

## Internal Constructions: Valuation, Reclassification, Impact on Ratios and Cash Flows



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**ABSTRACT:** In-house constructions represent assets built within the company with the labour force carrying out its activities. Such assets are tangible multi-year assets and, therefore, like all tangible multi-year assets, are depreciable according to the standard depreciation rules. In-house constructions pose problems at the valuation level as, at times, errors can note in the allocation of costs. In addition, there are logical errors in the reclassification of internal constructions within the reclassified balance sheet and the calculation of cash flows. These issues will be discussed in more detail in the following pages, highlighting the most frequent errors and the most appropriate solutions.

**KEYWORDS:** internal construction, construction contracts, internal construction valuation and reclassification, internal construction in monetary flows

### 1) Interior constructions: introductory notions<sup>1</sup>

In-house constructions represent those tangible goods that are manufactured, within the company, with the company's labour force and materials purchased from outside. In-house constructions are also called economy orders because they are goods constructed within the company's economy without establishing economic relations with third economies for the direct purchase of the goods in question.

In-house constructions can be, at the operational level, plants manufactured equipment or other types of goods that, operationally and materially, can be constructed within a company with in-house labour forces. A company that produces chocolates is unlikely to have the capacity, for example, to build an order for a motor vehicle as it would require the presence of experienced personnel in this field is the ability to manage the construction of a highly complex asset. This is the case in almost all companies, except those directly or indirectly related to the automotive sector. However, it is necessary to note that motor vehicles generally never represent internal construction. And it should note that internal construction since it is initiated, is concluded with the internal labour force of the business structure under study and usually has a relatively low complexity insofar as there are hardly any labour capacities with very high specialisations such as to be able to construct, for example, a modern and technologically advanced assembly line as an assembly line must be in a current company. Internal constructions are generally represented by buildings of small dimensions, low-tech plants, or equipment requiring extremely narrow specialisation. Apart from the theoretical considerations, however, there is no limit, legally or theoretically, to the type of assets that can be constructed in-house in an enterprise. It should be noted that if an asset is built in the economy, the cost of wages will appear in the profit and loss of the enterprise. In the profit and loss of the enterprise, all the goods purchased and used for the construction of the asset constructed in the economy will be recognised. Therefore, materials, mechanical elements, technical elements, and purchases of particular goods necessary for the construction of the economic commission will all be identified, at the time of purchase, in the costs of the enterprise, which, at the end of the financial year, will be summarised in the costs section of the profit and loss.

Before the final closing of the accounts at the end of the year, the costs associated with in-house construction will therefore be listed among the company's costs without being distinguished in any specific way.

<sup>1</sup> To facilitate reading, I have decided not to include in the text, except in exceptional cases, 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

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When it is stated that in the profit and loss, before the closing of accounts, all costs relating to the in-house construction order are listed, it is meant to refer to any type of cost, both direct, such as a specific material, a purchase of a particular good that is necessary for the in-house construction order to be carried out, and other costs that directly go into the in-house construction order. Alongside these costs, however, there will also be listed several costs which, in total, were not used exclusively for the internal construction but were used by the company for the internal construction and also for carrying out the normal production activity that the company performed during the year covered by the financial reporting. The commingling of these costs gives rise to a valuation problem, i.e. the question arises as to how the internal construction should be recognised in financial reporting for the income for the year to be correct and the total assets of the balance sheet to be equally valid. The valuation of internal constructions is generally governed by the regulations in force in a particular country and by the accounting standards applied in that country. In the following pages, we will highlight what the Italian legislation states, what the accounting principle concerning tangible fixed assets illustrates, the doctrinal evolution of the accounting principle that has occurred in the last twenty years, and what the IAS/IFRS international accounting standards state. The section on valuations will highlight which costs should be considered in the valuation of internal construction and which should not be considered in such a valuation.

### **2) Valuation of internal constructions according to Italian national standards and international IAS/IFRS standards**

The valuation of internal constructions is an issue that has generally been addressed in the same way in the various countries' legislation, the national accounting standards of the different countries, and international accounting standards. The logic of allocating costs to internal constructions, therefore, represents a mode that, with very few exceptions or slight differentiations, is present in all countries that regulate financial reporting. In this article, references will be made to Italian legislation, the Italian national accounting standards issued by the Italian accounting body and the international IAS/IFRS standards. However, the rules, which, as will be seen, are the same in all three of the sectors mentioned above, identify the method applied, in essence, worldwide to value these assets built within companies with a workforce assigned to the company the economic contract.

Article 2426 of the Italian Civil Code states that "it must observe the following criteria in valuations:

1) fixed assets are recorded at purchase or production cost. Ancillary costs are also included in the purchase cost. Production cost consists of all costs directly attributable to the product. It may also include other costs, for the portion reasonably attributable to the product, relating to the period of manufacture and up to the moment from which the asset can be used; using the same criteria, charges relating to financing of manufacture, either in-house or with third parties, may be added;....."

