

NO EQUIVOCATING: EXPENSE THOSE IDLE CAPACITY COSTS

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A few tiny words can sometimes have a big impact, especially when it comes to accounting standards. And it isn't just when words are added—it can also be a big deal when they disappear. Some seemingly minor changes to SFAS No. 151 may end equivocation when it comes to expensing the cost of idle capacity.

What are the manufacturing costs of inventory? And does the answer to this question differ across national boundaries?

It shouldn't, according to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The FASB, as a part of its ongoing cooperative efforts with the IASB to harmonize accounting standards across international borders (especially where accounting principles—although differing—are very similar), issued Statement of Financial Accounting Standards (SFAS) No. 151, "Inventory Costs—an amendment of ARB No. 43, Chapter 4." Issued in late 2004, SFAS No. 151 is intended to close one of the

gaps that exist between International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP). As stated in paragraph A2 of SFAS No. 151, the Statement brings us closer to the goal of "a single set of high-quality accounting standards."

In 2009 the FASB replaced individual standards with its *Accounting Standards Codification*TM (ASC) for authoritative reference purposes. We'll use "SFAS No. 151" in discussing these issues, but the wording of SFAS No. 151 can be found in the Codification in Section 330-10-30, paragraphs 1-8.

The FASB doesn't expect SFAS No. 151 to significantly affect inventory accounting. Perhaps the Board is right,

Table 1: Changes to SFAS No. 151

ORIGINAL WORDING ARB 43, CHAPTER 4	AS AMENDED SFAS NO. 151
<ul style="list-style-type: none"> ◆ In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost. 	<ul style="list-style-type: none"> ◆ Inventories are presumed to be stated at cost.
<ul style="list-style-type: none"> ◆ The definition of cost as applied to inventories is understood to mean acquisition and production cost,² and its determination involves many problems. 	<ul style="list-style-type: none"> ◆ The definition of cost as applied to inventories is understood to mean acquisition and production costs,² and its determination involves many considerations.
<ul style="list-style-type: none"> ◆ 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 problems encountered in the allocation of costs and charges. 	<ul style="list-style-type: none"> ◆ 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 in the allocation of costs and charges.
<ul style="list-style-type: none"> ◆ For example, 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 rather than as a portion of the inventory cost. 	<ul style="list-style-type: none"> ◆ 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 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. <ul style="list-style-type: none"> 5A. Unallocated overheads are recognized as an expense in the period in which they are incurred. Other items such as abnormal freight, handling costs, and amounts of wasted materials (spoilage) require treatment as current period charges rather than as a portion of the inventory cost.

ORIGINAL WORDING ARB 43, CHAPTER 4	AS AMENDED SFAS NO. 151
<ul style="list-style-type: none"> ◆ Also, general and administrative expenses 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). 	<ul style="list-style-type: none"> ◆ 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).
<ul style="list-style-type: none"> ◆ Selling expenses constitute no part of inventory costs. 	<ul style="list-style-type: none"> ◆ Selling expenses constitute no part of inventory costs.
<ul style="list-style-type: none"> ◆ It should also be recognized that the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. 	<ul style="list-style-type: none"> ◆ The exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure.
<ul style="list-style-type: none"> ◆ 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. 	<ul style="list-style-type: none"> ◆ 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.
<p>2 In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.</p>	<p>2 In the case of goods which have been written down below cost at the close of a fiscal year, such reduced amount is to be considered the cost for subsequent accounting purposes. Paragraph 14 of APB Opinion No. 28, <i>Interim Financial Reporting</i>, provides guidance for preparing interim financial statements.</p>
	<p>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.</p>

but a number of companies in recent times have released considerable capacity upon which overhead rates had been calculated. That includes companies whose product demand is waning as they try to survive a competitive environment as well as companies that are thriving because they've leveraged effectively-advanced operational techniques and tools. Specific words that are used in official pronouncements that guide human behavior can have extraordinary consequences, even when the words in and of themselves seem inconsequential. With SFAS No. 151, it's a case of specific words that were discarded.

A "Slight" Change in Wording

For fiscal years beginning after June 15, 2005, companies are subject to the changes brought about by SFAS No. 151 (see Table 1).

Only one section has changed considerably, and it has changed in two ways. The first change, which is less significant than the other, relates to the expanded discussion of what constitutes normal capacity. To keep SFAS No. 151 from requiring favorable production volume variances to reduce inventory costs but not allow unfavorable production volume variances to increase inventory costs (a criticism expressed by

many respondents to the exposure draft), the FASB added a number of sentences to paragraph 5 of the Statement that recognize normal capacity as a range of activity.

The second—and more significant—change concerns the specific words expressing the need for idle facility and other abnormal production costs to be expensed as current-period charges. The FASB issued the new Statement to “clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage).” ARB 43, Chapter 4, previously stated that companies *may* have to expense such items as long as they met the criterion of “*so abnormal*” (emphasis added by authors throughout). SFAS No. 151 requires abnormal amounts of facility expenses, freight, etc., to be expensed, regardless of whether they meet the criterion of “so abnormal.” SFAS No. 151 states, “...abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges.” “So abnormal” has been eliminated from the vernacular in inventory costing. In doing so, the FASB has also enhanced its efforts to move toward harmonization with IFRS, which neither prefaces the word “abnormal” with the word “so” nor includes the word “may.”

Ultimately, SFAS No. 151 states, “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*.” SFAS No. 151 explains, “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.” Paragraph 5A of the Statement says that “Unallocated overheads are recognized as an expense in the period in which they are incurred.” Gone is original wording that stated, “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...” etc.

