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Indirect Costs in the Valuation of Inventories: From Law, Accounting Principles to Case Law Decisions

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ABSTRACT: The valuation of inventories is one of the main issues in financial reporting. In particular, the issue of allocation of indirect costs identifies a problem under discussion. This article highlights how in Italy indirect costs are considered in the valuation of inventories by law, accounting standards and case law.

1. INDIRECT COSTS IN THE VALUATION OF INVENTORIES [1]

The valuation of closing inventories represents one of the most complex topics in the field of final financial reporting valuations. The determination of the value to be attributed to inventories requires identifying values that, not being objective, impose a subjective evaluation by the person preparing the financial report.

The Italian legislation and the Italian national accounting principles (OIC principles), and the European international IAS/IFRS principles must evaluate inventories at the lower cost and market value.

The determination of market value also implies the solution of valuation problems of absolute importance, but, in this context, we intend to focus our attention only on the issue of determining product costs. In particular, we want to focus on allocating indirect product costs, i.e., those costs that cannot directly assign to the asset itself.

In Italy, financial reporting is regulated by the civil code unless the company is listed or belongs to particular categories of companies for which IAS/IFRS and a series of special laws concerning the financial reporting of specific companies (e.g. insurance companies, banks, financial companies, electricity companies, etc.) must be applied respectively.

The Civil Code sets out the principle of valuation of inventories in a very concise manner. Concerning the determination of the cost, which must then be compared with the market value, it stresses, in Article 2426 of the Italian Civil Code, that inventories, securities, and financial assets that do not constitute fixed assets are recorded at purchase or production cost, calculated according to number 1), or at realisable value inferable from market trends, if lower; this lower value cannot be maintained in subsequent financial reporting if the reasons for it have ceased to exist. Distribution costs may not be included in production costs.

The cost of fungible assets can be calculated using the weighted average method or the "first in, first out" or "last in, first out" methods; if the value thus obtained differs appreciably from the current costs at the end of the financial year, the difference must be indicated, by category of asset, in the notes to the financial statements.

No. 1 of Article 2426 of the Civil Code states that fixed assets are recorded at purchase or production cost. The purchase cost also includes accessory costs. Production cost consists of all costs directly attributable to the product. It may also have other costs, to the extent reasonably attributable to the product, relating to the period of manufacture and up to the time when can use the asset; charges relating to the financing of in-house or third-party manufacture may be added on the same basis.

As can be seen, product costs can be direct or indirect.

[1] [1] To facilitate reading, I have decided not to include in the text, the names of the scholars who have dealt with the subject under analysis. Since the bibliography is endless, I have opted not to indicate all the terms of the scholars in the text because this would have meant a continuous interruption of the reading of the complete sentence in which I express my thought. Also, as it is endless, the bibliography had to be reduced because if it had listed every book or article on sustainability and greenwashing in the references, the article would have been too long.

Indirect Costs in the Valuation of Inventories: From Law, Accounting Principles to Case Law Decisions

Direct and indirect costs "boast" numerous definitions, as every researcher has tried to give a theoretical explanation expressing the "direct" or "indirect" correlation between the cost to be allocated and the product to be assigned.

While the classification of variable vs fixed costs and unique vs common costs, at least at an abstract level, shows the uniformity of interpretations, the theoretical identification of direct and indirect costs identifies a very mixed reality.

The writer believes that the most straightforward definition, albeit partly tautological, is the one that refers to the possibility of considering the costs to be charged as "incorporated" in the product. According to this logic, costs are direct when they can incorporate them in the object of reference or directly attributable to it. On the other hand, costs are indirect when they can be referred to a specific object only mediately (using an allocation parameter).

In other words, a cost is direct when it is possible to measure, in an objective manner, the consumption of a given factor. On the other hand, costs are to be considered indirect when such an eventuality is not identifiable. Therefore, indirect costs cannot be "directly" attributed to the object of allocation but can be allocated to it only after a "reversal", which, necessarily, provides for the use of an intermediate instrument that allows the "transfer" of the overall cost to the individual objects.

Scholars and practitioners generally agree with all the above observations, except for some pragmatic distinctions not relevant here.

A typical example of direct costs, referring to a given product, are raw materials and direct labour.

As can be seen, direct costs are always variable in nature.

