ACCOUNTING FOR OWN PRODUCTION – DEFINING THE NEGATIVES OF CURRENT CZECH METHODOLOGY

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Abstract: The paper deals with the analysis of the current methodology of manufacturing accounting in accordance with the Czech accounting standards. For the purposes of the paper, the method of process analysis is used. The paper defines the negatives of accounting procedures that have been used since 2016 and compares the current accounting procedures with the procedures used before 2016. It has been found that the current methodology according to the Czech accounting standards is in conflict with the Act No. 563/1991 Coll., on accounting. According to the former procedures, increase or decrease in manufacturing inventory were accounted for with the accounts in Class 6 – Revenue. Under the current rules, changes in manufacturing inventory are accounted for in the accounts in Class 5 – Costs. This significantly distorts the total value of costs and revenues. The financial statements prepared on the basis of such documents thus do not provide a true and fair view of the subject atter of the accounts, as required by Act No. 563/1991 Coll., on accounting. There is a conflict between the rules laid down by the Czech Accounting standards for manufacturing accounting and the requirements for financial statements under the Act No. 563/1991 Coll., on accounting.

Keywords: accounting for manufacturing inventory, Czech accounting standards, the Accounting Act, costs, revenues

1 Introduction

This paper focuses on manufacturing accounting and defining the negatives of the current applicable Czech methodology. Prompt information about the financial health of a company is provided in balance sheet (Anvarovich, 2020). Balance sheet is a principle to assess the company´s property from two perspectives, specific property items (assets) and the origin of the asset (liabilities) (Sroufe & Ramos, 2015). Assets include current assets, where manufacturing inventory represents a significant part. Inventory is intended for sale and include raw materials, work-in-progress (unfinished products), finished goods, purchased goods intended for resale, including e.g., goods purchased by a retailer for resale, land, or other assets intended for resale (Simeon & John, 2018).

According to Singh et al. (2021), the most common types of inventories by stage of processing are raw materials, work-in-process (WIP), and finished products. This classification is based on the location of inventory in various production stages and accentuates the position of inventory in the value chain of the company (Alfares & Ghaithan, 2022). Sroufe & Ramos (2015) add the fourth group to the classification, namely stock of goods, while Himick et al. (2022) supplement the classification of inventory by stage of processing with goods in transit. These can be considered a part of working stock, because even if not available for sale or delivery, they still provide a sense of security. They become available at the moment when arriving from one location to another (Potkány et al., 2022). Manufacturing inventory is included in the current asset, as it is produced by the accounting entity itself. It is valued at own costs or based on production costing in a given accounting entity (Wang & Wan, 2020). According to Verma (2015), inventories also include finished products produced by the accounting entity, work-in-process, material, and similar supplies intended for consumption within the production process. Inventory produced by own economic activity include work-in-process in the form of unfinished and semifinished products, finished products, and animals (Khusinov & Sh, 2021).

The terms work-in-process and semi-finished products are used for the products that have undergone certain production stages but cannot be considered finished products (Zhang et al., 2015). They also include unfinished activities that do not generate material products, such as separately registered products, i.e., semi-finished products that have not undergone all production stages and will be finished or completed by the accounting entity in the next stage of the production process (Han et al., 2021). According to the aforementioned decree, manufacturing inventory includes also young and other animals as well as their groups. These are young animals, including slaughter animals, which are not reported in adult animals and their groups, in material, or goods (Gottlieb et al., 2022).

Valuation of work-in-process, semi-finished products, or finished products is based on the type of the production process, production time, and the chosen technology (Nisha, 2015). Another factor playing a role is the time of the production cycle, i.e., whether the production time is or is no longer than one year. Information about the status and valuation of manufacturing inventory are obtained from internal accounts. For this reason, accounting standards require the company to provide conclusive documentation from internal accounts (Avi, 2021).

In 2016, there was a major change in the Czech Accounting Standards concerning accounting for manufacturing inventory. Until that year, increase and decrease in manufacturing inventory were accounted for in Class 1 – inventories in Class 6 – Revenues. Since 2016, these changes have been recorded in Class 5 – costs. The change in manufacturing accounting from revenue to cost accounts has been also reflected in the change of profit and loss account (Hašková & Fiala, 2022). The change has also affected the amount of turnover, since the term annual aggregate net turnover refers to the amount of revenue less sales discounts. Therefore, according to the new methodology, manufacturing inventory is no longer a part of net turnover. (Gláserová, 2015).