As can be seen, the Civil Code, as is always the case in all legislation concerning financial reporting, illustrates a fundamental principle in an extremely concise manner that is of limited help to the financial reporting preparer as it does not explain the fundamental principles and calculation methods that must be followed to carry out this valuation. In this regard, the national accounting standards issued by the Italian accounting body intervene. Principle number 16, tangible fixed assets devotes only a few lines to the issue of internal constructions. In fact, this principle states, 'The cost of production includes direct costs (material and direct labour, design costs, external supplies, etc.) and general production costs, which are not included in the cost of production. The cost of production includes direct costs (material and direct labour, design costs, external supplies, etc.) and general production costs, to the extent reasonably attributable to the asset for the period of its manufacture up to the time when the asset is ready for use; charges relating to the financing of their manufacture may be added on the same basis ... Costs associated with strikes, inefficiencies or other causes unrelated to construction activity are not capitalised. They are charged to profit and loss in the period they are incurred.

As can be seen, even Italian national accounting standard number 16 tangible fixed assets do not provide analytical elements that can help those who must carry out evaluations at an operational level. The only aspect that is analysed in great detail by accounting principle number 16, tangible fixed assets also relating to the construction of assets in the form of internal constructions, concerns the allocation of financial charges. In this regard, accounting principle number 16 states that 'since tangible fixed assets are part of the permanent organisation of the company and only produce income when they are in operation, the financial charges incurred for their internal or third party construction may be capitalised as costs of tangible fixed assets in the terms indicated in the following paragraph.

Borrowing costs may be capitalised when all of the following conditions are met, within limits applicable to the specific case: (a) capitalisation of borrowing costs is permitted concerning costs incurred, objectively determinable, within the limit of the recoverable amount of the asset. The amount of borrowing costs capitalised during a financial year may, therefore not exceed the amount of borrowing costs, net of any financial income arising from the temporary investment of borrowed funds, attributable to the realisation of the asset and incurred concerning the same financial year. This is on the assumption that acquiring the asset externally rather than realising it internally cannot lead to the same assets being reported for significantly different values; b) only interest accrued on assets that require a significant construction period may be capitalised. The construction period is defined as

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the period from the payment to suppliers of goods and services relating to the tangible fixed asset until it is ready for use, including ordinary assembly and commissioning time. In substance, the reference period for capitalising borrowing costs is strictly necessary for the technical activities aimed at rendering the asset usable. If the construction period is prolonged due to strikes, inefficiencies or other causes unrelated to the construction activity, the borrowing costs related to the extended period are not capitalised but are considered as costs of the period in which they are incurred. Capitalisation of borrowing costs is suspended during periods other than short periods, in which the construction of the asset is interrupted.

To the extent that funds are borrowed specifically to finance the construction of an asset (a purpose loan), and are therefore costs directly attributable to the asset, the amount of borrowing costs eligible for capitalisation on that asset shall be determined based on the actual borrowing costs incurred on that loan during the period, less any finance income arising from the temporary investment of those funds. Such charges are capitalisable to the extent of the asset's recoverable amount. To the extent that it is necessary to utilise borrowed funds generally, the amount of borrowing costs accrued on those funds is capitalised to the time of the portion attributable to assets under construction. This amount is determined by applying to costs incurred at a capitalisation rate corresponding to the weighted average of borrowing costs related to borrowings outstanding during the period, other than borrowings explicitly obtained for the purpose of acquiring a qualifying asset.

The transition from capitalising borrowing costs to recognising those costs directly in profit or loss (or vice versa) is a change in accounting policy.....".

Concerning what is stated in the Italian accounting principle number 16 tangible fixed assets, it is interesting to note the historical evolution that has occurred over the last two decades regarding the issue of internal construction ap. accounting principle number 16 regarding tangible fixed assets before the one currently in force and issued in 2016 was issued in 2005. In that principle and was set forth 1.1 calculation methodology different from what is indicated today in the principle of today in particular in the article in principle 16 of 2005 the following accounting rule was established:

".....Where the company performs the activity of in-house construction continuously with a dedicated department, in-house orders are to be valued at the total manufacturing cost of direct costs and a proportion of manufacturing overheads...

If, on the other hand, an enterprise occasionally builds an in-house job order, it may not be characterised by the presence of accounting tools that permit the correct determination of the portion of indirect costs reasonably attributable to in-house construction. For this reason, Principle 16 provides that in cases where the in-house construction activity is occasional, it is acceptable to exclude production overheads from the valuation. This simplification is dictated precisely by the difficulty of determining the proportion of indirect costs attributable to self-construction.

