The Emerging Authority of Statements on Management Accounting

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Abstract

Armco Inc. v. Comr. demonstrated that the accounting profession needs a source of authoritative guidance in management accounting. Statements on Management Accounting (SMA) offer consensus guidelines and definitions established and approved b a diverse group of accounting professionals and other members of the business community. SMA's provide a source of guidance that can outweigh other accounting literature that generally represents just one or two authors', or even an accounting firm's, opinion. It is imperative for the accounting profession to continue to develop detailed guidance for accounting and reporting practice. If we don't, the judicial system may fill this gap. This article has summarized a recent tax case involving a very specific definition of direct materials. The future role of the SMA series in similar circumstances is bright, give the need for guidance and the growing awareness of this important professional promulgated.

Introduction

In the last several years management accountants have gained a tool that has proven useful to accountants in other areas, including public accounting. Statements on Management Accounting (SMAs) represent the official position of the National Association of Accountants (NAA) on management accounting concepts, policies, and practices. These Statements, which are issued only after exposure and due process, have become a great help when management accountants face complex problems in practice.

Another area where SMAs can provide authoritative guidance is in tax accounting. In a recent case before the U.S. Tax Court,[1] one of the major issued hinged on the definition of a management accounting term. In defense of its position, the IRS called upon an expert witness who cited various definitions of the term from textbooks and similar sources. These definitions seemed to support the IRS's position on how certain costs should be classified.

The petitioner in this case, Armco, Inc., supported its position by citing a definition from a Statement on Management Accounting, and claimed that the authority of the SMA ranked higher than that of accounting handbooks and textbooks. The argument put before the court was the question of how to rank the various sources of authoritative guidance for accounting.

It is the purpose of this article to argue that SMAs should be considered authoritative on management accounting topics in the absence of "Pronouncements of an authoritative body designated by the AICPA Council to establish principles."[2] The article will explore the nature and sources of generally accepted accounting principles (GAAP), as defined by the amended version of Statement of Auditing Standards (SAS) No.5, and argue that SMAs should be accorded the same considerable authority as GAAP. The article will also illustrate the usefulness of SMAs by describing the Armco case as an example of a situation in which an SMA was relied upon as authoritative.

The Armco Case

Armco, Inc., an Ohio-based concern, is the nation's fifth largest manufacturer and service corporation for the integrated production of steel products. Armco filed a petition in the tax court to settle a dispute involving the classification of certain manufacturing costs and a Percentage Repair Allowance (PRA), which the corporation had elected to be subject to.

To fully appreciate this case, we will first review Armco's mill process and accounting procedures.[3] We will then se how Armco used a Statement of Management Accounting to strengthen its arguments against the IRS.

Mill Process and Accounting

One of Armco's products is flat-rolled carbon steel, which is used in the manufacture of such products as appliances and automobiles. The manufacturing process begins with a heated mass of metal which is compressed and reduced in a series of mills into a long coil of sheet steel.

The mill's production equipment consists of large cylinders, or rolls, which compress the metal; bearings and chocks at the ends of each roll; and the housing which supports the rolls. Since the classification of the costs
incurred to purchase and maintain these rolls was questioned by the Commissioner and the matter reached the tax court, let's elaborate on their function.

There are usually two work rolls through which the steel actually passes, and for each work roll there are two to four back-up rolls. The back-up rolls press even on the work rolls to ensure that the work rolls reduce the steel uniformly across the full width of the slab.

During the production process rolls become worn and deformed. Since deformities on the surface of a work roll are transferred to the sheet steel, the rolls must be changed regularly -- on average, every four to eight hours for work rolls and once a week for back-up rolls. The worn rolls are then taken to the roll shop for grinding and turning. Rolls can be reground approximately 70 to 150 times before too much of the surface area has eroded and the roll must be scrapped.

For financial reporting purposes in statements filed with the SEC and for income tax purposes, Armco treated replacement roll acquisitions as direct manufacturing costs that were included in product inventory. Salaries and benefits of employees working in the roll shop, as well as utilities and other expenses attributed to this cost center, were charged to an account called "Roll Shop Costs" and were treated as a direct cost of product inventory. All additional production costs are not he issue here and are assumed to have been classified correctly and costed using the full absorption method.