Manufacturing inventory, costs and revenues are also defined by International Accounting Standards (Napier & Stadler, 2020). These standards resulted from the situation in 1973, when due to the globalization of capital markets, the International Accounting Standards Committee (IASC13) was established by nine countries. Its primary goal was to create and improve harmonization rules and accounting standards, as well as to ensure their worldwide application through the formulation and publishing of accounting standards and rules for reporting for the benefit of the general public (Král, 2014).

According to the International Accounting standards, an expense is the reduction of the economic benefit that occurred during an accounting period in the form of outflows/inflows of assets or an increase in the value of liabilities, which results in the reduction of equity in a way other than distributing the equity to the owners. In the case of expenditures, reporting is conditioned by the timing of the recognition of the decrease in assets or increase in liabilities incurred by the expense (Gheorghe, 2016). It is also important to be able to value the expense. Expense incorporates the concepts of cost arising from ordinary activities and losses. Cost arising from ordinary activities include, e.g., cost of sales, wages, and depreciation. Income includes both revenues and gains (Turgunovich, 2021).

The goal of the paper will be achieved using a process analysis of the accounting for manufacturing inventory currently applicable in the Czech Republic. These procedures will be compared with the procedures valid before the amendment that has been in force since 2016. There will be compared the regulations in force according to the Act No. 563/1991 Coll., on Accounting and Czech accounting standards.

2 Methodology

There will be performed a process analysis of the current methodology of accounting for manufacturing inventory, where the prescribed procedures stipulated in the Czech Accounting Standards according to the Ministry of Finance of the Czech Republic (2023) will be analysed, specifically, the Czech Accounting Standard for Entrepreneurs No. 007 – inventory differences and declines, No. 015 – Inventory, No. 019 – cost and revenues. There will be defined the principles of using specific accounts in accounting for typical selected economic operations. The output will be the currently applicable account assignment.

These procedures will be compared with the methodology applicable before the year 2016. The output will be the previously valid account assignment of typical selected economic operations. This will be followed by assessment whether the currently valid methodology according to the Czech Accounting Standards is in line with the Act No. 563/1991 Coll., on accounting. It will also be assessed whether the accounting according to the currently valid methodology provides a truer and fair picture of the situation of the accounting entity compared to the situation before the year 2016.

3 Results

Accounting for manufacturing inventory is generally subject to the Act No. 563/1991 Sb., on accounting. The issue is addressed in the Czech Accounting Standard for Entrepreneurs No. 015 – Inventories (the Ministry of Finance of the Czech Republic, 2023).

According to this standard, accounting for manufacturing inventory, which will be valued at own costs, can be performed using the "A" method with the accounts in Class 1 – Inventories with the appropriate account in Account Group 58 – change in manufacturing inventory and capitalization. It is also possible to use the "B" method, where no entries are made in Class 1 during the accounting period and the costs incurred in production are accounted for in the accounts of Class 5 - Costs. When closing the books, the opening balances of these inventories are derecognised, and the inventories identified by stocktaking are then charged to the appropriate account in Group 12 – manufacturing inventory with the appropriate account in Group 58 – Changes in manufacturing inventory and capitalization.

The Czech Accounting Standard for entrepreneurs No. 007 – Inventory discrepancies and natural decline standards stipulates that in the case of inventory discrepancies in manufacturing inventory, these inventory discrepancies within the natural decline standards and surpluses are accounted for with the accounts in Group 58 - Change in manufacturing inventory and capitalisation.

The Czech Accounting Standard for Entrepreneurs no. 019 – Expenses and Income specified that in the accounts in Group 58 – Change in manufacturing inventory and capitalisation shall account for increases and decreases in manufacturing inventory, where the offsetting accounts are the corresponding accounts in Class 1 – Inventories.

Act No. 563/1991 Coll., on Accounting, Section 7 stipulates that accounting entities are obliged to keep accounts in such a way that the financial statements drawn up on their basis are clear and give a true and fair view of the subject matter of the accounts. The provided picture is true only if the contents of the items in the financial statements correspond to the actual situation presented in accordance with accounting methods the accounting entity is obliged to apply under this Act, and is fair, if the accounting methods are applied in a manner that enables achieving true representation.