On the other hand, indirect costs have a dual nature: they can be both variable and fixed. In a company's reality, fixed indirect costs are undoubtedly the majority, but can also variable indirect costs can identify. An example of this last category of costs is the productive electrical energy: indirect cost. It cannot be measured objectively concerning the product and variable because it can modify the quantity produced.

It can identify several examples regarding the category of fixed indirect costs since, by definition, all fixed costs are indirect since their allocation cannot be done objectively and, by necessity, must be implemented through an intermediate instrument such as the allocation parameter.

The subdivision between variable and fixed indirect costs assumes particular relevance in the context of the determination of the product cost that can use for the valuation of the final stock in the financial reporting because their allocation takes place according to different methods.

There has never been any operational or theoretical problem with the allocation of direct costs. These costs, e.g. direct labour, raw materials, ancillary materials, etc., have never created academic issues regarding whether they should be included in the cost used to value inventories.

On the contrary, problems have often arisen regarding the allocation of indirect costs, as their determination requires a subjective assessment by the financial reporting entity, which has frequently raised doubts and problems regarding the allocation of the portion of the cost to be added to the total cost useful for the valuation of inventories.

From a tax point of view, Article 110, paragraph 1, letter b) of the Consolidated Income Tax Law (Consolidated Text of Income Tax, or the tax law governing, inter alia, the determination of the taxable income of individuals and companies) provides that the cost of products also includes directly attributable accessory charges, excluding interest expense and general expenses. ... Costs other than those directly attributable to the product may also be added to the cost of manufacture using the same criteria. Here too, there have been differing and conflicting interpretations.

First of all, before entering into the focus of the allocation of indirect costs, it must remember that in Italy, the national accounting standards OIC integrate and complete, to all effects, the articles of the Civil Code.

On 20 August 2014, Law No. 116 of 11 August 2014 was published in the Official Gazette, converting Decree Law 91/2014, which recognises the role and functions of the OIC (Italian Accounting Organization). The law supplements Legislative Decree 38/2005 with Articles 9-bis and 9-ter, keeping unchanged the methods of financing the OIC already provided for by Law 244/2007.

Below is the text of the provisions relating to the OIC:

Article 9-bis - Role and functions of the Italian Accounting Board

1. The Organismo Italiano di Contabilità, the national accounting standards institute

a) issues national accounting standards, inspired by best practice, for the preparation of financial reporting following the provisions of the Italian Civil Code;

b) provides support to the activities of Parliament and Government Bodies on accounting regulations and expresses opinions, when required by specific legal provisions or at the request of other public institutions;

c) participate in the process of developing international accounting standards adopted in Europe, maintaining relations with the International Accounting Standards Board (IASB), the European Financial Reporting Advisory Group (EFRAG) and the accounting bodies of other countries.

Concerning the activities referred to in (a), (b) and (c), it shall coordinate with the national authorities that have competence in accounting matters.

2. In exercising its functions, the Italian Board of Auditors shall pursue public interest purposes, act independently and adapt its statute to the principles of efficiency and cost-effectiveness. It shall report annually on its activity to the Ministry of Economy and Finance.

2. INDIRECT COSTS IN THE VALUATION OF INVENTORIES IN ITALIAN NATIONAL ACCOUNTING STANDARDS

From what has been said above, it is clear that the OIC accounting principles do not limit themselves to giving general information on the preparation of financial reporting but integrate and complete the statutory regulations concerning the structure and valuations of financial reporting.

Although they cannot be considered primary legislative sources, the OIC standards fill the gaps and supplement the rules that the Code imposes on the preparation of financial reporting.

OIC standard no. 13 concerns inventories and, about the costs that must allocate to determine the cost of a product to be compared with its market value, states:

Acquisition cost is the actual purchase price plus accessory charges. Incidental purchase costs include all costs associated with the purchase and the costs incurred to bring the asset to its present location and condition. Production cost consists of all costs directly attributable to the asset. It may also include other costs, to the extent reasonably attributable to the asset, throughout manufacture and up to the time can use. Charges relating to the financing of in-house or third-party manufacture may be added on the same basis. Realization value based on market conditions is the estimated selling price of goods and finished goods in the ordinary course of business, based on market information, less estimated completion costs and direct selling costs.

