

# ***IT 2350 - Income tax : value of trading stock on hand at end of year : cost price : absorption cost***

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 This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

TAXATION RULING NO. IT 2350

INCOME TAX : VALUE OF TRADING STOCK ON HAND AT END OF  
YEAR : COST PRICE : ABSORPTION COST

F.O.I. EMBARGO: May be released

REF H.O. REF: 85/4971-1 DATE OF EFFECT: Immediate

B.O. REF: DATE ORIG. MEMO ISSUED:

F.O.I. INDEX DETAIL

| REFERENCE NO: | SUBJECT REFS:   | LEGISLAT. REFS: |
|---------------|---|-----------------|
| I 1209967     | TRADING STOCK<br>VALUATION OF<br>ABSORPTION COST METHOD | 31(1)           |

RULING

Sub-section 31(1) of the Income Tax Assessment Act gives to business taxpayers an option to value trading stock on hand at the end of a year at "its cost price or market selling value or the price at which it can be replaced". In sub-section 6(1) trading stock is defined to include "anything produced, manufactured, acquired or purchased for purposes of manufacture, sale or exchange, and also includes livestock".

2. The purpose of this Ruling is to set out the official approach to the determination of the cost price of trading stock on hand at the end of a year of income in the case where a taxpayer is engaged in a business of manufacture.

3. In a decision reported as Australasian Jam Co. Pty. Ltd. v. FCT (1953) 88 CLR 23 at p.29 Fullagar J. observed that the expression "cost price" was not literally appropriate to goods manufactured as distinct from goods purchased by a taxpayer - he was of the view that the expression should be read simply to mean "cost".

4. Jenkinson J. adopted the same approach more recently in a decision reported as Philip Morris Ltd. v. FCT, 79 ATC 4350 : 10 ATR 44. He expanded on the concept of "cost price" in relation to manufactured trading stock in the following words:-

"The concept expressed by the words 'cost price' in section 31(1) in my opinion is, in its application to an article of trading stock manufactured by a taxpayer, directed to the ascertainment of the expenditure, in the course of his materials purchasing and manufacturing activities, to bring the article to the state in which it was when it became part of his trading stock on hand."

5. As the decision in the Philip Morris case illustrates there are two methods of ascertaining the cost of manufactured trading stock which are recognised for accounting purposes. The first, known as direct costing or variable costing, takes into account the cost of materials and the cost of labour used

directly in the manufacturing operations. The second method, known as absorption costing or conventional costing, has regard not only to the costs of materials and direct labour but takes into account also what are known as indirect costs, e.g. factory overheads.

6. It is the official view that the absorption cost method is the correct means of ascertaining the cost of trading stock on hand at the end of a year in a manufacturing business. This view was endorsed in the Philip Morris case. Guidelines for the application of the absorption cost method were outlined in a memorandum from Head Office of 22 June 1978, H.O. reference 77/3720. Taxation Rulings Nos. IT 33 and 2001 are examples of its application to nurserymen and winemakers respectively.

7. Under the absorption cost method there are three elements to be taken into account in determining the cost of an article of trading stock manufactured by a taxpayer:-

- (a) Material Costs - the cost of materials used to manufacture the particular article.
- (b) Direct Labour Costs - the cost of labour used directly in the manufacturing operations.
- (c) Production Overheads Costs - all production costs other than materials and direct labour costs.

8. Production overheads costs are sometimes described as factory overheads, indirect manufacturing costs, manufacturing overhead or manufacturing expense. There are two categories of production overheads:-

- (a) Variable Production Overheads - production costs which vary with the volume of production, e.g. factory light and power, stores and most indirect labour.
- (b) Fixed Production Overheads - production costs which remain relatively constant from period to period irrespective of any variation in the volume of production, e.g. factory rent, insurance, depreciation, etc.

9. For the purposes of sub-section 31(1) the cost price of manufactured trading stock on hand at the end of a year includes not only material and direct labour costs but also an appropriate proportion of production overheads costs without which the trading stock on hand would not be produced at all. The same elements of cost should be taken into account in ascertaining the cost of work in progress at the end of a year.

10. In apportioning production overheads costs in practice it is necessary in the first instance to ascertain the extent to which they may have been incurred for non-manufacturing purposes. Only that part of the total production overheads costs relating to the manufacturing operations should be absorbed into product cost. Next, it is necessary to ascertain

the proportion of production overheads costs attributable to work in progress at the end of a year. The balance of production overheads costs would relate to finished goods and the amount to be allocated to manufactured goods on hand at the end of a year of income would normally be determined by the application of the formula:-

$$\text{MGH} = \text{FGH} / \text{FGP} * \text{POC}$$

Where: MGH denotes Manufactured Goods on Hand  
(at the end of a year of income)

FGH denotes Finished Goods on Hand

FGP denotes Finished Goods Produced During the Year

POC denotes Production Overhead Costs to be Absorbed

11. In respect of manufacturing businesses generally the following production overheads costs should be taken into account when valuing the cost of manufactured trading stock on hand and work in progress by the absorption cost method:

- . Factory light and power.
- . Factory rent, maintenance and repair expenses.
- . Factory rates and taxes.
- . Insurance of factory, plant and machinery.
- . Indirect labour and production supervisory wages, including:
  - . Holiday pay, sick pay and tea money
  - . Long service leave (actual amounts paid)
  - . Workers compensation
  - . Superannuation
  - . Payroll tax.
- . Indirect materials and supplies.
- . Royalties in respect of any production process.
- . Tools and equipment not capitalised.
- . Quality control and inspection.
- . Factory administration expenses.
- . Raw materials - handling and storage.
- . Depreciation on factory, factory plant and equipment.