However, the national accounting standard emphasises that if the company's own-account construction activity is occasional, it may also voluntarily capitalise a share of overhead costs. In such a case, it is specified that it must determine this share in such a way that it only includes that part of the costs incurred by the business due to the self-construction work. Thus, average period costs that would have been incurred by the company in any case independently of the in-house construction work are to be excluded. This principle aims to ensure that regular period costs are correctly allocated to the accrual period and to avoid economically incorrect capitalisation.

This principle concerning the choice of allocation of the share of indirect costs by enterprises that only occasionally develop internal construction activities is not explicitly mentioned in the code. However, it is considered that given the reasons that prompted National Accounting Standard No. 16 to make this observation, applying the accounting as mentioned above standard leads to the preparation of civil law financial reporting.

As can be seen, the standard issued in 2005 envisaged the possibility of not allocating overhead costs if internal construction was a purely occasional activity. This rule was completely abolished in 2016 with the issuance of the new national accounting standard issued by the Italian accounting body, and therefore, at present, whether internal construction represents an occasional activity or an activity carried out on an ongoing basis with a specific department, and there is an obligation to allocate an available part of the general production costs based on allocation parameters chosen from those indicated in the accounting principle itself or rather from those shown in accounting principle number 13 to which, indirectly, accounting principle number 16 refers, just as in the civil code for the valuation of inventories there is a direct reference to what is established for the internal construction of tangible multi-year assets.

Apart from these observations concerning the allocation of financial expenses to internal constructions, the currently valid accounting standard No. 16 devotes only a few lines described above to the issue of the valuation of internal structures.

IAS 16 Tangible Assets also does not devote much space to the valuation of internal constructions. It states a general principle and leaves the application and operational identification of the calculation methods to the financial reporting writer. In particular, IAS 16 states: " 22 The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing

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an asset for sale (see IAS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. IAS 23 Borrowing Costs establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment."

"As can be seen, all accounting standards and legislation do not go into the theoretical and operational aspects relating to the valuation of internal constructions. For this reason, to address the operational problems faced by those charged with the valuation of internal constructions, it is appropriate to refer to national accounting standard no. 13 concerning inventories and IAS 2 concerning stocks. These standards define production costs, which also characterise the valuation of inventories, in much more detail than the Italian national and international IAS concerning tangible fixed assets.

The Italian accounting principle No. 13 inventories point out that 'the charges typically identifiable as components of the cost of production can be summarised, by way of example but not limited to, in the following: 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. General production overheads - Salaries, wages and related charges pertaining to indirect labour and costs of the plant's technical management; - Depreciation of tangible and intangible assets contributing to production; - Maintenance and repairs; - Consumables; - Other costs incurred in the processing of products (methane 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 not directly attributable to products. 7 Subject to the particular characteristics of the production process of each company, the allocation parameters that may use to allocate common overheads are, by way of example but not limited to: - direct labour hours; - direct labour costs; - 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."

Concerning the allocation of overhead costs to internal construction, it should note that the above indications of Principle 13 issued by the Italian accounting body are only general indications in principle. There is nothing to prevent the adoption of other reference parameters for allocating overhead costs to the internal construction constructed by the company. Each company must naturally identify the parameters and main ones so it can allocate overhead costs in a meaningful and truthful manner to the internal construction. As is the case with inventories and , also for internal constructions and the costs to be considered are exclusively the production costs as indicated and in the preceding pages. Distribution and sales costs must therefore be excluded from general and administrative costs.

About the distribution costs of the sale of products manufactured in-house, the justification for the exclusion in the context of expenses relating to internal constructions is clear. The sale of products has nothing to do with the manufacture of a multi-year internal construction within a company. On the other hand, concerning administrative costs and general non-productive costs, these negative income components cannot be allocated to internal buildings as they are considered inherent in companies' ordinary business and administrative management. There is, therefore, no direct connection between these costs and internal construction, just as there is with the valuation of inventories. Concerning internal structures, regarding stocks, the only costs to be considered are costs of a productive nature, whether directly or indirectly attributed.

From production costs, costs of an exceptional or abnormal nature must always be excluded, such as, for example: the costs of transferring a plant from one factory to another (unless they are necessary in the production process before a further production stage), repair costs of an exceptional nature due to fires, hurricanes, etc., or the costs of repairing the plant in the event of a fire or a hurricane.

### **3) Internal constructions in the reclassified balance sheet and profit and loss**

With regard to the recognition of internal constructions in financial reporting, no particular problems arise for the recognition in the balance sheet and in the non-reclassified profit and loss and therefore prepared in opposing sections.

In the balance sheet, there are no particular reclassification problems since internal constructions are to be included among the assets. If, on the other hand, the internal construction is still in progress, an account must be opened with the name of the asset under construction, with the specification 'under construction'. If, for example, buildings have been constructed internally to the company and these constructions are still in progress, the account will be called 'buildings in progress'.