Tab. 1: Selected accounting operations – accounting for manufacturing inventory according to the current methodology

Economic operation	**Account assignment**
Production of WIP - method "A"	121/581
Production of semi-finished products – method "A"	122/582
Manufacturing products – method "A"	123/583
Inventory discrepancies within the natural inventory decline standards – finished products	583/123
Inventory discrepancies – deficits – finished products	54x/123
Inventory discrepancies – surpluses – finished products	123/583
Loss of WIP during their removal from storage	581/121
Loss of semi-finished products during their removal from storage	582/122
Loss of finished products during their removal from storage	583/123

Source: Authors

Before the year 2016, the Czech Accounting Standard for Entrepreneurs no. 007 – inventory discrepancies and losses within the natural inventory decline standards, specified that in the case of manufacturing inventory, the inventory discrepancies and losses within the natural inventory decline standards were recognised to the relevant account in Account Group 61 – changes in inventory, deficits to the relevant accounts of the Account Group 54 – other operating costs, and surpluses to the relevant accounts in Account Group 61 - Changes in manufacturing inventories.

Before the year 2016, Czech Accounting Standards for Entrepreneurs No. 015 - Inventories specify that increases in manufacturing inventory accounted at own costs as well as changes resulting from the removal of the inventory from stock are accounted for with the relevant accounts in Group 61 – changes in manufacturing inventory.

Before the year 2016, Czech Accounting Standards for Entrepreneurs No. 019 – Expense and Income stipulated that increases and decreases in manufacturing inventory, or changes based on discrepancies identified in stocktaking are accounted for in Accounting Group 61 – changes in manufacturing inventory. Accounting Group 62 – capitalization was used for the production of materials and goods.

Tab. 2: Selected accounting operations – accounting on manufacturing inventory according to the methodology valid until 2016

Economic operation	**Account assignment**
Production of WIP - method "A"	121/611
Production of semi-finished products – method "A"	122/612
Manufacturing products – method "A"	123/613
Inventory discrepancies within the natural inventory decline standards – finished products	613/123
Inventory discrepancies – deficits – finished products	54x/123
Inventory discrepancies – surpluses – finished products	123/613
Loss of WIP during their removal from storage	611/121
Loss of semi-finished products during their removal from storage	612/122
Loss of finished products during their removal from storage	613/123

Source: Authors

If we agree that costs can be characterised as a monetary consumption of inputs used by an accounting entity for the purpose of generating income (Antle & Bogetoft, 2018), then it is clear that the current methodology of manufacturing accounting contradicts this definition.

Product manufacturing is associated with consumption accounted for in various accounts in Class 5 - Costs. The aggregate amount of costs thus indicates the total sum of inputs in the accounting entity. However, if increases and decreases in WIP are accounted for in accounts in Accounting Group 58– changes in manufacturing inventory, this decreases the total value of costs and breaks the overview of the total costs of an accounting entity. The figure given under item 5 – Costs is thus unrealistic.

If we agree with the definition that costs represent the outputs of economic activities and increase economic profit (Zha Giedt, 2018), then it is evident that the current methodology of accounting for manufacturing inventory also contradicts this definition. If we produce something, then we perform; performance expressed in money is referred to as revenue. According to the current methodology of accounting for VLASTNÍ VÝROBA, accounting entities thus do not actually perform any services, do not have any outputs of from their economic activities. The figure given under item 6 – Income is thus unrealistic as well.

The Act No. 563/1991 Coll., on Accounting, stipulates that financial statement needs to be compiled in a comprehensive manner and shall give a true and fair picture of the subject matter of accounting. This picture is fair if the content of the financial statement items corresponds to the actual state, which is presented in accordance with the accounting methods. It follows from the above that according to the current effective accounting procedures, the individual items of financial statements in the case of manufacturing inventory do not correspond to the actual state, which means that the given picture is not fair and true. Accounting entities are obliged to follow the valid methodology; however, as documented above, this methodology is in conflict with the Accounting Act.

Moreover, this change in the methodology is completely unsystematic. As an example, we can mention accounting for damage. The amount is accounted for as a cost. The request for reimbursement from the insurance company is then recognised in income, as this is the other side. If the current accounting procedures were consistent and systematic, the request for reimbursement from the insurance company would not be recognised as income but it would reduce the overall costs of the given entity.

