

THE SPECIFIC ACCOUNTING TREATMENTS REGARDING STOCKS

PALIU – POPA LUCIA

Professor Ph.D., “Constantin Brancusi” University, Târgu Jiu, Romania

e-mail: univers_cont@yahoo.com

COSNEANU LAVINIA

Phd Student, West University of Timisoara, Romania

e-mail: lavinia.cosneanu@gmail.com

Abstract

The process of harmonization and convergence of IFRS – U.S. GAAP represents a significant advance in the approach of internationally recognized accounting referential frames, context where the accounting system in our country – undergoing internationalization and Europeanization – also experiences the assimilation of harmonization and convergence products between the two accounting standardizations worldwide. Looking from this perspective, we can say that no nation has the right to be considered superior in accounting, as several steps need to be taken in different countries in order to reach a level of compliance on a global scale – desirable. Because companies have expanded their boundaries and thus increasing the importance of managerial communication and the increasingly deeper globalization of capital markets requires and imposes the global use of a single accounting language, we deemed it useful to conduct a study regarding the main differences between the national accounting regulations and the provisions of the international reference frame on stocks, as the users of information from the financial statements seek to evaluate the profitability of the company in general, but also in terms of its risk of illiquidity, as stocks are an important component of an entity's assets. In this respect, we will address the stocks in terms of the main differences between the national accounting regulations, the provisions of the international reference frame, and the economic and financial indicators – expression of different accounting treatments.

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JEL Classification: *M40, M41, M48, M49*

1. Introduction

The financial statements, which actually are a core synthesis of accounting information are the most popular method regarding managerial communication and the least expensive one, but the accounting system of any country is dependent on the nature and evolution of society, taking into account both the existence and emergence of particular issues and phenomena and the relations that it develops with other countries.

The last decades of development of the world economy are characterized by accelerated internationalization of capital markets and trade. The increasing globalization of capital markets imposes throughout the world a single financial reporting language so that the world economic system should enjoy credible and transparent accounting information.

The reason why we chose the different accounting treatments regarding stocks as our topic resulted from the major importance of the stock – related accounting information in the economic activity of the entity because they generate most of the revenue and expenses in the profit and loss account, and such information reflects the financial and patrimonial economic growth of the company.

This article deals with the issue of accounting treatments applicable to stocks, namely of the main differences between the accounting treatment in accordance with the national and international reference frames, in terms of their different assessment methods and the influence they generate in covering the economic and financial indicators of an economic unit in reporting the accountant facts.

In this sense, we will deal next with theoretical considerations on the differences between the accounting treatment under the national and international reference frames, pointing out defining elements related to the values recorded by the economic and financial indicators in the application of different accounting treatments.

2. Theoretical considerations on the main differences between the national accounting regulations and the provisions related to the international reference frame

Because of the meaning of stocks on the financial position and performance of entities, inventory accounting is a current topic that must be considered with concern and responsibility by two types of entities:

- a.** commercial (distribution) entity, which has one inventory account – the inventory of goods represented by goods at its disposal, which it purchased for the purpose of resale;

b. the manufacturer, which has three categories of inventory consisting of raw materials, production in progress and finished goods.

In this context, the International Accounting Standard 2 “Inventories” (IAS) *aims* to describe the accounting for inventories and also to provide guidance on the basic rules on how to determine the cost of inventories, and its subsequent recognition as an expense, including any reduction in the book value to net realizable value.

Although most of the provisions of the Accounting Standard IAS 2 “Inventories” have been included in the national legislation, there are, however, some *differences* [6, 8, 9], such as:

✚ **Accounting policies** specific to stocks set out in the Order of Minister of Public Finance No. 3055/2009 approving the accounting regulations (OMPF) are also applied to assets that fall within the scope of other international standards such as IAS 11 “Construction Contracts” or IAS 41 “Agriculture”.

When referring to the recognition of stock, we can say that according to OMPF 3055/2009 they are, where appropriate, material goods, works and services to be consumed from their first use, to be sold, if they have a status of freight or products of processing, as well as production in progress as unfinished production. The inventories also includes goods in custody, for processing or in consignment to third parties or used only as demonstration material for negotiations in cars, with the useful life of less than one year. The purchased stocks for which the related risks and benefits have been transferred but which are under supply also separately reflected in accounting.