IRS Audit

An IRS audit of Armco's corporate returns for 1976 and 1977 resulted in reclassification of replacement roll costs and roll shop costs as expenditures for repair and maintenance. Armco had elected to be subject to the Percentage Repair Allowance for both years. Under the election, Armco could deduct currently, as a repair expense without challenge from the IRS, an account not in excess of a prescribed percentage of the cost of the related assets. The consideration for this treatment was an agreement to capitalize any remaining repair expense.[4] The adjustment made by the Commission forced the repair and maintenance expense for both years well over the prescribed percentage and resulted in proposed tax increases totaling over $13 million.[5]

Armco filed a petition in the U.S. Tax Court challenging the Commissioner's adjustment and the validity of the PRA for the steel industry. Armco also questioned the Commissioner's view that roll acquisition and roll shop costs were repairs and maintenance, stating that the company viewed such costs as direct materials.

To strengthen its case, Armco needed to show that its classification of these expenses was consistent with the best accounting practices. Since generally accepted accounting principles "encompass the conventions, rules, and procedures necessary to define accepted accounting practice,"[6] in its finding of facts the court looked to this body of knowledge. The Commissioner agreed with the classification of roll costs as costs directly related to production. However, were these costs to be included in (1) factory overhead as repair and maintenance expenditures, (2) direct materials, or (3) an industry-specific expense to be classified as direct but not under any standard category?

In the area of manufactured inventory pricing, the guidance provided by officially established accounting principles is largely limited to ARB #43, stating only that the major objective of inventory valuation is to achieve proper matching of profits and revenues.[7] Therefore, Armco and the IRS turned to other sources of accounting literature for definitions.

The IRS's Position

To refute Armco's contention that the roll and shop costs should be classified as direct materials, the IRS called upon an expert witness, who offered the following definition:

Direct material costs are considered by the accounting profession to be materials that become a physical part of the finished product and can conveniently and directly be traced to particular units of output... To be direct material, the material must be capable of being physically traced to the final product.[8]

The witness then quoted similar definitions from accounting textbooks, handbooks, and other sources. However, closer examination of these sources reveals they do not agree in their definitions of direct materials.

Black and Edwards, in the *Managerial and Cost Accountant's Handbook*, provide a similar definition to that given by the expert witness. However, Black and Edwards state that "despite the description of a raw material as an 'integral' part of the finished product, it does not have to be a visible facet of the final product. As long as the use and cost of a material or supply can be specifically related to the quantity of product processed, it should be included in the cost component of direct materials.[9]

In addition, Davidson and Weil, in their *Handbook of Cost Accounting*, define materials as direct when their cost warrants identification with a job or process for managerial control and planning, even though the costs do not become part of the finished product.[10] Yet another viewpoint is provided by Price Waterhouse in its *Specialized Industry Practices--Steel Industry*. In fact, Price Waterhouse categorizes such costs as indirect, but not as repairs and maintenance.[11]

It seems clear that the traditional literature classifies the roll and shop costs in a variety of ways. For example, if the expert witness's definition is used, these costs would be classified as indirect and most likely as repairs and maintenance. In contrast, the costs would still be indirect but would not be categorized as repairs and maintenance if the Price Waterhouse definition is used. The costs would have their own classification. Under Black and Edward's definition, the rolls could be viewed as a material that can be specifically related to the quantity of product processed and therefore would be classified as direct materials.

Armco's Position

In defense of its position on how the roll and shop costs should be classified, Armco cited SMA 4E, *Definition and Measurement of Direct Material Cost*. This Statement defines direct material as "materials that become a physical part of the cost object and those materials that are consumed in the manufacturing process that can be specifically identified with that object."[12]

Thus, SMA 4E supports Armco's argument that the costs in question should be classified as direct material costs and included in inventory. Armco argued further that the definition provided by the Statement of Management Accounting should take precedence over the definitions that the IRS had used to defend its position.

In response to Armco's arguments and the variety of definitions available in accounting literature, the Tax Court tried in its finding of facts to determine the proper ranking of the various definitions. Unfortunately for our purposes, the court did not rule on this question, but rather decided the case in Armco's favor on other grounds. *Nevertheless, it is to this question of the authority of SMAs and the ranking of accounting pronouncements and publications that we now turn.

