INVENTORIES

Accounting 580T – Lectures 10 and 11
Gertzman: Chapters 6 and 7
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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

- 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)

- 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

- 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

● Simplified Service Cost Method
  – Use the following formula:
    – Allocation Ratio X Total Mixed Service Costs

● 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 allocate additional costs to ending inventory

- Absorption Ratio X Total sec. 471 costs in ending inventory = Total additional costs in ending inventory