With regard to the recognition in profit and loss on a contra-entry basis, internal constructions should be recognised in revenue not because internal constructions are revenue but because, exactly as with inventories, they should be recognised in revenue as an indirect adjustment to expenses.

In non-reclassified financial reporting, internal constructions do not pose any particular recognition problems. Recognition problems can be identified when working on reclassified financial reporting in a specific way, especially when the financial

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reporting considered is not that provided for by the individual laws of the various countries, which usually indicate a compulsory structure and a compulsory positioning of each item, but above all, when we are dealing with reclassifications used to carry out internal financial reporting analyses. Such reclassifications have the characteristic of being proposed by the doctrine as a basic structure without a specific list of items to be indicated in the individual items. and for this reason, it is sometimes possible to find errors in the structures proposed by the doctrine that, if the amount of internal constructions is significant, can completely distort the equity and income results of the company resulting from the analysis itself with respect to the company reality that that financial reporting should photograph.

The Balance sheet and profit and loss structure analysed here, and use you for internal company analysis, are those proposed in the context of the integrated information system, i.e. in the context of that system which provides for an Inter relationship between financial reporting analysis and management control and between each part of the financial reporting analysis and each part of the management control. everything is connected with everything and that is why the system is called integrated. The integrated information system to the characteristic of never using two the same words to indicate different events and different words to indicate the same events . the clarity of communication of what forms the integrated information system itself a primary element of the system .

As far as the balance sheet is concerned, the reference structure within the integrated information system is as follows:

### RECLASSIFICATION SCHEME BALANCE SHEET/BUDGET BALANCE SHEET IMPLEMENTED AS PART OF AN INTEGRATED INFORMATION SYSTEM.

ASSETS	31/12/N	LIABILITIES AND EQUITY	31/12/N
<b>SHORT-TERM ASSETS</b>		<b>SHORT-TERM LIABILITIES</b>	
1. Immediate liquidity		1. Short-term financial liabilities	
2. Deferred liquidity			
* Trade receivables			
* Financial liquidity		2. Short-term tax liabilities	
* Tax-deferred income			
* Non-characteristic deferred income			
3. Availability (inventories)		3. Short-term non-financial liabilities	
4. Short-term assets non-characteristic			
5. Advances to trade suppliers			
<b>LONG-TERM ASSETS</b>		<b>LONG-TERM LIABILITIES</b>	
1. Long-term tangible assets		1. Long-term financial liabilities	
2. Long-term intangible assets		2. Long-term tax liabilities	
3. Long-term credit assets			

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	* <i>Trade accounts receivable</i>		
	* <i>Financial assets</i>		
	* <i>Tax assets</i>		
	* <i>Non-typical accounts receivable</i>		
		<b>3. Long-term non financial liabilities</b>	
		<b>EQUITY</b>	
<b>4. Long-term assets non characteristic</b>			
<b>Stand-alone items</b>		<b>Stand-alone items</b>	
<b>NET ASSETS</b>		<b>BALANCE TOTAL</b>	

As seen from the above scheme, internal constructions, whether completed or in progress, must be shown in the long-term tangible assets, including all assets used in the company's characteristic activity. Suppose the internal construction is a civil building, i.e. a building that is regarded as an investment and has no connection with the core business. In that case, this value must be shown in the long-term non-characteristic assets or the short-term non-characteristic assets, depending on whether the building is to be held in the company's assets for more than one year or is to be sold within 360 days. However, it should note that the internal construction of assets that are not used in the company's characteristic business is not very common. Therefore, the most common and logical location is long-term tangible assets. When the assets are used, they will be objects of depreciation, like those acquired from third economies. Between assets constructed in-house as internal constructions and assets obtained from third economies en bloc, there will be no difference in accounting or depreciation.

Concerning the reclassification of profit and loss in the integrated information system, it should note that the reclassification of profit and loss that provides the greatest utility for information and management purposes is, without doubt, the reclassification to "cost of sales and revenue".

While about the balance sheet, the most commonly used reclassification is based on the differentiation of the maturities of accounting items of an equity and financial nature, in the context of the profit and loss reclassified to cost of sales and revenues, the re-aggregation of the items is carried out according to a logic that is based on the demarcation line between core and non-core activities.

The contrast between characteristic revenues and costs makes it possible to determine an aggregate of extreme informative relevance: the operating income from characteristic operations (Rogc), otherwise known as GOP (Gross Operating Profit).

This sub-aggregate represents the profit or loss from conducting the typical business activity.

A typical activity is defined as the core business of the enterprise, i.e. the activity for which the enterprise was established. The core business, therefore, represents the focus of the company's activity. Maximising this activity's profitability should, barring pathological situations, constitute the primary objective of conducting business activity.

As can be understood from what has been said so far, precisely identifying the dividing line between core and non-core activities is an indispensable condition for the GOP aggregate to be meaningful and informative.