It shall be noted that Účtová osnova pre podnikateľov 2023 Slovenské republiky (the Chart of Accounts for Entrepreneurs of the Slovak Republic, 2023) (the Ministry of Finance of the Slovak Republic, 2023) still includes the Accounting Group 61 – changes in organizational inventory and 62 – capitalization. Specifically, this refers to accounts 611 – changes in the status of WIP, 612 – changes in the status of semi-finished products, 613 – changes in the status of finished products, 614 – changes in livestock, 621 – capitalization of material and goods, 622 – capitalization of intra-organizational services, 623 – capitalization of fixed intangible asset, and 624 –capitalization of fixed tangible asset (specific example is mentioned e.g., by Polikarpova & Mizikovskiy, 2018). Slovak accounting experts have undoubtedly concluded that manufacturing accounting in Class 6 – Revenue is methodologically correct. The users of their financial statements are thus able to obtain true and fair data on a given accounting entity in a simple and understandable form.

4 Discussion of results

In terms of current publications but from a historical perspective, the issue of accounting for manufacturing inventory is addressed by Loft (2020), who pays particular attention to a period in the history of accounting and examines the interaction of knowledge, techniques, institutions, and professional demands in Great Britain. Another historical reflection on this issue is provided by Carvalho et al. (2007), whose research contributes to understanding the historical development of accounting by providing an example of the cost accounting practices in a Portuguese company and analyses the integration of the systems of cost and financial accounting within double entry accounting. The current approach to how to account for manufacturing operations is provided by Schmidt & Nakajima (2013), who use German method developed for material flow cost accounting (MFCA).

The current Czech methodology of manufacturing accounting differs in many aspects from the procedures and practices applied abroad. In the context of accounting for manufacturing inventory, a research question was formulated on whether the current applicable methodology according to the Czech Accounting Standards for manufacturing accounting is in compliance with the Act No. 563/1991 Coll., on accounting. It has been found that the Czech Accounting Standards and the Act No. 563/1991 Coll., on accounting contradict each other in accounting for manufacturing inventory. According to the standards, increases or decreases in manufacturing inventory are accounted for in accounts in Class 1 – Inventory with a corresponding entry in the accounts in Group 58 – change in manufacturing inventory and capitalization. This results in the manipulation with Account Class 5 – Cost. At the same time, production outputs and the increase in economic profit are completely ignored, as the accounts in Class 6 – Revenue are not considered.

The second research question was whether accounting for manufacturing inventory according to the current methodology provides a truer and fairer picture of the situation of a given accounting entity compared to the methodology used before the year 2016. The Act No. 563/1991 Coll., on accounting prescribes that financial accounts based on individual items needs to be compiled in a comprehensive way and shall provide a fair and true picture of the subject matter of the accounts. However, this is in contradiction with the above prescribed procedures. Accounting entities are obliged to follow the Czech Accounting Standards; however, this means that provisions stipulated in Section 7 of the Act No. 563/1991 Coll., on accounting cannot be complied with. The methodology of accounting for manufacturing inventory valid until 2016 undoubtedly guaranteed that the financial statements compiled in accordance with this methodology would provide a true and fair view of the subject matter of the accounts.

In addition to the above, it shall be noted that the new amendment to the methodology increases the compatibility with the International Accounting Standard IAS 2 Inventories, according to which it is necessary to allocate everything, not only the items determined by the accounting entity. The question is how unaudited small and micro accounting entities will be able to handle deciding on the chosen method and including or excluding causally attributable indirect costs (Otavová & Gláserová, 2017). This is because an incorrect valuation of inventories will not only cause an administrative accounting offence but will also have a impact on corporate income tax (Aljinovic Barac et al., 2017).

5 Conclusion

The goal of the paper was to analyse the current methodology on manufacturing accounting and the comparison of the current methodology with the methodology used before the year 2016.

It has been found that the current prescribed accounting practices in manufacturing accounting prescribe to account for increases and decreases in these products incorrectly in Class 5 – Cost. This results in the distortion of the total value of costs. Conversely, these facts are not reflected at all in Class 6 – Revenue, which distorts the overall value of income.

The methodology currently in force is thus in contradiction with the Act No. 563/1991 Coll., on accounting, since the financial statement drawn in accordance with these regulations does not provide a fair and true picture of the subject matter of the accounts.

The methodology valid before the year 2016 concerning accounting for manufacturing inventories stipulated that the increases and decreases in manufacturing inventory were accounted for with the accounts in Class 6 – Revenue. This avoided distortion of the total costs and the actual value of the outputs of an accounting entity was accounted for in revenues, where the increased economic profit of a given company was accounted for. The previous methodology was thus in line with the requirements stipulated in the Accounting Act.

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Primary Paper Section: A

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