IAS 2, Inventories - A Closer Look

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The Institute of Cost and Works Accountants of India

20 July 2008

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A Closer Look

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In September 1974, the International Accounting Standards Committee (IASC) issued the Exposure Draft E2, *Valuation and Presentation of Inventories in the Context of the Historical Cost System*. In October 1975, the IASC issued IAS 2, *Valuation and Presentation of Inventories in the Context of the Historical Cost System.* In August 1991, the IASC issued the Exposure Draft E38, *Inventories* as part of the 'Comparability of Financial Statements' project started in 1987. In December 1993, the IASC issued IAS 2, *Inventories.* The effective date was fixed as 1 January 1995. On 18 December 2003, the International Accounting Standards Board (IASB) issued the revised version of IAS 2 and is applicable for annual periods beginning on or after 1 January 2005.

Objective

The objective of IAS 2 is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. IAS 2 provides guidance for determining the cost of inventories and for subsequently recognising an expense, including any write-down to net realisable value (NRV). It establishes the guidelines for the recording and presentation of inventories. It also provides guidance on the cost formulas that are used to assign costs to inventories.

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IAS 2 provides guidance on the following in respect of the accounting for inventories:
• The amount of cost to be recognised as an asset and carried forward until the related revenue is recognised.
• Guidance on determining cost and the subsequent recognition as an expense, including any write-downs to NRV.
• Guidance on cost formulas that are used to assign costs to inventories.

Scope

Inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in process), and materials and supplies that are consumed in production (raw materials).

The revision to IAS 2 has introduced 2 types of exclusions, those that are entirely outside the scope and those that are outside the scope of measurement only.

The following inventories are excluded entirely:

- Work in process arising under construction contracts, including directly related service contracts (IAS 11, *Construction Contracts*);
- Financial instruments (IAS 39, *Financial Instruments*); and
- Biological assets related to agricultural activity and agricultural produce at the point of harvest or collection point (IAS 41, *Agriculture*).

The following are within the scope of the standard, IAS 2 does not apply to the measurement of inventories held by:

- Producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at NRV (above or below cost) in accordance with well-established practices in those industries. When such inventories are measured at NRV, changes in that value are recognised in profit or loss in the period of the change.
- Commodity broker-traders who measure their inventories at fair value (FV) less costs to sell. When such inventories are measured at FV less costs to sell, changes in FV less costs to sell are recognised in profit or loss in the period of the change. Commodity broker-traders are defined as those who “buy or sell commodities for others or on their own account”.

Definition of Inventories

Inventories are assets:
(a) owned to be sold in the normal course of operation;
(b) in the process of production in connection with said sale; or
(c) in the form of materials or supplies, to be consumed in the production process or in the provision of services.

Definitions of NRV and FV

NRV is the estimated sale price of an asset in the normal course of operation less the costs estimated to complete their production and those necessary to make the sale. This value is entity-specific.

FV is the amount for which an asset can be exchanged or a liability written off, among knowledgeable, interested and duly informed parties performing a transaction at arms-length. This value is not entity-specific.

NRV for inventories may not equal FV less costs to sell.

Measurement of Inventories

Inventories shall be measured at the lower of cost and the NRV.

Inclusions

The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase

•means purchase price, non-recoverable import duties and other taxes (which are not subsequently recoverable from the tax authorities), transportation, storage, handling and other costs directly attributable to the acquisition of merchandise, materials or services.

•trade discounts, rebates etc should be deducted.

•foreign exchange differences should not be included.

Costs of conversion

• means direct labour plus an allocation of fixed and variable production overheads that are incurred in converting materials to finished goods.

• such costs should be allocated using the normal capacity of the production facilities. Actual production level can only be used if it approximates normal capacity.

• expense unallocated overheads.

Other costs

• only to the extent they are incurred in bringing inventories to their present location and condition.

• does not include abnormal wastage, storage costs (unless necessary during the production process before the next production stage), administrative overheads that do not contribute to brining inventories to their present location and condition or selling costs.