Concerning the non-core part of the company's activities, it can be briefly stated that, in this sphere, it can identify four distinct management :

- 1) asset management;
- 2) financial management;
- 3) non-core management by definition;
- 4) tax management.

Concerning the content of each section of non-characteristic assets, it may make the following brief remarks:

1) Non-Characteristic Asset Management refers to all income and expenses emanating from capital investments, constituting invested capital, which are not used in the company's core business. As noted in the preceding pages, capital assets comprise two sub-aggregates, referred to as short-term assets and long-term assets, within which those balance sheet items must be included, respectively maturing within the financial year or beyond the next financial year, not utilised in the company's core business.

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Examples include civil buildings, securities and equity investments (note that the above reclassifications and remarks on profit and loss reclassified to cost of sales and revenues can be applied to all non-banking and insurance companies).

Where such non-characteristic asset items result in revenue or where such investments require incurring costs, the negative and positive income values are to be included in the asset management of the non-characteristic business activity of the enterprise.

2) All income and expenses arising from receivables or payables of a financial nature are to be included within the scope of financial management. These amounts consist primarily of interest receivable and payable on current bank accounts or other financial receivables and payables. Following both national and international accounting standards, exchange rate gains and losses are also shown in this aggregate. This is because exchange rate activity is always considered extraneous to the typical business activity by the above standards.

3) About non-recurring operations by definition, it must be emphasised that the aggregate under consideration is often improperly identified with the phrase 'extraordinary income and expenses. However, the aggregate of extraordinary income/expenses does not coincide with the aggregate of non-recurring items by definition, as it is possible to identify numerous accounting values that, although ordinary, identify income items of non-recurring nature (e.g. capital gains/losses arising from the sale of fixed assets connected to the normal replacement of assets within the production process).

The aggregate 'non-typical income and expenses by definition' must include items that, by their intrinsic nature, cannot relate to the performance of typical activities. We mean, for example, all capital gains/losses and contingent assets and liabilities of both ordinary and extraordinary nature.

4) Tax management identifies income taxes for the financial year.

This item makes it possible to determine how much income tax has affected pre-tax income, i.e. calculated gross of this cost.

It should therefore include neither taxes nor property taxes in this aggregate. The former is because they identify sums paid to obtain identifiable services, as opposed to taxes paid to enjoy a range of services provided by the public entity. On the other hand, wealth taxes are not included in tax management because the requirement to be met by identifying this aggregate is the determination of the percentage of produced income subject to taxation.

From the analysis of the non-characteristic profit and loss items, it is clear that the part of the profit and loss that identifies the characteristic activity is made up of the set of company 'areas' that allow the performance of the activity for which the company was established.

By characteristic activity is therefore meant not only the transformation activity in the physical-technical sense (or production in the strict sense), but the whole of the latter, of the administrative, commercial and, procurement and research and development activities (in addition to these costs, the so-called overhead costs are also relevant, for the analysis of which the reader is referred to the following pages).

To maximise the informative capacity of profit and loss, the characteristic costs must be re-grouped based on 'the area of utilisation of the production factor being recognised'.

What matters in the reclassification to cost of sales is the destination of the input entered into the business. On the other hand, the origin of the cost is of no importance, an element on which, on the contrary, the civil law reclassification provided for by Articles 2425 et seq. of the Civil Code is based.

The aggregates that can be identified as part of the typical business activity are the following:

- 1) production costs
- 2) administrative costs
- 3) commercial costs
- 4) research and development costs
- 5) overhead costs.

Their content can be summarised as follows: the core business is the set of company 'areas' that allow the activity for which the company was established to be carried out.

By core business is therefore not only meant the transformation activity in the physical-technical sense (or production in the strict sense), but also the combination of the latter, of administrative, commercial and, procurement and research and development activities (in addition to these costs, the so-called overhead costs are also relevant, for the analysis of which the reader is referred to the following pages).

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- 2) administrative costs
- 3) commercial costs
- 4) research and development costs
- 5) overhead costs.

Their content can be summarised as follows:

CHARACTERISTIC COST AGGREGATE BROKEN DOWN BY MANAGEMENT AREA	CONTENT OF THE COST AGGREGATE
Cost of sale	<p>The cost of sale, or production of the product sold, identifies all production costs incurred by the enterprise in carrying out its core business. To make a complete analysis, it is necessary to locate a sub-aggregate, the cost of the finished product, which identifies the cost incurred to finish the object of production. This cost does not include inventories of finished goods and merchandise, just as it should not include any purchases of goods in the above aggregate. In summary terms, the cost of sale can be summarised as follows:</p> <p>Consumption of raw materials            Consumption of ancillary materials            Consumption of semi-finished goods            Production depreciation            Productive wages            Production severance pay            Other industrial costs            .....</p> <p>Inventories Initial work in progress            (Final inventories of work in progress)            Inventories. Initial semi-finished products of production            (Final inventories of semi-finished products of production)</p> <p><b>COST OF FINISHED PRODUCTS</b></p> <p>Inventories Initial of finished products            (Closing inventories. of finished products)            Inventories Initial goods not processed but sold in the state in which they were purchased            goods not processed but sold in the state in which they were purchased            (Closing inventories of goods not processed but sold in the state in which they were purchased)</p> <p>-----</p> <p><b>COST OF GOODS SOLD ( COST OF SALE )</b></p>
Costi di amministrazione	Identifies all administrative costs and negative income components incurred for corporate representation purposes