12. It is important to note that, while most, if not all, production overheads costs would be allowable as income tax deductions, not all income tax deductions would qualify as production overheads costs. From time to time the income tax law may provide special concessions which apply in the area of the manufacturing process. The investment allowance deduction is one example. Accelerated depreciation is another. Income tax deductions of this nature are not taken into account for absorption cost purposes.

13. The following expenses are not considered to be production overheads costs:

- . Marketing expenses.
- . Storage expenses.
- . Advertising expenses.

- . Selling expenses.
- . Other distribution expenses.
- . Interest and other financial expenses.
- . Research and experimental expenses, including engineering and product development.
- . Income taxes.
- . General administrative expenses.
- . Employee benefits, such as:
  - . training
  - . profit sharing
  - . employee shares
  - . first aid stations
  - . cafeteria
  - . recreational facilities.
- . Costs attributable to strikes, rework labour, scrap and spoilage.

14. In bringing relevant costs to account in any case it is not expected that each article of trading stock be valued individually. In many cases the nature of the business and the nature of the trading stock makes individual valuation physically impossible. Any method capable of consistently producing a total valuation of trading stock on hand reasonably approximating its full absorption cost will be acceptable.

15. Methods that have been accepted include:-

First In First Out (FIFO) - this method calculates cost on the basis that quantities of stock on hand are the most recently produced.

Average Cost - this method averages costs of the whole year.

The Last In First Out (LIFO) method is not acceptable because, in times of steadily rising prices, it tends to undervalue the cost of stock on hand at the end of a year.

16. Use of the standard cost method is acceptable provided that the standard contains a component for production overheads costs (i.e. a standard absorption cost system) and the standards have been properly set and are regularly reviewed and updated to meet current conditions. Where a discrepancy, i.e. a variance, between budgeted cost (being the total cost based on the standards) and actual cost is due to faulty or incorrect standards, for example when they have not been changed to reflect changed circumstances, the variance, if significant, should be apportioned between the stock that has been sold and that remaining at the end of the year of income, whether finished goods or work in progress.

17. The application of the absorption method will require modification in certain circumstances. In the Philip Morris decision, for example, Jenkinson J. recognised that the manufacture of some items of trading stock may entail greater costs than other items and that a separate cost may be necessary for each category.

18. A manufacturer who suffered a downturn in production would not need to take into account more than a reasonable share of production overheads costs in calculating the cost price of trading stock on hand at the end of a year. Similarly, production overheads costs attributable to abnormal idle capacity brought about, for example, by prolonged strikes may be excluded from the calculation of full absorption cost. This is not to say, however, that anything less than full or maximum operating capacity is to be taken as a downturn in production or abnormal idle capacity. In each case it would be necessary to have regard to the normal operating capacity taking into account the level of production under normal circumstances. At the end of the day what is being sought is a fair and reasonable cost price for trading stock on hand at the end of a year of income having regard to the particular abnormal circumstances.

19. In practice the application of the absorption cost method is likely to arise in two situations, i.e. at the request of a taxpayer or in the course of audit or investigation activities.

20. Where a taxpayer seeks to change from the direct cost method to the absorption cost method there will be a question of how any adjustment is to be effected. Strictly speaking, in the year of changeover the absorption cost method should be applied to trading stock on hand both at the beginning and end of the year - otherwise there would not be a true reflex of the income derived during the year. Prior year assessments may be re-opened to the extent permitted by section 170. In many cases it is likely that the taxpayer will be prepared to accept adjustment in the year of changeover, i.e. the cost price of trading stock on hand at the beginning of the year will be taken into account on the direct cost method and the cost price of trading stock on hand at the end will be ascertained by the absorption cost method. In effect any understatement of stock values in years preceding the year of changeover is compressed into one year. Where the taxpayer is agreeable this procedure may be followed.

21. The procedure outlined in the preceding paragraph may also be followed in cases encountered in the course of audit or investigation activities where it is necessary to adjust the cost price of trading stock on hand to give effect to the absorption cost method. Where the taxpayer is agreeable any adjustment on this account may be made in the first year to which the audit or investigation activities relate in lieu of re-opening assessments of years prior to the first years. In some situations it may be acceptable to make the adjustments in the last year covered by the audit or investigation activities.

22. Understatements of income arising from the incorrect use of the direct cost method of ascertaining the cost price of manufactured trading stock on hand attract the operation of the additional tax provisions of sub-section 227(3) and the former sub-section 226(2). The extent to which the additional tax may be remitted in any case should be determined in accordance with

the general guidelines in Taxation Ruling No. IT 2206.

COMMISSIONER OF TAXATION

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