Production cost includes direct costs and indirect costs (so-called production overheads) incurred in the course of production and necessary to bring inventories to their present condition and location for the portion reasonably attributable to the product for the period of manufacture and up to the time the asset can be used; charges relating to the financing of in-house or third-party manufacture may be added on the same basis, in the cases and under the conditions provided for by law. It excludes distribution costs pursuant to Article 2426, paragraph 1, number 9 of the Italian Civil Code. The charges typically identifiable as components of production cost can be summarised, by way of example but not limited to, as follows: Direct costs Cost of materials used, including transport on purchases (direct material); Cost of direct labour, including ancillary charges; Packaging; Costs for services directly related to the manufacturing process; Costs associated to production licences. Production overheads Salaries, wages and related charges related to indirect labour and costs of technical management of the plant; Depreciation of tangible and intangible assets contributing to production; Maintenance and repairs; Consumables; Other costs actually incurred in the processing of products (natural gas, water, external maintenance, security services, etc.). Production overheads include all common production costs necessary to bring inventories to their current condition and location. Production overheads include production costs that are not directly attributable to products.

Without prejudice to the particular characteristics of the production process of each company, the allocation parameters that may use to attribute common overheads are, by way of example but not limited to direct labour hours; direct labour cost; machine hours; prime cost (i.e. direct material and direct labour). In some cases, it may be appropriate to use absorption percentages by department or groups of departments. Production overheads may be either fixed or variable. Fixed production overheads are those indirect costs of production that remain relatively constant as the volume of production changes, such as depreciation and maintenance of plant and machinery and the costs of technical management of the plant. Variable production overheads are those indirect costs that vary with the volume of production, such as indirect materials and labour. Fixed production overheads are allocated to each unit produced based on standard production capacity. Standard production capacity represents the production that is expected to be achieved on average during several years or seasonal periods under normal conditions, taking into account the loss of capacity resulting from planned maintenance; it is lower than the theoretical maximum capacity, as from it must be deducted downtime for repairs, unavailability of material or labour, other unforeseeable causes of interruption, etc. In the allocation of fixed production overheads, one may use the actual production level if it approximates standard production capacity. The amount of fixed overhead costs allocated to each unit produced must not increase due to low production or idle plant. Indeed, if, for various reasons, the standard production capacity of a plant is not reached, the allocation of fixed overhead costs of production based on an actual level of production that is lower than the normal levels for that plant would result in the allocation to inventories of higher costs due to the non-utilisation of average production capacity. These higher costs that are not

attributable to the products in inventory are recognised as expenses for the period. When production capacity is utilised beyond the level considered normal, the allocation of fixed overhead costs to products is made based on actual production capacity to avoid the value of inventories exceeding the cost incurred.

Variable production overheads are allocated to each unit produced based on the actual level of production. Costs of an exceptional or abnormal nature are excluded from production overheads; for example, the costs of moving a plant from one facility to another (unless they are necessary in the production process before a further production stage), repair costs of an exceptional nature due to fire, hurricanes, etc. 8 33. In addition to general and administrative costs, distribution costs are excluded from the measurement of inventories. The reasons for banning selling, general and administrative costs from the measure of semi-finished goods, work in progress. Finished goods may be summarised as follows general. Administrative costs, because they do not constitute charges specifically incurred to bring inventories to their present location and condition, they relate to common functions of the company as a whole and as such they represent harmful components of income in the period in which they are recognised; distribution costs, because they belong to a stage after production. Research and development costs are generally excluded from the production cost of inventories because, in most cases, such costs are unlikely to contribute, in the same period as they are incurred, to bringing inventories to their present condition and location.

From the above, it can be seen that OIC 13 Inventories requires the allocation of indirect production costs and excludes, as in the code, the addition of indirect administrative, distribution and research and development costs.

From a simultaneous reading of the legislation and the OIC accounting principles, it is clear that indirect costs must be allocated to the cost of the product, even if the legislation, both civil and fiscal, uses the verb "may be allocated". The verbal form "may be allocated" should be interpreted as a legislative obligation and, in fact, concerning this issue, there has been a doctrinal debate not on the existence or otherwise of an obligation to allocate indirect costs, but on the methods to be applied in this delicate phase.

The fact that indirect costs must be attributed has never been in doubt, either from a civil or a fiscal point of view, even if the use of the phrase "indirect costs may be imputed" could give rise to some doubts. However, until last year, no one ever doubted that indirect costs should be allocated to the finished product or work in progress.

The European IAS/IFRS standards also lay down, in essence, the same principle. In summary, in principle IAS 2 Inventories, these standards impose the following allocation method:

the costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of-use assets used in the production process, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they

are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) selling costs.

