Covid 19: possible impacts on the valuation of inventories

With the end of 2020 and the closure of the financial statements, the fundamental issue of the valuation of inventories emerges.

In the current economic situation, characterized by temporary closures of some production activities, or by the reduction in the production capacity of plants, critical issues emerge in the evaluation of the production cost of goods in stock, as well as in the identification of the presumable realisation cost.

Without going into detail on the general criteria for valuing inventories, as established by the Civil Code and the reference accounting standards, we wish to highlight the importance of a correct determination of the cost of production in periods when the company does not fully exploit its production capacity.

Paragraph 13 of IAS 2 establishes that "the allocation of general fixed production costs to processing costs is based on normal production capacity. This represents the production that is expected to be realized on average during a number of fiscal years or seasonal periods under normal circumstances." Similarly, national accounting standards, and in particular OIC 13, stipulate that fixed production overheads must be allocated to each unit produced on the basis of normal production capacity. In this case, paragraph 29 of the above-mentioned principle illustrates that "The amount of fixed overheads allocated to each unit of production must not increase as a result of low production or plant inactivity".

The absence of the "normal circumstances" cited by IAS 2 and the "low production or idle capacity of the plants" set out by OIC 13 force a review of the correct allocation of fixed overheads to the individual production units. In fact, production levels below the norm force the company to record in its operating result a part of those fixed overheads which cannot be allocated to inventories.

The following example may well show what the distorting accounting effect may be:

Assume that a company normally produces 500 units of an Alpha product. For this product, the direct production costs are equal to 15 for each unit produced and the general fixed production costs are equal to 1,000. If at the end of the year the product inventories are 150 the production value would be determined as follows:

Fixed production overhead costs (a) = 1,000

Units produced with normal capacity (b) = 500

General fixed costs of production per unit (a/b) = 1.000/ 500 = 2

Value of the inventories produced by Alfa = Final inventories X (direct costs + fixed overhead costs per unit produced)
Balance sheet value = 150 x (15+2) = 2.550

If the same company, due to the production stoppage in the lock-down period, or in general due to a reduction in production linked to the reduction in turnover, had produced during the 2020 financial year only 200 units of Alfa product, therefore 300 units less than the normal production capacity, referring to the actual production and not to the normal production, and always assuming a level of final inventories equal to 150 units, we would have:

Production overheads (a) = 1,000

Units produced with effective capacity (b) = 200

General fixed production costs per unit (a/b) = 1,000/200 = 5

Value of the inventories produced Alfa = Final inventories X (direct costs + general fixed costs per unit produced)

Balance value = 150 x (15+5) = 3.000

Considering this last calculation, it is evident the risk of an overvaluation of the inventories.

In this regard, the difference between the fixed overhead costs per unit calculated on the basis of normal production capacity and those calculated considering the actual production capacity, equal to 450, must pass through the income statement as a cost for the period.

Therefore, the auditor is required to verify that the allocation of fixed production overheads is carried out, in full compliance with the principle of prudence, on the basis of the actual production capacity of the 2020 financial year in order to avoid that the valuation of inventories is higher than the cost incurred to produce them. At the same time, this valuation will result in a lower result for the year due to the cost of inefficiency that will affect the income statement.

Ivano Nerbini