SMAs as GAAP

The best authority for defining the nature and sources of GAAP is the AICPA's Statement of Auditing Standards (SAS) No. 5, as amended in 1982 by SAS No. 43. The purpose of SAS No. 5 is to explain the meaning of the phrase "present fairly in conformity with generally accepted accounting principle's by Rule 203 of the AICPA's Code of Professional Ethics.

The amended SAS No. 5 has defined the sources of GAAP and ranked those sources as follows:[13]

a. Accounting Principles promulgated by a body designated by the AICPA Council to establish such principles, pursuant to rule 203 [ET section 203.01] of the AICPA *Code of Professional Conduct*.

b. Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing existing practices that are generally accepted.

c. Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent a practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

d. Other accounting literature.

Statements of Management Accounting would seem to fall under category (b); they are "pronouncements of bodies composed of expert accountants: and they are issued only after "a due process procedure, including broad distribution." Moreover, they describe "existing practices that are generally accepted."

Appendix A, which describes in greater detail the purposes of the statements and how they are issued, will illustrate how they meet these criteria.

The Future of SMAs

Armco Inc. v. Comr. provides an illustrative example of one application of this relatively new and potentially powerful guidance tool. The Armco case also brought to light the need to develop detailed, industry-specific consensus guidelines to address accounting for industry-specific costs such as roll costs. In many industries there are major cost categories that are handled one way by one company and a different way by another company. The different treatments make it difficult to compare results of operations of various companies in the same industry. Such guidelines could in fact define industry practices.

The NAA Management Accounting Practices Committee is in a position, based on its constituency, to develop these industry guidelines.

In the Armco case, a guideline for the steel industry could have clarified the classification of the roll and shop costs, and thereby strengthened Armco's case against the IRS. The Income Tax Regulations acknowledge that the valuation of inventory"...must give effect to trade customs which come within the scope of the best accounting practice in the particular trade of business."[14]

The usefulness of these guidelines could be limited to internal reporting applications or disputes with the IRS, but should provide guidance in other areas of accounting as well. The guidelines would be useful to the public accounting profession because they would provide an authoritative source of guidance when CPAs are engaged in an unfamiliar industry, and thereby help the independent auditor to meet the standard of fieldwork by providing information about accounting practices unique to the industry.[15]

We can hope, then that the NAA's Committee on Management Accounting Practices will issue such industry guidelines in the future. The authority the guidelines would have as Statements on Management Accounting would make them useful in a variety of accounting contexts.

Conclusion

Armco Inc. v. Comr. demonstrated that the accounting profession needs a source of authoritative guidance in management accounting. Statements on Management Accounting offer consensus guidelines and definitions established and approved b a diverse group of accounting professionals and other members of the business community. SMAs provide a source of guidance that can outweigh other accounting literature that generally represents just one or two authors', or even an accounting firm's, opinion.

It is imperative for the accounting profession to continue to develop detailed guidance for accounting and reporting practice. If we don't, the judicial system may fill this gap.

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APPENDIX A
Statements on Management Accounting

Statements on Management Accounting represent the official position of the National Association of Accountants through its senior Committee on Management Accounting Practices (MAP Committee). It should be noted that recent FASB members Victor Brown and Arthur Wyatt, as well as current Chairman Dennis Beresford, have been members of the NAA's MAP Committee. The MAP Committee is composed of two-thirds corporate and one-third public accounting representatives.

The NAA created the Management Accounting Practices Committee to serve as the senior technical committee of the NAA for these purposes:

* To express the official position of the NAA on accounting and financial reporting issues raised by standards setting groups such as the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Securities Exchange Commission, and the International Accounting Standards Committee.

* To provide authoritative guidance to the membership of the NAA and to the broader business community on management accounting concepts, policies, and practices.[16]

Since 1980, a standing subcommittee on the MAP Committee has been working on the development of SMAs. The work of the subcommittee is structured around a framework for management accounting consisting of: objectives, terminology, concepts, practices and techniques, and management of accounting activities[17].

