplified Taxation System, ie whose turnover is $1m or less pa.

The following is an example only and each store would have different issues.

Example Assumptions:

Supermarket has $250,000 at stock at normal cost that includes in-built allowance for freight in. It does not have a separate storage facility. The store manager labour package cost is $75,000 and he has estimated that 25 per cent of his time is related to the buying of stock. Other employee time in this area is negligible. The costs for operating the grocery management system (software & maintenance) is $10,000 and 20 per cent of it's usage is for the buying function.

The stock turnover cycle is four weeks on average.

Normal practice has been that $250,000 of stock is shown in the closing accounts and tax returns.

Under this ruling the closing stock would now be $250,000 plus an allocation for the manager's time and software costs inherent in the closing stock. This would be calculated as follows:

= $250,000 + ($75,000 @ 25% @ 4/52 weeks) + ($10,000 @ 20% @ 4/52 weeks)

= $250,000 + $1,442 for the manager + $154 for the software

= $251,596

If the store traded as a company then additional tax payable would be $479.

This is a "one-off" cost as the opening stock tax claim for the next financial year will be $1,596 higher that presumably offsets against a full absorbed stock value at the end of year two.

Please contact the writer should you have any queries.

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