DIGITAL CFO SOLUTIONS • IFRS SERIES

ACTIVE STANDARD

INTERNATIONAL FINANCIAL REPORTING STANDARDS

IAS 2 — Inventories

Valuation of Inventories — cost, net realisable value, and the principles that decide which number reaches the balance sheet

BD

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PART I — DEFINITION & SCOPE

What Counts as Inventory

The definitions and core recognition principles that decide whether an item belongs on the balance sheet as inventory.

Definition of Inventories

Inventories are assets that fall into one of the following categories:

1. Held for sale in the ordinary course of business
2. In the process of production for such sale
3. In the form of materials or supplies to be consumed in the production process
4. Held for the rendering of services, in the case of service providers
5. Costs of services for which the related revenue has not yet been recognised — e.g. work in progress for lawyers, auditors, architects

Recognition & Measurement Principles

IAS 2

Initial Measurement

At historical cost

Subsequent Measurement

At the lower of cost and net realisable value

In the period in which inventories are sold and revenue is recognised, the carrying amount of those inventories is charged to expense in that same period.

PART II — COST OF INVENTORIES

Building Up the Cost

Three building blocks combine to form the total cost of inventories: cost of purchase, cost of conversion, and other costs.

The Three Components of Cost

TOTAL COST OF INVENTORIES

=

1

Cost of Purchase

Purchase price, duties, freight and handling

2

Cost of Conversion

Labour and production overheads

3

Other Costs

Costs incurred in bringing inventories to their present location and condition

Cost of Purchase

1

Purchase Price

The price paid to the supplier for the goods

2

Duties & Taxes

Import duties and other taxes that are not recoverable by the entity

3

Freight Charges

Costs of transporting the goods to the entity's premises

4

Clearing & Handling

Clearing and handling charges incurred in acquisition

Cost of Conversion

1

Labour Cost

Direct labour cost of production

2

Variable Production Overhead

Allocated to units produced based on actual use of production facilities

3

Fixed Production Overhead

Allocated based on the normal capacity of production facilities

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Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity from planned maintenance.

Joint Products & By-Products

A production process may yield more than one product simultaneously — joint products, or a main product with a by-product.

1 Allocating Joint Costs

When conversion costs for each product aren't separately identifiable, they're allocated on a rational, consistent basis — often the relative sales value of each product, either when they become separately identifiable or on completion of production.

2 Treatment of By-Products

Most by-products, scrap and waste materials are immaterial by nature. They are often measured at net realisable value, which is deducted from the cost of the main product — leaving the main product's carrying amount close to its cost.

Other Costs

Other costs are included only to the extent that they are incurred in bringing the inventories to their present location and condition.

Costs NOT Included

- Abnormal wastage of material, labour and other production costs
- Storage costs, unless necessary for further production
- Administration overheads that do not bring inventories to their present condition and location
- Selling & distribution overheads

PART III — MEASUREMENT & VALUATION

From Cost to Carrying Value

How costs are measured in practice, which cost formula applies, and when net realisable value takes over from cost.

Measurement Techniques

Standard Cost

1. Takes into account normal levels of materials, labour, and actual capacity
2. Reviewed regularly to ensure it approximates actual costs

Retail Method

1. Sales value is reduced by the gross margin to arrive at cost
2. An average percentage is used for each homogeneous group of items
3. Marked-down prices are taken into consideration

Bases of Valuation

1

FIFO

First-in, first-out — the earliest costs incurred are assumed to be the first sold

2

Weighted Average Cost

Cost of each item is determined from the weighted average of similar items at the start of the period and the cost of similar items produced or purchased during it

3

Specific Identification

Used for items not ordinarily interchangeable, and for goods or services produced and segregated for specific projects

Net Realisable Value (NRV)

NRV Falls Below Cost When...

1. Costs increase, or selling prices fall
2. There is physical deterioration in the condition of inventory
3. Products become obsolete
4. Marketing strategy calls for selling at a loss
5. Errors occur in production or purchasing

Writing Down to NRV — Principles

1. Items are treated on an item-by-item basis
2. Similar items are normally grouped together
3. Each service is treated as a separate item

Charging Inventories to Expense

1. In the period in which inventories are sold and revenue is recognised, the carrying amount of those inventories is charged to expense during that same period.