IAS 2 “Inventories” *applies to all inventories, except:*

- production in progress under the construction contracts, including contracts for the provision of related services (are subject to IAS 11, “Construction Contracts”);
- financial instruments (subject to IAS 32, “Financial Instruments: Presentation” and IFRS 9 “Financial Instruments”); and
- biological assets related to agricultural activity and agricultural production at harvest (subject to IAS 41, “Agriculture”).

Also, IAS 2 “Inventories” *does not apply to the measurement of inventories held by:*

- producers of agricultural and forest products, agricultural produce after harvest, minerals and other mineral products, to the extent that they are measured at net realizable value, based on the practices of that sector; the changes in such value are recognized in the profit or loss for the period when the change occurs;
- brokers – traders on commodity exchanges in order to obtain profit due to fluctuations in the market price. They evaluate inventories at fair value less the selling costs. The changes in fair value less the selling costs are recognized in the profit or loss for the period the change occurs. [8]

Thus, it appears that unlike OMPF 3055/2009, the accounting standard IAS 2 “Inventories” has some exceptions when it comes to this classification of inventories, such as:

- for the *construction contracts*: the accounting standard IAS 2 “Inventories” excludes the construction contracts from its scope, which are defined in the accounting standard IAS 11 “Construction contracts” and OMPF 3055/2009 recognizes “the housing estates or complexes performed by entities whose main object of activity if the housing acquisition and sale” as stocks. [1]
- for the *assets for sale*: in compliance with IAS, these types of assets fall within the scope of IFRS 5 “Non-current assets held for sale and discontinued operations held for sale”, while OMPF 3055/2009 states that an item of property decided to be improved and then sold will be transferred to inventories.

✚ **Evaluation plan:**

A. Evaluation when entering the entity

1) *According to IAS 2 “Inventories”*, the inventory cost is evaluated, which can take two forms depending on its inflow in the entity, namely:

– *Purchase cost* of purchased stock – which includes purchase price, import duties and other taxes (except those subsequently recoverable by the entity from the tax authorities), costs of transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Although the value added tax (VAT) is not included in the purchase cost, however there is an exception to this rule when stocks are purchased by a non-taxable entity, in which case the entity will include VAT in the purchase cost of stocks.

– *Production cost* for the goods produced within the entity – this is for the finished goods and work in progress and includes the following: direct labor, manufacturing overhead costs, variable production overhead and fixed manufacturing overhead allocated to normal production capacity and other costs, such as the design and leverage. Thus, the production cost includes two types of expenses:

- direct, related to the consumption of raw materials in the production process and labor.
- indirect, related to the overall volume of production, and they can be allocated to each product following a certain distribution scale (key).

Indirect costs are of two types:

- variable – change directly with the production volume - indirect raw materials, indirect labor and;
- fixed – are incorporated into the cost of products, even if do not depends on the volume of production. Since fluctuations in the production cost from one period to another can not capture the real cost of production, it is recommended that fixed overhead should be referenced to the normal capacity of the production facilities, in which terms data on the normal volume of activity can be extracted from the technical documentation of machinery. Therefore, when production is lower than normal, fixed overhead is not fully covered in the production cost, so the

production cost does not include the cost of sub-activity, and the overhead that is not allocated to the production cost is recognized as an expense in the period. On the other hand, when there are periods of over-activity, fixed overhead is not increased, but is considered to be in the normal level accounted for.

In this context, the following shall not be included in the cost of inventories but are recorded as *expenses in the period*: the loss of materials, labor or other production costs beyond the limits normally permitted, including losses due to wastage; storage costs, unless these costs are necessary in the production process, before passing into a new phase of manufacturing, administrative overheads that do not contribute to bringing inventories to the current location and condition, as well as the selling costs. Storage costs are included in the production cost when necessary to bring inventories to their current location and condition. It is also important to note that “in the event of stocks that are not interchangeable (good that can not be replaced by another of the same kind) and those intended for separate orders, the cost must be determined by specific identification of individual costs.” [1]

– *Standard cost method*

Occurred in the United States in 1901 as “Estimated Cost System” – pre-calculated cost system, the first method which takes into account the normal levels of consumables, labor, efficiency and production capacity utilization. Accounting Standard IAS 2 recommends it as useful for simplification purposes, if the result approximates cost. This method calculates the anticipated production costs, monitors and controls deviations from these costs, which are called deviation from reality, i.e. from normal manufacturing conditions and it is recorded on the profit and loss account of the entity.

