

Defining Issues[®]

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Accounting for Unexpected Production Defects and Waste — Inventory or Expense?

Companies will no longer be permitted to capitalize inventory costs on their balance sheets when the production defect rate varies significantly from the expected rate, according to a new FASB Statement that eliminates the “so abnormal” criterion in ARB 43.¹ New Statement 151 also makes clear that fixed overhead should be allocated based on “normal capacity.” The Statement is an outcome of the FASB’s project to reduce differences between U.S. and international accounting standards and is effective for inventory costs incurred during annual periods beginning after June 15, 2005.

The “Abnormal” Criterion

ARB 43 held that unanticipated spoilage, defects, and analogous inventory costs could be “so abnormal as to require treatment as current period charges.” The “so abnormal” criterion was undefined and could be inconsistently applied. It has been replaced by a requirement that “abnormal freight, handling costs, and amounts of wasted materials (spoilage)” should be treated as current-period costs. Under this concept, if the costs associated with the actual level of spoilage or production defects are greater than the costs associated with the range of normal spoilage or defects, the difference should be charged to current-period expense, not included in inventory costs.

To illustrate the “abnormal” criterion, assume the requirements in Statement 151 apply to the widget manufacturer ABC Company. ABC’s variable manufacturing costs (materials and labor) average \$5 per unit. ABC’s production quality standards are designed to ensure a defect rate no higher than 2%. The average variable cost for reworking is \$3 per unit.

In January, ABC manufactured 9,500 widgets with a defect rate of 5%. In February, ABC manufactured 10,200 widgets with a defect rate of 6%. The costs of materials and labor continued to average \$5 per unit.

¹ FASB Statement No. 151, *Inventory Costs: an amendment of ARB No. 43*, Chapter 4, November 2004; Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing*, June 1953.



ABC's abnormal rework costs for January and February are:

	January	February
Abnormal Rework:		
Number of defects (Jan-5%, Feb-6%)	475	612
Normal defects (2%)	190	204
Abnormal defects	285	408
Unit cost to rework abnormal defects	\$3	\$3
Total abnormal rework costs	\$855	\$1,224

The abnormal costs (\$855 for January, \$1,224 for February) would be expensed in the income statement, not added to the cost of inventory.

Fixed Overhead Allocation

Statement 151 clarifies that a facility's fixed production overhead cost should be allocated to inventory based on the facility's "normal capacity." Normal capacity is defined as "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." If the production level is abnormally low or abnormally high, the unallocated overhead should be charged to current-period expense.



The new Statement is only a start in eliminating differences between U.S. and international standards on inventory accounting. Many differences still remain. For example, international standards prohibit the last-in, first-out (LIFO) cost method, whereas U.S. standards permit its use, and U.S. standards require the lower-of-cost-or-market approach, whereas international standards require lower of cost or net realizable value. The FASB and IASB have pledged to work together to continue to reduce the number of differences between U.S. and international accounting standards.

The descriptive and summary statements above are not intended to substitute for the text of Statement 151 and are not necessarily applicable to any company's particular circumstances. Companies applying Statement 151 should consult its text and their accounting and legal advisors.

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