Each subcommittee member is responsible for monitoring the progress of a draft of a particular statement. Once a final draft is prepared, it is brought before the subcommittee for majority approval for exposure to member of two advisory panels. The members of one panel are composed of a representative sample of NAA chapter presidents (the NAA is composed of over 400 chapters nationally) or other chapter representatives. This constituency is rotated annually. Members of the second panel consists of nominees from other organizations having an interest in accounting, including the American Institute of Certified Public Accountants, the Financial Executives Institute, the American Accounting Association (AAA), and the Society of Management Accountants of Canada. The AAA has set up a specific subcommittee to respond to SMA exposure drafts. Members of this panel are rotated at the option of the sponsoring organization.[18]

After the subcommittee reviews all comments received from the panelists and makes the appropriate modifications of the draft, it is submitted to the MAP Committee for approval. The MAP Committee options are: (a) to approve the issuance unchanged, (b) to approve the issuance after modification, or (c) to return the draft to the subcommittee for further development. Approved statements by a two-thirds majority of the MAP Committee are published by the NAA within the series of Statements on Management Accounting and are reprinted in the NAA's monthly magazine, *Management Accounting*.[19]

The MAP Committee to date has promulgated the following statements of purpose and operation

1A	Definition of Management Accounting
1B	Objectives of Management Accounting
1C	Standards of Ethical Conduct for Management Accounting
1D	The Common Body of Knowledge for Management Accounting
1E	Education for Careers in Management Accounting
2	Management Accounting Terminology
4A	Cost of Capital
4B	Allocation of Service and Administrative Costs
4C	Definition & Measurement of Direct Labor Costs
4D	Measuring Entity Performance
4E	Definition and Measurement of Direct Material Costs
4F	Allocation of Information System Costs
4G	Allocation of Indirect Manufacturing Costs
4H	Uses of the Cost of Capital
4I	Cost Management for Freight Transportation
4J	Property, Plant, and Equipment
4K	Cost Management for Warehousing

Because of the detailed procedure for issuing SMAs, the exposure they receive, and the expertise of the accountants who participate in their development, the Statements do seem to meet the criteria of category (b) as defined by the amended SAS No. 5.

In the context to the Armco case, the definition of direct materials would be more authoritative than the definitions used the IRS to defend its classification of the roll and shop costs. The definitions cited by the IRS would fit into category (d) or "other accounting literature," which specifically includes accounting textbooks and similar sources.[20]

Footnotes

1 *Armco Inc. v. Comr.* 88 TC 51 (1987)

2 AICPA, *SAS No.5* (1975), as amended by SAS No. 43 (1982). Reprinted in *Professional Standards*: Vol. A, U.S. Auditing Standards (Commerce Clearing House), AU Sec. 411.04a.

3 Information about Armco's production process and accounting procedures were provided by interviews with W.J. Hatfield, Associate Tax Attorney, Armco, Inc.

4 *Treas. Reg.* Sec. 1.167(a)-11(d)(2).

5 *Armco, Inc. v. Comr.* (1987).

6 AICPA, *SAS No. 5*, AU Sec. 411.02.

7 ARB 43 Chapter 4 Sec. 178.104 (1971). Reprinted in *Accounting Standards* (McGraw Hill Book Company).

8 "An Examination of the Expert Witness Testimony of Ronald V. Hartley in the Accounting for the Costs of Rolls, Roll Bearings and Roll Shop Costs and Assigned Maintenance Labor."

9 Homer A. Black and James Don Edwards, eds., *The Managerial and Cost Accounting Handbook* (Homewood, Ill: Dow Jones-Irwin, 1979),p.68.

10 Sidney Davidson and Roman Weil, *Handbook of Cost Accounting*, McGraw-Hill, 1978.

11 Price Waterhouse, *Specialized Industry Practices--Steel Industry.*

12 NAA, *Statement on Management Accounting: Definition and Measurement of Direct Material Cost* 4E, para. 16. *Statement 4E was referenced only briefly, because the final draft statement was not promulgated until the court case was within a week of completion.

13 AICPA, *SAS No. 52*, AU Sec. 411.05 a-d.

14 *Treas. Reg.* Sec. 1.471-2(b).

15 AICPA, *SAS No. 31*, AU Sec. 326.09.

16 NAA, *Statement on Management Accounting: Statement of Purpose and Operation*, papa. 2.

17 Ibid., para.6.

18 Ibid., paras. 8-10.

19 Ibid., para. 11. SMAs are currently published by Shepard's McGraw-Hill of Newark.

20 AICPA, *SAS No. 52*, AU Sec. 411.08.