– *Specific cost identification method*

It is an appropriate method, where stock items are intended for a particular project, whether purchased or produced and involves assigning specific costs to each element of stock, cost being determined by specific identification of individual costs. The accounting treatment is not recommended when stocks contain a variety of elements, which are usually interchangeable.

2) According to OMFP 3055/2009, assets are assessed and accounted for at their original cost, which is determined as follows:

a) at the purchase cost – for goods purchased for consideration;

b) at the production cost – for goods produced in the entity.

Depending on the specific activity, *the standard default cost method* may be used to determine cost (the cost of inventories is a pre-calculated cost, compared to the data recorded in prior periods) in the course of manufacturing, *the retail method* in retail and the *cost – effective method* (the cost of inventories is determined based on data recorded in supporting documents). In Romania, when using the standard or default cost methods, an evidence of the differences in the default and effective cost is drawn in parallel, and such differences are ultimately reflected in the effective cost.

c) at the amount of contribution, determined after the evaluation – for goods representing share capital;

d) at fair value – for goods obtained free of charge or found in excess in the inventory.

B. Inventory evaluation when leaving the entity

According to IAS 2 “Inventories”, they are measured when leaving the assets, by the weighted average cost method (WAC) or by the “first in – first out” (FIFO) method; the use of the “last in – first out” (LIFO) inventory valuation method is forbidden, because the inventory flows are not fairly presented. Looking from this perspective, we can say that the use of the LIFO method is based on tax considerations; companies use it to get a lower profit with implicit payment of a lower tax. In this context, the use of LIFO method does not reflect the true performance of the company and therefore it is not appropriate as an accounting treatment.

However, in accordance with the provisions of OMFP 3055/2009, there are three methods that can be used at the inventory outflow: FIFO method, WAC method and LIFO method, unlike the accounting standard IAS 2 “Inventories” which provides only for the first two.

Summarizing the above, in the evaluation plan of inventories in the entity the differences between the OMFP 3055/2009 and IAS 2 “Inventories” refer to the *standard cost method* and the *retail method*. Under IAS 2 “Inventories”, according to the first method, this price is adopted as an assessment and settlement amount at the inventory inflow - outflow in financial accounting and according to the second method this valuation technique is used for the fast moving stocks in the trading entities, when items have similar margins it is not easy to use other costing methods in such circumstances. On the other hand, IAS 2 does not prescribe the distribution ratio.

If the retail price in Romania is obtained from the purchase or production cost plus trade margins and VAT, under the accounting standard IAS 2 “Inventories”, the stock is determined based on the retail price by deducting the margin, and in a market economy subject to competition this formula is the only viable one. Stock accounting is organized in volume and value or only in value by using perpetual or intermittent inventory.

In order to **assess the cost of inventories leaving the entity**, IAS 2 “Inventories” uses most frequently the *method of specific individual cost identification*. However, it is necessary in some cases to use another method of determining the cost of inventories – *FIFO or WAC* – thus excepting the *LIFO* method, because it does *not fairly present the inventory flows*, as in the case of the FIFO method.

Moreover, the International Accounting Standards Board (IASB) noted that the use of LIFO formula was often driven by tax incentives and held that the use of an inferior treatment is not allowed only from tax considerations. Thus, according to Ross Jennings & all (2009) “It is often argued that LIFO income statements are more useful as a basis for valuation than those prepared under alternative cost-flow assumptions (such as FIFO or average cost) because LIFO cost of goods sold is based on relatively current inventory costs. In contrast, non-LIFO balance sheets are alleged to be

more useful for measurement because their inventory values, also based on relatively current costs, better represent the net assets available to generate future resource inflows”. [2]

Do not forget, however, that the FIFO method requires recognition as expenses of the oldest prices in the profit and loss account, and this feature is often seen as a shortcoming of FIFO as the current replacement cost of stocks is not correlated with income generated by these stocks. However, in the balance sheet, the FIFO stock valuation method presents the latest prices of stock, and if the rotation speed of stocks is fast enough, evaluation by this method will approximate the actual cost. If there are companies that use the LIFO method for inventory outflow assessment or release for consumption, it is necessary for stocks to be retreated as FIFO or WAC in order to ensure comparability of accounting information with other companies in the same industry.

We believe that the account balances determined using the FIFO method reflect more faithfully the value of company stocks, because they are valued at the latest purchase price.

