Accounting (Basics) - Lecture 6

Inventories

Contents

- Measurement of inventories
- Impairment of inventories
- Recognition as an expense
- Disclosures

Measurement of inventories

- An entity shall measure inventories at the lower of cost and estimated selling price less costs to complete and sell.
- An entity shall include in the cost of inventories all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
- The costs of purchase of inventories comprise the purchase price, import duties and other taxes, and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted from the costs of purchase.
- The costs of conversion of inventories include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production,

Measurement of inventories

such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labor.

- An entity shall allocate fixed production overheads to the costs of conversion on the basis of the normal capacity of the production facilities. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Measurement of inventories

- A production process may result in more than one product being produced simultaneously (i.e. product and by-product). When the costs of raw materials or conversion of each product are not separately identifiable, an entity shall allocate them between the products on a rational and consistent basis. Most by-products, by their nature, are immaterial. When this is the case, the entity shall measure them at selling price less costs to complete and sell and deduct this amount from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.
- An entity shall include other costs in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.
- Examples of costs excluded from the cost of inventories and recognized as expenses are abnormal amounts of wasted materials, labor or other production costs, storage costs, unless those costs are necessary during the production process before a further production stage etc.

Measurement of inventories

- To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labor and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labor and other costs relating to sales and general administrative personnel are not included but are recognized as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.
- An entity may use techniques such as the standard cost method, the retail method or most recent purchase price for measuring the cost of inventories if the result approximates cost. Standard costs take into account normal levels of materials and supplies, labor, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions. The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin.

Measurement of inventories

- An entity shall measure the cost of inventories, other than costs of purchase, by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified. The last-in, first-out method (LIFO) is not permitted by this IFRS.

Impairment of inventories

- An entity should assess at the end of each reporting period whether any inventories are impaired, i.e. the carrying amount is not fully recoverable (e.g. because of damage, obsolescence or declining selling prices). If an item (or group of items) of inventory is impaired, the entity is required to measure the inventory at its selling price less costs to complete and sell, and to recognize an impairment loss.

Recognition as an expense

- **When inventories are sold, the entity shall recognize the carrying amount of those inventories as an expense in the period in which the related revenue is recognized.**
- Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are accounted for subsequently in accordance with the section of these IFRS relevant to that type of asset.

Disclosures

- An entity shall disclose the following:
  a) the accounting policies adopted in measuring inventories, including the cost formula used.
  b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.
  c) the amount of inventories recognized as an expense during the period.
  d) impairment losses recognized or reversed in profit or loss in accordance with Section “Impairment of Assets”.
  e) the total carrying amount of inventories pledged as security for liabilities.