As can be seen from reading the legislative principles of the Civil Code, the Italian national standards OIC and the European international standards IAS/IFRS, indirect costs must be allocated to the product whose cost is being determined for the purpose of valuing inventories.

3. INDIRECT COSTS IN THE EVALUATION OF INVENTORIES ACCORDING TO THE ITALIAN JUDICIARY

For the first time, last year, a Tax Commission of Piemonte (Piemonte is an Italian Region), with judgment no. 524/36/15 of 13.5.2015 (the first level of tax judgments in Italy) questioned the mandatory nature of the allocation of indirect costs precisely by referring to the verb used by civil and tax legislators.

Based on the letter of the Civil Code and the Tuir, the Tax mentioned above Commission concluded that it was merely optional for the entrepreneur to consider indirect production costs, since, according to that Commission, the regulatory obligation concerns, instead, only directly attributable accessory charges.

The Court of Cassation (the court of the last instance in Italian jurisprudence) with sentence 19749 of 12/7/2021 annulled the Commission's sentence highlighting the error of interpretation of civil and fiscal law made by the Commission itself.

Already in 2020, with sentence no. 27334 of 30.11.2020, the Court of Cassation had expressed itself on the issue of our interest. In the latter judgment, the Court of Cassation had stated that "according to civil law rules, inventories are therefore valued at cost, which, depending on how the asset is found, is distinguished between purchase cost and production cost. Article 2426, no. 1) of the Italian Civil Code defines purchase cost and production cost; the former includes not only the actual purchase price but also accessory costs, i.e. those directly attributable to the purchase contract, as well as directly attributable costs (including tax and customs charges, packaging, transport and insurance costs, and brokerage costs). On the other hand, the cost of production includes all costs directly attributable to the product (so-called direct costs) through the so-called direct costing technique, consisting of the cost of materials used, packaging, and direct labour employed. Indirect costs), for the portion reasonably attributable to the product based on certain parameters (cost drivers) (such as labour hours, machine hours), relating to the period of manufacture and up to the time when the goods can be used, represented by general production costs common to several products (indirect labour, depreciation, maintenance and repairs, consumables used, energy consumption)".

Far from stating that the entrepreneur is free to value inventories by including indirect costs in the cost of production or excluding them, the same above mentioned ruling stated that "the recognition in financial reporting at the cost of production, prescribed for work in progress and semi-finished products, is not a mere option, but rather represents the application of the statutory principle of true and fair representation".

This obligation was also reiterated in the very recent ruling of 12 July 2021 no. 19749, where it is stated: "On the one hand, the accounting principle referred to by the Piemonte Regional Administrative Court (C.T.R.) allows us to state that the costs as mentioned above do not increase the value of inventories: "D.III. (h) In addition to abnormal production costs, general and administrative expenses, distribution costs (or selling expenses), and research expenses should also be excluded from the valuation of inventories. In contrast, financial expenses can be included exclusively in the cases provided for by accounting principle OIC No. 13.

The reasons for excluding selling, general and administrative expenses from the measurement of semi-finished products, work in progress and finished products can be summarised as follows: - general. Administrative expenses are not expenses specifically incurred to bring inventories to their present location and condition. Still, they relate to common functions of the enterprise as a whole, and as such, they represent negative components of income in the period in which they are recognised. These are operating expenses of a predominantly recurring nature, which the enterprise must incur in any case, i.e. period expenses; - selling expenses related to the distribution activity of the enterprise and, therefore, by definition, are not inventory costs to value inventories.".

On the other hand, however, in the formation of a true e and fair financial reporting - respectful of the criteria of prudential valuation, but also of the economic function of the products in stock - the entrepreneur has the duty (and not only the option) to consider also those indirectly attributable charges that have increased their original utility or functionality compared to the initial values.

In conclusion, the Commission sentence is an error in the interpretation of the aforementioned provisions, since the failure to take into account indirect costs in the cost of production is not a mere option of the entrepreneur, but - rather - presupposes a concrete assessment of the costs that had to be taken into account and those that, on the contrary, did not have to be taken into account since they are general and administrative expenses or selling expenses".

After the intervention of the Court of Cassation, there is no longer any doubt: indirect costs must be allocated to the cost of the product according to the methods recommended by national and international accounting standards. No one can now question what can be considered a fundamental principle of inventory valuation.

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