• can include borrowing costs in circumstances identified in IAS 23, *Borrowing Costs*.

• if settlement terms for the purchase of inventory are deferred, there is a financing element that should be recognised as an interest expense if the amount paid is different from that paid for normal credit terms.

Exclusions

Inventory cost should not include:

- abnormal waste
- storage costs
- administrative overheads unrelated to production
- selling costs
- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms.

The standard cost and retail methods may be used for the measurement of cost, provided that the results approximate actual cost.

Cost formulas

The cost of inventories of those products that are not usually interchangeable, as well as of the goods and services produced and segregated for specific projects shall be determined through the method of specific identification of their individual costs.

The cost of inventories of those products that are interchangeable shall be determined using the first-in first-out (FIFO) or the weighted average cost formula. The last-in first-out (LIFO) formula, which had been allowed prior to the 2003 revision of IAS 2, is no longer allowed.

The entity shall use the same cost formula for all inventories having a similar nature and use within the same. For group of inventories with a different nature or use, the utilization of cost formulas that are also different may be justified.

Joint and by-products

If costs are not separately identifiable, they should be allocated between joint products on a rational and consistent basis e.g. relative sales value (at stage when the products become separately identifiable or on completion of production).

Immaterial by-products should be measured at NRV and deducted from the cost of the main product.

Determining NRV

It is important to consider the most reliable evidence at the time estimates are made. This should include price / cost fluctuations directly relating to events after balance sheet date but only to the extent that they confirm conditions existing at balance sheet date.

Write-Down to NRV

The amount of any write-down of inventories to NRV and all losses of inventories should be recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, should be recognized as a reduction in the amount of inventories recognized as an expense in the income statement in the period in which the reversal occurs.

Expense Recognition

IAS 18, *Revenue*, addresses revenue recognition for the sale of goods. When inventories are sold and revenue is recognised, the carrying amount of those inventories is recognised as an expense (often called cost-of-goods-sold). Any write-down to NRV and any inventory losses are also recognised as an expense when they occur.

When inventories are sold, the carrying amount of those inventories should be recognized as an expense in the period in which the related ordinary revenue is recognized.

The cost of some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed tangible fixed assets.

The value of inventories allocated to other assets in this way should be recognized as an expense during the useful life of the former.

Disclosure Requirements

Financial statements shall disclose the following information:
(a) The accounting policies adopted in valuating inventories, including the cost valuation formula that may have been used;
(b) The total carrying amount of inventories generally classified as merchandise, supplies, materials, work in progress, and finished goods and partial (split) amounts according to the classification that may be appropriate for the entity;
(c) The carrying amount of the inventories that may be accounted for based on their reasonable value less the sale costs;
(d) The amount of inventories recognized as an expense during the period (cost of goods sold);
(e) The amount of inventory write-downs that may have been recognized as an expense in the year;
(f) The amount of reversals in previous value write-downs, which may have been recognized as a reduction in the amount of the expense (offset) on account of inventories in the period;
(g) The circumstances or events that led to the reversal of write-downs; and
(h) The carrying amount of inventories pledged as a guarantee for the payment of debts.

IAS 2 acknowledges that some enterprises classify income statement expenses by nature (materials, labour, and so on) rather than by function (cost of goods sold, selling expense, and so on). Accordingly, as an alternative to disclosing cost of goods sold expense, IAS 2 allows an enterprise to disclose operating costs recognised during the period by nature of the cost (raw materials and consumables, labour costs, other operating costs) and the amount of the net change in inventories for the period. This is consistent with IAS 1, *Presentation of Financial Statements,* which allows presentation of expenses by function or nature.

Conclusion

IAS 2 stipulates how the asset considered as an inventory is measured, which concepts make up the cost and when it should be recognized as an expense and which information should be disclosed in the financial statements. But, the inventories concept established in IAS 2 fails to indicate that the assets held by a company may be kept as an investment or used as an internationally accepted means of payment.

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