Statement of Financial Accounting Standards No. 151

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FAS151 Summary

Inventory Costs

an amendment of ARB No. 43, Chapter 4

November 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 151: Inventory Costs

an amendment of ARB No. 43, Chapter 4

FAS 151 Summary

This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal." In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities.

Reasons for Issuing This Statement

This Statement is the result of a broader effort by the FASB to improve the comparability of cross-border financial reporting by working with the International Accounting Standards Board (IASB) toward development of a single set of high-quality accounting standards. As part of that effort, the FASB and the IASB identified opportunities to improve financial reporting by eliminating certain narrow differences between their existing accounting standards. The accounting for inventory costs, in particular, abnormal amounts of idle facility expense, freight, handling costs, and spoilage, is one such narrow difference that the FASB decided to address by issuing this Statement. As currently worded in ARB 43, Chapter 4, the term *so abnormal* was not defined and its application could lead to unnecessary noncomparability of financial reporting. This Statement eliminates that term.

How the Changes in This Statement Improve Financial Reporting

ARB 43, Chapter 4, and IAS 2, *Inventories,* are based on the principle that the primary basis of accounting for inventory is cost. Both those accounting standards also require that abnormal amounts of idle freight, handling costs, and spoilage be recognized as current-period charges;

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however, differences in the wording of the two standards could lead to inconsistent application of those requirements. This Statement improves financial reporting by amending ARB 43, Chapter 4, to clarify that abnormal amounts of costs should be recognized as period costs. The amending language is similar to that in IAS 2, in order to promote consistent application of those standards.

INTRODUCTION

1. ARB No. 43, Chapter 4, "Inventory Pricing," discusses the general principles applicable to the pricing of inventory. Paragraph 5 of ARB 43, Chapter 4 provides guidance on allocating certain costs to inventory. This Statement amends ARB 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment of ARB No. 43, Chapter 4

2. Paragraph 5 and footnote 2 of ARB 43, Chapter 4, are amended as follows: [Added text is underlined and deleted text is struck out.]

> 5. ~~In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost.~~ Inventories are presumed to be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost,[2] and its determination involves many considerations~~problems~~. Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of considerations~~problems encountered~~ in the allocation of costs and charges. For example, variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. However, the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity refers to a range of production levels. Normal capacity is the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. Some variation in production levels from period to period is expected and establishes the range of normal capacity. The range of normal capacity will vary based on business- and industry-specific factors. Judgment is required to determine when a

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production level is abnormally low (that is, outside the range of expected variation in production). Examples of factors that might be anticipated to cause an abnormally low production level include significantly reduced demand, labor and materials shortages, and unplanned facility or equipment downtime. The actual level of production may be used if it approximates normal capacity. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of abnormally low production or idle plant.

5A. Unallocated overheads are recognized as an expense in the period in which they are incurred.~~under some circumstances,~~ Other items such as abnormal ~~idle facility expense, excessive spoilage, double~~ freight, ~~and re~~handling costs, ~~may be so abnormal~~and amounts of wasted materials (spoilage)~~as to~~ require treatment as current period charges rather than as a portion of the inventory cost. Also, under most circumstances, general and administrative expenses[2a] should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges). Selling expenses constitute no part of inventory costs. ~~It should also be recognized that t~~The exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

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[2]In the case of goods which have been written down below cost at the close of a fiscal ~~period~~year, such reduced amount is to be considered the cost for subsequent accounting purposes. Paragraph 14 of APB Opinion No. 28, *Interim Financial Reporting*, provides guidance for preparing interim financial statements.

[2a]General and administrative expenses ordinarily should be charged to expense as incurred but may be accounted for as contract costs under the completed-contract method of accounting or, in some circumstances, as indirect contract costs by government contractors.

Other Amendment to Existing Pronouncements

3. Paragraph A3 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, is amended as follows:

An entity owns a manufacturing facility that together with other assets is tested for recoverability as a group. In addition to long-lived assets (Assets A–D), the asset group includes inventory, which is reported at the lower of cost or market in accordance with

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ARB No. 43, Chapter 4, "Inventory Pricing," as amended by FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 151, *Inventory Costs,* and other current assets and liabilities that are not covered by this Statement. The $2.75 million aggregate carrying amount of the asset group is not recoverable and exceeds its fair value by $600,000. In accordance with paragraph14, the impairment loss of $600,000 would be allocated as shown below to the long-lived assets of the group. [Table has been omitted here.]

Transitional Disclosures

4. The disclosures required by paragraph 19(c) of APB Opinion No. 20, *Accounting Changes,* are applicable if significant changes to an entity's inventory accounting result from the adoption of this Statement.

