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Company procedures

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American Institute of Certified Public Accountants. Study Group on the Objectives of Financial Statements

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Recommended Citation

Objectives of financial statements: Selected papers, pp. 199-201

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Volume 2 Selected Papers

Objectives of Financial Statements

AICPA

**American Institute of
Certified Public Accountants**

May 1974

EMPIRICAL PAPERS

Company Procedures

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The company selected for the study is engaged in the production of electronic equipment. Since the purpose of the study was to explore feasibility rather than to assess the significance of differences between methods, the researchers were instructed to dispense with adjusting for (1) change in the general price level and (2) the discounting of sums to be received or paid in the future which would normally be reflected in order to prepare current value accounting statements. These adjustments were believed to be unnecessary to meet the objectives of the study because the adjustments are defined operations using known adjustment factors.

Description of Inventory System

The test company is essentially a batch manufacturing processor. The inventory system employed is a variant of a standard cost job-order system.¹ Standards are determined quarterly by reference to prevailing prices for raw materials and labor.

Materials. The company purchases a large number of raw material items to be used in the manufacture of system modules which, in turn, are assembled into completed systems. The company negotiates blanket contracts for the purchase of most of its high volume inputs in order to maintain a definite source of supply and to gain the benefit of volume discounts. These blanket contracts are in force for a one-year period. During the year, the prices of all inputs included in a contract are fixed. Delivery orders are placed as needed. The expiration dates of blanket contracts are staggered throughout the year.

¹ While the procedures employed resemble those of a standard cost system, the company does not isolate certain variances. The impact of these departures from a true standard cost system will be discussed, where necessary, in the individual papers.

A separate raw materials inventory account is not maintained. The company uses a periodic inventory system, and all purchases are recorded in a combination raw materials/work-in-process account at actual purchase prices. Usage variances are not computed. The standard cost of completed units is transferred to a finished goods account based upon the number of units completed during the period.

Labor. Assembly labor is relatively homogeneous with regard to skill and pay level. Wage rates are changed annually at the balance sheet date. Direct labor is charged to the raw materials/work-in-process account at actual hours and cost as taken from the payroll records.

Overhead. Manufacturing overhead is absorbed on the basis of a fixed rate determined by reference to expected actual direct labor hours. These costs include supervisory salaries, fringe benefits, and other selected indirect expenses.

Determining standards. A computer run is prepared quarterly which lists all purchases of raw materials and outstanding purchase orders by item, quantity, and average unit price per item. This purchase-order listing is reviewed by company personnel who select a long-term inventory price for each inventory item.² (On the average, these prices change infrequently since blanket contracts with fixed prices for the contract period govern the purchase of many inputs.) Emergency purchases of a small number of units at a higher than normal price are ignored in determining this long-term inventory price. From these prices for input components, current standards for modules and complete systems are constructed. This reconstruction of inventory components (i.e., the bill of materials) is computerized and includes all materials used in the manufacture of completed goods. In essence, standard materials cost closely approximates current replacement cost of the materials components of inventory.

Labor and manufacturing overhead standards are computed in similar fashion. Standard labor hours for each module and system are determined. Since labor rates change only once a year, unit labor cost is virtually constant during the year. Manufacturing overhead included on the bill of materials is developed by multiplying the predetermined rate by the standard labor hours required.

Inventory records. The company employs an ABC inventory system in which detailed perpetual records are maintained only for the high dollar value raw material items. All purchases of materials and direct labor costs

² This price will always be based on current purchase orders. However, it is not necessary for the goods to be physically received in order for this "long-term" purchase price to be used. For example, where a seemingly nontransitory increase in price has occurred in a recent purchase order, all similar goods on hand at the end of the period would be priced by reference to that purchase order, even if the higher priced goods are not yet in stock. However, company personnel indicated that this circumstance occurs infrequently.

are charged to the raw materials/work-in-process account at actual price. Manufacturing overhead is applied at the predetermined rate for the direct labor hours actually used to produce the output. Production costs are transferred to finished goods upon completion of orders. The transfer is effected at the predetermined standard cost for the output completed. Variances are thus left in the raw materials/work-in-process account. Price variances are small since standards are recomputed quarterly, and transfers to finished goods are based upon current prices. Usage variances are another matter. Material usage variances are usually small since defective parts can be reworked. However, labor usage variances could conceivably be important. These variances remain in the raw materials/work-in-process account and are not analyzed at the end of the period.

Cost of goods sold is determined by reference to the standard cost of items appearing on sales invoices, and finished goods inventory is reduced by a corresponding amount.

The company takes a physical inventory twice each year. After the year-end count, the book inventory figures are adjusted to reflect actual physical units. However, the resulting valuation of ending inventory closely approximates current replacement cost. As indicated above, the inventory valuation is determined quarterly on an item-by-item basis for all raw materials. These replacement costs for raw material inputs are accumulated in accordance with engineering specifications in order to determine the current replacement cost of modules and entire systems. The current replacement standards for labor and overhead are computed annually. Since labor rates change at the end of the fiscal year, the ending inventory is adjusted to reflect labor rates that will be in effect in the ensuing period.

It is necessary to emphasize that the inventory system described above has been developed primarily for *internal management* use at the test company. In the event that financial statement figures that result from application of the above procedures differ materially from generally accepted accounting principles, they are adjusted to conform with results which would be generated from the application of generally accepted accounting principles. Thus, external accounting reports always conform to generally accepted reporting requirements.