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Costi commerciali	It identifies the sum of commercial, marketing and sales costs
Costi Ricerca e sviluppo	Identifies the sum of research and development costs incurred during the year
Overhead Cost	<p>These costs identify notional values present only in companies belonging to a group. The holding company performs activities from which the subsidiaries or affiliated companies benefit free. It defines group strategy, identifies tax strategies, determines the financial management of intra-group flows, manages human resources at the senior/management level and, often, engages in institutional marketing activities. Subsidiaries or associates enjoy the benefits of these activities free of charge. The holding company does not 'pass on the costs to the companies by issuing invoices but carries out the transaction off the books for internal company purposes only.</p> <p>In the presence of overhead costs in the reclassified profit and loss account, the net income for the year in the final balance sheet differs from the income in the reclassified profit and loss account by precisely the amount of the costs charged off-balance sheet. These amounts are set off the books, and thus, without impact on the subsidiary's financial statements, by parent companies. In the absence of accounting movements, these costs do not appear in the subsidiary's financial statements and therefore only represent amounts included in the reclassification to assess the performance of the subsidiary's management. Including this item allows for a better assessment of the subsidiary's characteristic performance. This company is also "loaded" with the negative income components of which, although it does not make any disbursements as the parent company bears them, it benefits from these amounts.</p>

Based on the above, one can structure the profit and loss reclassified to cost of sales within the integrated information system on the basis of the scheme below:

<b>Characteristic</b>
<p><b>Characteristic Revenue</b></p> <p><b>Cost of Sale</b></p>
<b>Gross Profit</b>
<p><b>(Administrative Costs)</b></p> <p><b>(Commercial Costs)</b></p> <p><b>(Research and Dev. Costs)</b></p> <p><b>(Overhead cost)</b></p>
<b>Gross operating Profit (GOP)</b>
<b>Non Characteristic</b>
<p>Revenue from asset non characteristic Management</p> <p><b>(costs from asset non characteristic Management)</b></p> <p><b>Financial management</b></p>

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<b>Operating Profit</b>	
(financial management costs)	
revenues from non-operating activities by definition	
(rCost from non-operating activities by definition)	revenues
<b>Ante tax Profit</b>	
(Tax))	
<b>Net Profit</b>	

Based on the preceding pages, the question arises as to where the amount of internally constructed depreciable deferred costs should be reclassified. In this regard, it can note how widespread the errors are found in books and scientific articles and the schedules drawn up by the operating and corporate officers. Internal constructions represent an item often placed either under revenue or under non-operating activities by definition. These reclassifications are profoundly flawed and misleading, the implementation of such a classification error leads to the determination of a GOP of an operating profit wrong compared to the reality of the company, and then the entire income and equity analysis are distorted. If, for example, we consider the internal construction of a plant, it is evident how the reclassification is based on the very notion of internal construction. It is evident that these costs are production costs. Therefore, it is clear that the internal construction must be placed as an adjustment to the production cost list that appears in the classification structure. It is equally evident that the labour force used is productive in that it is unthinkable that it can employ commercial and administrative labour in manual work such as the construction of any asset and many years. The internal construction of a plant must therefore be placed as a deduction from the cost of sale. Only in this way will the cost sale turn out to be realistic insofar as it is deducted from the expenses used to realise the internal construction and, consequently, the PE tour the work in re profit will be significant. It should note that a persistent error that is also identified in scientific articles and books concerning financial reporting problems is the correct recognition of constructions of assets used in the administrative sphere. It has been noted several times that the recognition of such internal constructions has deducted administrative costs. Such recognition is deeply flawed in that, such an indication goes, directly to adjust administrative costs that have not participated and have not been considered in the indication and calculation of internal constructions, even in the hypothesis that the asset constructed was used in the administrative or commercial or research and development sphere, internal constructions must always be indicated as a deduction of cost six as the costs to be adjusted are always indicated in the production costs. This also considers that the law and international, national accounting standards require that internal constructions be determined based on production costs and that they may include no administrative or commercial costs. Internal constructions must, therefore, always be deducted from cost six, regardless of the asset constructed internally within the company.