The FASB contends it eliminated “so abnormal” because the phrase was too difficult to interpret. Perhaps the Board is correct, but we suspect that the words “may” and “so abnormal” had the effect of allowing companies to absorb costs into inventory that should have been expensed. Such words as “may” and “so” lend an air of equivocation that no longer exists with the changes brought about by SFAS No. 151, and the changes have occurred at the same time as an unprecedented amount of corporate downsizing.

Corporate giants like General Motors and Ford have undergone, or are undergoing, massive layoffs due in part to *significantly reduced demand*, which of course leads to *unplanned facility or equipment downtime*. These are only two noticeable examples, but certainly not the only ones. Such companies don’t shut down entirely, but unless they abandon entire plants (which GM and Ford have done in some places), they have idle facility expenses at locations operating at reduced production, i.e., significant idle facility expenses. Under SFAS No. 151, proportionate expenses such as depreciation, insurance, and property taxes on unused portions of building and equipment, not to mention diminished but still ongoing utilities and maintenance costs, shouldn’t be charged to production but instead expensed as current-period charges. Supposedly this isn’t different from what ARB 43, Chapter 4, called for, but again it used the words “may” and “so abnormal,” which have been removed in SFAS No. 151.

Amelioration of Current Expense

We can see four ways in which companies may ameliorate the need to charge as current-period expense the ongoing costs related to abnormally low production or idle plant. First, finding alternate uses, production, or service for otherwise idle plants, property, and equipment alleviates the need to expense idle plant space currently and allows allocation of such costs to the alternate use(s). This was exactly the experience of one of the authors many years ago when a Midwest manufacturer of agricultural equipment with which he was familiar found itself with a decreasing market for its product. The company became the U.S.-outsourced manufacturer for a European manufacturer. Luckily, as the demand for its own product decreased, U.S. demand for the European company’s product increased. Other issues of cost allocation fairness arose, but these issues weren’t related to SFAS No. 151.

Second, if entire plants are shut down and put up for sale, the property is no longer in productive use and should be reclassified from property and plant in use to an investment category, which would remove the fixed assets previously involved in production from a company’s depreciation schedules. Third, it’s possible that an expense of another kind will occur that would ameliorate expenses, at least in future periods, from abnormally low production. If a company determines an asset impairment has occurred, a write-down because of the impairment may be appropriate, which would reduce the base on which fixed facility costs would be expensed because of abnormally low production. The company would incur a large

charge to current operations in the year of the impairment, but future periods are, to a large degree, unbundled by idle facility expenses. Asset impairment rules, however, don't cover the periodic expenses of maintenance, insurance, property taxes, etc.

Finally, in some circumstances, lower of cost or market rules for inventory valuation may render the issue moot. If a company defers idle facility costs and other such expenses into its inventory assets, the costs, if too excessive, may cause recorded inventory amounts to exceed their market values. The company would wind up charging the current period anyway with costs attributable to idle plant and other such costs. This is a more likely event if abnormally low production has occurred because of significantly reduced demand for the product. The lower of cost or market rule is also one in which U.S. GAAP and IFRS diverge. Currently under U.S. GAAP, firms that lower the basis of their inventory to market can't subsequently raise the cost back to the original basis under any circumstances. IFRS allows this type of reversal.

The Costs of Thriving

What about companies that have successfully reduced production costs because of advanced cost management techniques, such as activity-based costing, resource consumption accounting, and Just-in-Time inventory management practices? These techniques often reduce the use of existing plant space in production activities. Sometimes these practices free up enormous plant space. Are the costs applicable to freed-up plant space still necessary to make the product? Enlightened companies don't count such costs as a product cost internally, but do they—or do their auditors require or allow them to—defer these costs into inventory assets for external financial reporting?

Are such costs inventoriable? The answer: No more than idle facilities costs that are idle because of decreased demand for the product previously produced in the plant. Companies sometimes favor deferring such costs into the inventory asset that won't be expensed until the inventory asset is sold, reflecting a management propensity to focus on immediate financial returns. If those facilities are actually used to produce the inventory asset, GAAP requires that those facilities' costs be a part of the inventory asset. But can a company justify allocating entire plant costs to inventory production even when the entire plant is no longer dedicated to inventory production activities? SFAS No. 151 would seemingly say no.

On the other hand, SFAS No. 151 defines normal capacity as a range of activity. But normal capacity refers

to a company's budgeted production level in physical units and relates to the denominator, not the numerator. Capacity costs are the numerator to normal capacity's denominator. So could a company argue that normal costs include plant costs in their entirety even if substantial parts of the plant used productively in the past are no longer needed because there is the potential for plant utilization in its entirety in the future? On the surface it may seem that SFAS No. 151 will better handle the problem of demand-caused manipulations of overhead costs, but closer examination reveals that no such goal is accomplished because the standard of normal is based on production rather than sales. SFAS No. 151 doesn't address the buildup of inventory levels through excess production. The new stricter Statement may encourage this buildup instead of discouraging it if a company wants to avoid expensing idle facilities costs until the inventory is sold (or written down because of lower of cost or market rules).

A Boon or Burr to Professional Judgment?

Abnormally idle capacity costs have no place in inventory values. The FASB has stepped in the right direction by reducing at least some doubt as to what constitutes "abnormal" and eliminating the hedging words of ARB 43. SFAS No. 151 and the Codification rightfully leave intact management discretion and the need for affected parties to exercise professional judgment. The FASB expects SFAS No. 151 to cause *little* significant change in company inventory accounting practices. The FASB may be right industry-wide, but responsible accountants in companies that find themselves in situations to which SFAS No. 151 applies will find the "slight" wording changes of SFAS No. 151 *significant* to the exercise of their professional judgment. **SF**

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