Effective Date and Transition

5. The provisions of this Statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after the date this Statement is issued. The provisions of this Statement shall be applied prospectively.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
George J. Batavick
G. Michael Crooch
Gary S. Schieneman
Katherine Schipper
Leslie F. Seidman
Edward W. Trott

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Appendix A: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

A2. In September 2002, the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) committed to a broad effort to improve international comparability of financial reporting by working toward development of a single set of high-quality accounting standards. As part of that effort, the Boards jointly undertook a short-term project to eliminate certain narrow differences between the accounting pronouncements issued by the IASB and the accounting standards issued by the FASB. Both Boards agreed to limit the scope of the short-term project to issues for which (a) the Boards' respective accounting pronouncements were different; (b) convergence to a high-quality solution would appear to be achievable in the short-term, usually by selecting between the existing standards of either the FASB or the IASB; and (c) the issue was not within the scope of other projects on the current agenda of either Board. The accounting for inventory costs, in particular, the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage), is one such difference that the FASB decided should be addressed in the short-term convergence project. While the Board believes ARB 43, Chapter 4, and IAS 2, *Inventories*, are based on the same principle—that abnormal amounts of such costs should be recognized as current-period charges—the Board decided that differences in the wording of the two standards could have led to inconsistent application of that principle.

A3. In December 2003, the Board issued an Exposure Draft, *Inventory Costs*, for a 120-day comment period. The Board received 26 comment letters on the Exposure Draft. In August 2004, the Board redeliberated the issues identified in the Exposure Draft and concluded that on the basis of existing information, it could reach an informed decision without a public hearing.

Basis for Conclusions

A4. Paragraph 5 of ARB 43, Chapter 4, previously stated that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may

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be so abnormal as to require treatment as current period
charges. . . ." In the Exposure Draft, the Board proposed amending paragraph 5 to adopt the language of IAS 2. That proposed amendment would have (a) clarified that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges, regardless of whether the "so abnormal" criterion is met and (b) incorporated into ARB 43, Chapter 4, guidance for determining whether idle capacity was abnormal. In proposing that amendment, the Board believed that adopting the language used in IAS 2, in this instance, would not substantially change current inventory accounting practice in the United States.

A5. Many respondents to the Exposure Draft disagreed with the Board's conclusion that the proposed amendment would not substantially change current inventory accounting practice. In particular, they noted that incorporating the guidance from IAS 2 that states that fixed production overhead costs should be allocated to inventory based on the "normal capacity" of the production facility would result in recognition of all unfavorable volume variances as a period expense, while favorable variances that are normal would be recognized in inventory. Those respondents noted that under ARB 43, Chapter 4, volume variances are recognized as a period cost only when the "so abnormal" criterion is met. For that reason and others, some respondents urged the Board not to proceed with the proposed changes unless and until a comprehensive project on inventory accounting is undertaken.

A6. In its redeliberations, the Board reaffirmed its decision to amend ARB 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as a period expense regardless of whether the "so abnormal" criterion is met. However, to address respondents' concerns, the Board decided that the amendment should include guidance slightly more detailed than that in IAS 2 regarding normal capacity. In particular, the Board decided to add guidance clarifying that normal capacity refers to a range of production levels within which ordinary variations in production levels are expected. The Board believes the amendment to ARB 43, Chapter 4, as modified, will not lead to significant changes in inventory accounting practice.

A7. Some respondents to the Exposure Draft requested that the Board provide definitions of certain terms such as *fixed* and *variable production overheads, low production,* and *idle plant.* The Board considered those requests but decided not to provide those definitions because the terms have been used for many years and, therefore, should be well understood by constituents.

Effective Date and Transition

A8. The Board decided that this Statement should be effective for fiscal years beginning after June 15, 2005. The Board does not anticipate significant changes in financial reporting to result from these clarifications and therefore does not believe that a more significant amount of lead time is required prior to implementation. Further, early application of the provisions of this Statement is permitted. Allowing early adoption will enable entities based in the European

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Union that report under U.S. generally accepted accounting principles to implement these provisions prior to the requirement to report under international financial reporting standards.

A9. The Exposure Draft reflected the Board's decision that prospective application of the provisions of this Statement would be appropriate because the effects of retrospective application may not be determinable for many entities or because the cost to accomplish retrospective application would be excessive in relation to the benefits to users of the financial statements.

A10. Several respondents to the Exposure Draft asked the Board to clarify whether the provisions of this Statement were intended to be applied to inventory on hand as of the date of adoption. In response, the Board clarified that this Statement applies only to inventory costs incurred during periods beginning after the date of adoption.

Benefits and Costs

A11. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy. The Board believes the benefit of reducing the possibility for potential misinterpretation of the principles of inventory pricing outweighs the cost of applying this Statement.

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