#### 4) Internal constructions in ratios and cash flow calculations

Regarding the impact of internal constructions on ratios, it should note that these financial reporting items impact all ratios that, at the numerator or denominator, include material long-term assets. The fact that long-term investments include internal constructions does not have any specific impact on the ratios. Internal buildings, whether completed or ongoing, represent typical long-term assets. Therefore, explicitly concerning internal structures, the effect on ratios will be similar to the impact that all other long-term material a sez a year within the in says. The only observation is that if the internal construction is an asset used in the characteristic activity, such as planting small industrial buildings used in the typical business activity, equipment, etc., these long-term asset items will be part of the capital invested in the characteristic activity.

On the other hand, the internal constructions relate to civil buildings, i.e. buildings that have nothing to do with the core business; these assets will not form part of the capital invested in the core business. In this case, in the first case, the internal constructions will form part of the capital in relation to which the ROI (return on investment) is calculated, i.e. the profitability of the core business. In the second case, on the other hand, if internal reconstructions are not part of the characteristic assets, they will not be included in the ROI calculation as this ratio only concerns the typical activity's performance. It has already been pointed out above that this second hypothesis is more theoretical than a real operational one since internal constructions are generally carried out to manufacture assets, generally not particularly complex, used in the company's characteristic production process. Apart from these considerations, it can make no other observations about internal constructions and their impact on ratios.

## Internal Constructions: Valuation, Reclassification, Impact on Ratios and Cash Flows

On the other hand, as regards internal constructions in the area of monetary flows, it can be noted that there are operational difficulties in this issue, which, although not particularly complex, are often misunderstood, leading to erroneous and, consequently, misleading monetary flow calculations. This happens very often at the operational level. Still, one can also see how the topic is treated incorrectly in some books, creating interpretation problems in those who read the article or book. The impact of internal constructions on flows is twofold: profit and equity. In the non-reclassified profit and loss, it has already been pointed out that internal constructions are recognised as income not because they are revenue, but because they must indirectly rectify costs that are recognised in the opposite section and that contain a series of negative income components that do not relate to the financial year, i.e. the current year, but were used to manufacture the internal construction, i.e. a depreciable multi-year asset. This circumstance results in need to adjust those costs and remove the portion of costs used to construct a depreciable multi-year asset. It is well known how this is done by writing internal constructions under income. This concept underlies the reason why, in the calculation of cash flows, internal constructions recognised in profit and loss must be shown in the financial sources. This is not because internal constructions create a monetary income but because such recognition must indirectly correct and adjust the items that identify the requirements, i.e. the expenses related to those costs that are used to implement the internal construction. When calculating the characteristic monetary cash flow, i.e. the monetary flow resulting from typical operations, one must add up all characteristic costs, transformed into monetary outgoings, and characteristic revenues, which include internal constructions.

As already mentioned, this is not because the internal construction is a monetary income or revenue. Still, because its value must adjust, also from a monetary point of view, the outgoings resulting from the incurring of characteristic costs are included, albeit transformed into a financial flow, in the cash flow calculation. For the sake of clarity, let us assume, for the time being, that the internal constructions contain neither depreciation nor severance pay. In this case, it must consider the value of the internal constructions among the characteristic monetary sources. Consequently, this financial reporting item will fall within the scope of the typical monetary cash flow calculation. From a balance sheet point of view, internal constructions represent very regular purchases made, however, not with third-party economies, but through the use of factors internal to the company, which, however, have given rise, or may have given rise, to expenditures and therefore to monetary requirements. Therefore, internal constructions in the balance sheet must be considered regular purchases from third parties. This is the case when calculating the overall condition resulting from purchases of tangible long-term assets. In this regard, however, it is necessary to point out that purchases from third parties should be shown separately from purchases through internal constructions in the cash flow statement. The reason for this concerns the origin of the purchase. Whereas with purchases from third parties, the company acquires an asset with an objective value derived from the invoice amount, internal constructions derive from a subjective valuation of cost allocation. Therefore, the purchase from third parties is objective, while internal constructions represent subjective values. For this reason, they should show separately. For the sake of clarity, the following example is proposed, in which both the cash flow impact of internal constructions and their equity aspect are apparent:

Based on the following figures, determine all cash flows corresponding to the items shown below. (NB! The table below only shows some accounting items extrapolated from financial reporting. For this reason, the figures do not add up as all other business transactions are missing).

	31/12/N	31/12/N+1	Real cash needs	Real cash sources
Profit on disposal		100		
Sales revenues		1.000		999
loan	100	150	30	80
purchased		500	500	
suppliers	50	60		
customer	80	70		
Provision for dep. Rec	10	15		
Provision for bad debts receivables		6		
Customer Germany	10	20		
Commercial debt.Sweden	50	40		

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Equipment	1.000	1500	450 Of which 50 internal constr. And 400 purchased from third parties	165
Depreciation fund	500	550		
depreciation		80		
Plant sale receivable	10	15		
Plant suppl. payables i	100	150		
Share capital	1.000	1.500		300
Profit reserves	200	100		
Plant internal construction		50		This item must be included in the calculation of charact. Cash flow 50
.....				