2. If inventories are written down to NRV, the difference between carrying value and NRV is recognised as an expense in the period in which the write-down or loss occurs.

PART IV — SPECIAL SITUATIONS

Beyond the Standard Case

Borrowing costs, service providers, and agricultural produce each carry their own nuance under IAS 2.

Borrowing Costs & Inventories

%

IAS 23 Borrowing Costs identifies limited circumstances where borrowing costs are included in the cost of inventories.

An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element — for example, the difference between the price under normal credit terms and the amount paid — that element is recognised as interest expense over the period of the financing.

Cost of Inventories — Service Providers

1

What's Included

Labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads

2

What's Excluded

Labour and costs related to sales and general administrative personnel — recognised as expenses in the period incurred

3

Never Included

Profit margins or non-attributable overheads that are often factored into the prices service providers charge

Cost of Agricultural Produce

Under IAS 41 Agriculture, inventories comprising agricultural produce harvested from an entity's biological assets are measured on initial recognition at fair value less costs to sell, at the point of harvest.

This fair value less costs to sell becomes the cost of the inventory at that date for the purposes of applying IAS 2.

PART V — DISCLOSURE

What Financial Statements Must Show

The disclosures IAS 2 requires so users can understand how inventory has been measured, valued and reported.

DISCLOSURE

Disclosure Requirements

- **a** Accounting policies adopted in measuring inventories, including the cost formula used
- **b** Total carrying amount of inventories, and the carrying amount in classifications appropriate to the entity
- **c** Carrying amount of inventories carried at fair value less costs to sell
- **d** Amount of inventories recognised as an expense during the period
- **e** Amount of any write-down of inventories recognised as an expense in the period
- **f** Amount of any reversal of a write-down recognised as a reduction in expense in the period
- **g** Circumstances or events that led to the reversal of a write-down of inventories
- **h** Carrying amount of inventories pledged as security for liabilities

THANK YOU

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A Career Built on Making IFRS Understandable

B D Chatterjee is a Chartered Accountant and financial thought leader with over 35 years of global experience spanning corporate finance, accounting standards, financial reporting, business valuation and financial due diligence. As a seasoned CFO, he has led finance functions across major corporations and now heads Digital CFO Solutions, a platform delivering institutional-grade IFRS, US GAAP and valuation workbooks alongside fractional CFO services.

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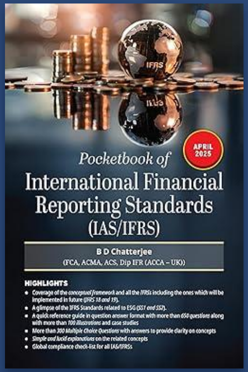

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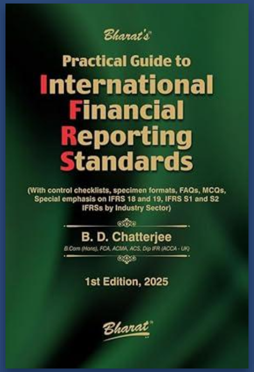

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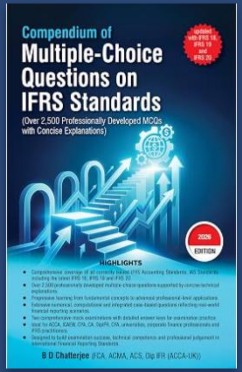

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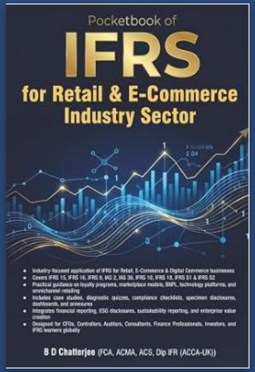

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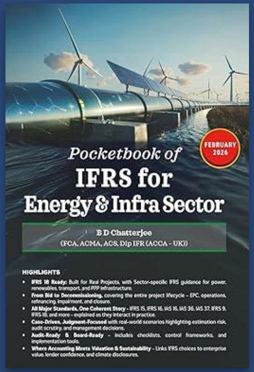

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