Another difference relates to the **price reductions** difference relates to the **price reductions**. Thus, if IAS 2 “Inventories” does not distinguish between different types of price reductions, all this reducing the purchase cost, OMPF 3055/2009 governs the accounting treatment of price reductions differently, depending on their nature (commercial, financial), type (rebate, draw, discount) and time of grant (at the time of invoice or in a later bill).

Thus, the *commercial discounts* received or granted at the time of purchase or sale, decrease the purchase price, being calculated in cascade, by applying the percentage rate to the previous net. Therefore, they are not accounted for separately. However, in the event of commercial discounts received or granted after the purchase, they are reflected both with the client and supplier in the accounts “Trade discounts received” and “Commercial discounts granted”, thus adjusting the operating expenses, i.e. the net turnover and *breaching some provisions of IAS/IFRS on the purchase cost, the fiscal year independence (the stock may be in the entity, and the reduction was included in the result of the year), as well as the true image*. [4]

Financial cuts are calculated after deducting the commercial discounts and if no such discounts were granted, the discount percentage is applied to the selling price. The financial cuts may be accounted for upon billing or afterwards and the discount will be shown with the client in the account “Income from discounts received” and with the supplier, in the account “Expenditure on the discounts granted”. [4]

3. Economic and financial indicators – expression of accounting treatments regarding stocks

Choosing an accounting treatment regarding stocks and, consequently, an accounting method of evaluating stocks has a direct influence on the *variables in the financial statements* and, accordingly, on the *financial indicators*. Choosing rules involving the abandon of another has consequences on the financial statements and the accounting result.

In this context, an objective in the analysis based on rates was the successive study of the financial dimension of the entity, taking into consideration indicators related to: liquidity, activity, risk, return - the latter being one of the most synthetic efficiency indicators expressing the results of the company in all stages of the economic and financial circuit. Professor M. Ristea believes that performance can be associated to the three concepts: efficiency, economy and effectiveness (the three E's equation). Return is a component of efficiency, and to be as efficient as possible, the resource utilization rate should be as high as possible. [3]

For example, if we compare the LIFO method to the FIFO method, we can see that the use of the first method leads to: lower income, a higher cost of the goods sold, lower cash flows (lower taxes), lower current assets. When using the FIFO method the situation is reversed. Given these considerations, comparing several economic and financial indicators, it appears that these values are diametrically opposed, namely:

– *current liquidity ratio (current assets / current liabilities)* is higher when using the FIFO method and lower when using the LIFO method;

– *stock rotation speed (cost of sales / average stock)* is lower when using the FIFO method and higher if the LIFO method is used;

– *leverage (long term debt / equity ratio)* is lower when using FIFO, higher when using the LIFO method;

– *net profit margin (net profit / turnover)* is higher when using FIFO method and lower when using the LIFO method;

– *return on assets (net income / total assets)* is higher when using FIFO and lower when using the LIFO method;

– *return on equity (net income / equity)* is higher when using FIFO and lower when using the LIFO method;

– *economic profitability (operating income / total assets)* is higher when using FIFO and lower when using the LIFO method.

Looking from this perspective, we consider that the valuation of stocks is a problem, and its solving depends on the assortment complexity, profitability and taxation.

Given that the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an economic unit, useful for a wide range of users in making economic decisions, special attention should be paid to the entity's accounting policies and treatments since today it is no longer possible to properly judge the performance of an economic entity based on the financial statements if the entity's accounting policies and treatments are not mastered in detail.

4. Conclusions

Many times the same economic event gives rise to different reactions due to cultural differences in accounting and the IASB – for the provision of a common approved framework for preparing and submitting financial statements – tried to achieve a reconciliation of the two accounting cultures arguing for primacy: the European accounting culture and the Anglo-Saxon accounting culture.

As a general rule, an entity must use the same costing method for all inventories. However, for stocks with different nature or use, there are situations when different methods may be rightly used for calculating the cost (the inventories used in different business segments can be mentioned here). But if differentiation occurs in the geographical location of inventories and in regulations regarding the taxation, this is not enough to justify the use of various cost calculation methods. After choosing the treatment, it is applied consistently and disclosed in accordance with the requirements of IFRS/IAS. [5]

In the absence of other arguments, we believe that *only the application compliant with the International Financial Reporting Standards provides us with a complete presentation of financial information on stocks* to its users, and an entity can not state that the financial statements comply with the regulatory framework unless they meet all the requirements of IFRSs. [7] Thus, all the above, converted into performance requirements related to stocks, leads to accurate information to recipients, namely to informational reliability.

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