The cash flows are drawn up with the following information in mind:

- repaid loan instalment of 35, of which 30 on capital account, 5 on interest account
- sold plants. Historical value 100
- share capital is increased with plant contribution for 100, with free increase for 100, remaining liquidity
- internal construction includes services from third parties, miscellaneous industrial costs and materials.

calculation methodologies:

Determining raw material purchasing needs

purchased	500
- supplier	-10
+ commercial debt. Sweden	+ 10
<b>raw material purchasing needs</b>	<b>500</b>

Determination of source from sales revenues:

Sales	1.000
+ customers	+10
- customers Germany	-10
- write-off of receivables	- 1
<b>source from sales revenues</b>	<b>999</b>

Determination of equipment purchase need

Initial value	1.000
- historical sale value	- 100
Value to be expected after sale	900
Final value buildings	1500
Potential need due to potential purchase	<b>600</b>
- contributions to share from shareholders	- 100
- payables to plant suppliers	- 50
Requirement due to purchase	<b>450</b>
	<b>of which 50 internal construction, 400 purchase from third parties.</b>

Source determination from plant sales:

Historical sales value	100
- Provision for depreciation of the asset sold	- 30

## Internal Constructions: Valuation, Reclassification, Impact on Ratios and Cash Flows

Net book value	70
+ capital gain from disposal	+100
- increase in receivables from sale of plant	- 5
Source determination from plant sales	<b>165</b>

If, on the other hand, depreciation and severance pay is included in the internal constructions, it is necessary to strip the value of these constructions of the amounts of non-monetary costs such as depreciation and severance pay. Therefore, in the presence of such non-monetary items, it is necessary to perform one more operation than in the previous example. In this case, gross errors are noticeable at both the operational and doctrinal levels. It is, therefore, particularly relevant to highlight this issue, as the failure to cleanse internal constructions of non-monetary values such as depreciation and severance pay leads to the calculation of an incorrect cash flow and an incorrect capital requirement for the purchase of tangible deferred assets. The flows are therefore untrue, with the consequent impossibility of deducing helpful information, which is also realistic concerning the reality that it must photograph for the company's decision-making process.

By way of example, we propose this case:

The following data shows all the cash flows corresponding to the items below. (NB! The table below only shows some accounting items extrapolated from financial reporting. For this reason, the figures do not add up as all other business transactions are missing).

Voci contabili	31/12/N	31/12/N+1	Real cash needs	Real cash sources
plant	60	100	52 of which: 25 internal constructions and 27 purchases from third parties	38
Plant in progress	100	120		
receivables from shareholders for payments to share still due	400	405		
payables to plant suppliers	10	16		
plant revaluation reserve	100	120		
share	200	250		2This item must be included in the calculation of charact. Cash flow
plant interior constructions		30		25
provision for depreciation of plant and furniture	100	105		25
depreciation of plant and furniture		8		
Capital gains from disposal		3		
advances to plant suppliers	10	13		
receivables for plant sales		2		
.....				

## Internal Constructions: Valuation, Reclassification, Impact on Ratios and Cash Flows

Determine the cash flows considering the following information:

- equipment was sold: historical value 40
- no furniture was sold
- the share capital was increased with plant contribution 20 and the remainder with cash.
- internal constructions include services from third parties for 5, wages for 10, severance pay for 2, depreciation for 3, the remainder miscellaneous production costs.

calculation methodologies:

Determining equipment purchase requirements

Initial value	60
- historical sale value	- 40
Value to be expected after sale	20
Final value buildings	100
Potential need due to potential purchase	80
- plant contribution	- 20
- revaluation	- 20
- plant suppliers	- 6
+ plants in progress	+ 20
- depreciation and severance pay included in internal construction	- 5
+ advances to building suppliers	+ 3
Requirements due to purchases	<b>52 of which:</b>
	<b>25 internal construction and 27 purchase from third parties</b>

Source determination from plant sales:

Historical sales value	40
- Accumulated depreciation asset sold	3
Net book value	37
Capital gain from disposal	+ 3
Potential monetary collection value	40
- Receivables from plant sale	- 2
Source of plant sale	<b>38</b>

## 5) Conclusion

To conclude these brief remarks on internal constructions, it is worth emphasising that while the valuation of these items is very important, knowledge of the correct reclassification of these constructions in the financial statements and financial flows is equally important. All too often, serious errors are noted in these areas at both an operational and doctrinal level. It is for this reason that it was deemed appropriate to include, in this scientific article, a practical example, since frequently, internal constructions are represented in ratios and flows in an incorrect manner, leading the analysis to obtain misleading results because they are incorrect.

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