



INVENTORIES

Accounting 580T – Lectures 10 and 11
Gertzman: Chapters 6 and 7
Robert A. Scharlach



Statutory Provisions

- Code Sec. 263(a)
- Code Sec. 263A
- Code Sec. 263A(f)
- Code Sec. 460(c)



LITTLE a VS BIG A

Sec. 263(a) determines whether an asset exists

Sec. 263A determines the overhead costs allocable to the asset



When Does Sec. 263A Apply

- **Property Produced**

- Real property
- Tangible personal property



When Does Sec. 263A Apply

- **Property Acquired for Resale**

- Real property
- Personal property



STEPS IN DETERMINING OVERHEAD ALLOCATION

- **Identify costs to be capitalized under full absorption**
- **Identify additional overhead which must be capitalized under UNICAP**
- **Allocate costs between ending inventory and cost of goods sold**



IDENTIFY THE FULL ABSORPTION INVENTORY COSTS

- **Determine the Direct Materials cost**
- **Determine the Direct Labor cost**
- **Determine the Overhead that should be capitalized**



IDENTIFY ADDITIONAL UNICAP COSTS

- **General rule for UNICAP**
 - **Capitalize all costs that directly benefit production or resale activity**



SECTION 263A MECHANICS

- **Step One –**
 - **Identify types of additional 263A costs**



STEPS TO COMPUTE INVENTORY

- **Regulations list 23 types of indirect production costs**
 - These include the costs of administrative, service and support functions
 - If not already included in the sec. 471 costs, they are grouped together in departments



STEPS TO COMPUTE INVENTORY

- **Departments are of three types –**
 - Departments related entirely to production
 - Departments not related to production
 - Departments related to both production and non-production activities (mixed service departments)



STEPS TO COMPUTE INVENTORY

- **Entire cost allocated to production departments must be capitalized**
- **None of the costs allocated to non-production departments must be capitalized**
- **Costs related to the mixed service departments must be allocated in part to inventory**



SECTION 263A MECHANICS

● Step Two –

- Compute the capitalizable mixed service department costs



STEPS TO COMPUTE INVENTORY

● Self-Developed Allocation Methods

- Taxpayer develops method using a reasonable factor



STEPS TO COMPUTE INVENTORY

● Direct reallocation method

- Total cost of all mixed service departments are allocated only to production departments



STEPS TO COMPUTE INVENTORY

● Step-Allocation Method

- Sequence of allocations is made beginning with the allocation of the mixed service department which provides benefits to most other service departments



STEPS TO COMPUTE INVENTORY

● Simplified Service Cost Method

- Use the following formula:
- Allocation Ratio X Total Mixed Service Costs



STEPS TO COMPUTE INVENTORY

● Use either:

- Production Cost Allocation Ratio
- Labor Based Allocation Ratio



PRODUCTION COST ALLOCATION RATIO

● **Total Production Costs* / Total Costs****

– *Determined under 263A less mixed service costs and interest

– ** Less mixed service costs and interest



LABOR BASED ALLOCATION RATIO

● **Total Production Labor Costs* / Total Labor Costs***

– *Excluding labor costs included in mixed service costs



DE MINIMUS RULE

● **If 90% or more of a mixed service department's costs are deductible service costs, all of the department's costs can be deducted**

● **If 90% or more of such costs are inventoriable, the department's entire cost is capitalizable**



SECTION 263A MECHANICS

- **Step Three –**

- Allocate additional 263A costs between ending inventory and cost of goods sold



ALLOCATION TO ENDING INVENTORY

- **Several methods are available:**

- Self developed allocation methods
- Simplified production method without historic absorption ratio election
- Simplified production method with historical absorption ratio



SIMPLIFIED PRODUCTION METHOD

- **Step 1: Compute an “absorption ratio”**

- **Total additional 263A inventoriable costs (other than interest) / Total 471 costs incurred during the year = Absorption Ratio**



SIMPLIFIED PRODUCTION METHOD

- **Step 2: Use the “Absorption Ratio” to allocation additional costs to ending inventory**
- **Absorption Ratio X Total sec. 471 costs in ending inventory = Total additional costs in ending inventory**
