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Theory and Practice: Current Studies and Concepts

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THEORY AND PRACTICE

Current Studies and Concepts

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GUEST WRITER

The column for this issue is the work of a guest writer that this editor is pleased to present. She is Karen Bailey, a junior member of the Denver Chapter of the American Society of Women Accountants. Karen has studied at Colorado State University at Fort Collins, Colorado, and at Community College of Denver.

Inventory Valuation

We are all aware of the constant changes taking place in the methods and reports of the accounting profession. One new proposed regulation has such wide-reaching effects that we should make a concerted effort to understand it. It will have a direct effect on all companies engaged in manufacturing or production operations. The proposed regulation would amend Regs 1.61-3, 1.446-1, 1.471-2, and 1.471-3, and add new Reg. 1.471-11, and would require usage of the full absorption method of inventory valuation.

The full absorption method requires that all direct and indirect production costs be allocated to goods sold and goods in inventory at the end of the year. This means that instead of treating certain indirect costs as period costs and deducting them fully in the year incurred, at least a portion of these costs would be held in the inventory valuation until the next year. No longer would it be permissible for a manufacturer to choose the inventory valuation that suits his fancy. At the present time no strict rules govern who shall use what method of valuation for inventories, except that the consistency principle is expected to be applied from year to year.

One might think that this new proposed regulation, by requiring a specific group to use one method of inventory valuation, would simplify the accounting process and terminology of this perplexing area. Unfortunately, the proposed regulation is not so simple as it appears at first glance.

Direct production costs must all be included in the inventoriable cost calculations. The proposed regulation sets up four categories to provide guidelines as to which indirect costs are to be included in the calculation of inventoriable costs:

Category 1 lists indirect costs which *must* be included in the calculation regardless of their treatment in the financial statements. Such items include repairs and maintenance, utilities, and rent.

Category 2 includes indirect costs which needn't be included in the calculations regardless of their treatment in financial reports. Such costs include interest, advertising and marketing, and distribution and selling expenses.

Category 3 lists indirect costs which must or must not be included in inventory calculations, depending on their treatment in financial reports of the taxpayer, provided that treatment is in accordance with generally accepted accounting principles. This category deals with costs associated with the processes or operations of production or manufacturing including depreciation and depletion, officer's salaries, and insurance expenses.

Category 4 includes a list of costs which either must be or needn't be included in the computation of the taxpayer's financial accounting method is not comparable to his tax accounting method. Items which must be included under this category include those costs associated with manufacturing or production operations or processes such as overtime or vacation pay or taxes otherwise deductible under section 164. Costs which needn't be included are research and experimental expenses and losses.

Taxpayers who have been using other methods of costing their inventories and would therefore be required to change under the proposed regulations may elect to change to full absorption during a transition period. This election would need to be made during the first

180 days of any tax year beginning on or after the regulations become final and before 2 years after their finalization. Taxpayers who have elected to make the correction during the transition period need not change to the full absorption method for taxable years prior to the year of that election provided they have not received a deficiency notice for prior years with respect to an inventory costing issue. Taxpayers electing to change during the transition period will receive the benefits of transition rules which allow the taxpayer to make appropriate adjustments for the change over a ten-year period.

The new proposed regulations provide for the use of the standard cost method as well as the manufacturing burden rate method which was allowed under the previously proposed regulations. If significant in amount, adjustments resulting from both methods must be reallocated to ending inventory if the taxpayer allocates them in his financial statements. The concept of practical capacity can be used in conjunction with either the manufacturing burden rate or the standard cost method of allocating indirect production costs to the cost of goods in ending inventories.

Practical Capacity Concept

Practical capacity may be established by comparison with theoretical capacity after adjustments for allowances for estimated inability to achieve maximum production for items such as machine breakdown, idle time, or other normal work stoppages. Theoretical capacity is, of course, the level of production which could be reached if all machines and departments operated continuously at peak efficiency. Both theoretical capacity and practical capacity may be computed in terms of tons, yards, labor hours, machine hours or other units of production appropriate to the cost accounting system used by the company. An example is provided which can be summarized as follows:

XYZ Company operates a plant with a theoretical capacity of 50 units per hour. The plant actually operates 1960 hours per year (based on a 5-day week with 15 days shutdown for vacations and holidays). Down time can be reasonably estimated at 5%. Assuming no loss of production during starting up, closing down, or employee work breaks, the XYZ Company computes a practical capacity as follows:

Practical capacity before allowance for down time (based on theoretical capacity per hour—1960 × 50)	98,000
Less—5% reduction for Down time	4,900
Practical Capacity	93,100

Therefore 93,100 units would constitute the base for calculating fixed indirect production costs to be included in the computation of amount of inventoriable costs for the period. On this basis if only 76,000 units were produced, the effect would be that 81.6% of the fixed indirect production costs would be included in the inventoriable costs during the year. Those not included (18.4%) would be deductible during that year. Assume further that 7,600 units were on hand at the end of the year (or 10% of the 76,000 actually produced. Thus 10% of the fixed indirect production costs and 10% of the variable indirect production costs would be included in the cost of goods in ending inventory.

Summary

Various forms of absorption costing have been in use for several years where prime costs and predetermined fixed and variable costs are used to compute inventory costs. Modified full absorption, allowed in certain cases under the old regulations, allows the exclusion of costs under the full absorption method, if the inventory valuation method includes at least 35% of all fixed indirect production costs, and those costs are excluded from the taxpayer's financial reports. The new proposed regulation liberalizes this arbitrary percentage test by allowing costs to be excluded provided they are excluded from the company's financial reports and also provided those exclusions are in accordance with generally accepted accounting principles.