





# Overview

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### **Objective:**

Prescribe the accounting treatment for inventories



## **Introduction – Scope & definitions**

- LKAS 2 applies to **all** inventories, **except**:
  - (a) Work in progress under construction contracts
  - (b) Financial instruments
  - (c) Biological assets related to agricultural activity
  - (d) Agricultural produce at point of harvest

LKAS 2 applies to measurement of all inventories within scope, **except**:

- Agricultural and forest products, agricultural produce after harvest and minerals & mineral products to extent measured at net realizable value
- Inventories of commodity brokers measured at fair value less costs to sell.



## Introduction - Scope & definitions

#### Inventories are assets:

(3) Held for sale in the ordinary course of business;

(1) In the form of materials or supplies to be consumed in production process or in the rendering of services

(2) In the **process** of **production** for such sale



### Recognition as an expense

### Recognition

- When inventories are sold, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognized.
- ➤ The amount of any write-down of inventories to net realizable value (NRV) and all losses of inventories shall be recognized as an expense in the period the write-down or loss occurs.
- ➤ Reversal of any write-down of inventories, arising from an increase in NRV shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.



Inventories shall be measured at lower of cost and NRV

#### Cost of inventories:

#### (i) Purchase costs

- Purchase price
- Import duties and other taxes (other than those subsequently recoverable from taxing authorities)
- Transport, handling & other directly attributable costs
- > Deductions: Trade discounts, rebates & other similar items

#### (ii) Costs of conversion

Costs directly related to units of production. E.g. Direct labor, production overheads

#### (iii) Other costs

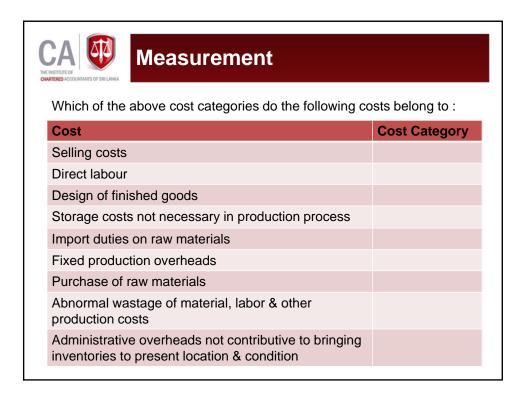
Other costs directly attributable to bringing inventories to present location & condition



# Measurement

Costs of conversion	Basis
Variable production overheads	Actual use of production facilities
Fixed production overheads	<b>Normal capacity</b> of production facilities

- · Costs excluded from the cost of inventories :
  - (i) abnormal amounts of wasted materials, labor or other production costs;
  - (ii) storage costs, unless those costs are necessary in the production process before a further production stage;
  - (iii) administrative overheads that do not contribute to bringing inventories to their present location and condition
  - (iv) selling costs



Measurement  Measurement			
Which of the above cost categories do the following costs belong to :			
Cost	Cost Category		
Selling costs	Excluded		
Direct labour	Costs of conversion		
Design of finished goods	Other costs		
Storage costs not necessary in production process	Excluded		
Import duties on raw materials	Costs of purchase		
Fixed production overheads	Costs of conversion		
Purchase of raw materials	Costs of purchase		
Abnormal wastage of material, labor & other production costs	Excluded		
Administrative overheads not contributive to bringing inventories to present location & condition	Excluded		



#### **Example - Allocation of Overheads**

The following example illustrates how to allocate overhead cost to inventory at normal capacity. The following is relevant information of entity A.

Full capacity	10,000 hours in a year
Normal capacity	7,500 hours in a year
Actual labor hours for current period	6,500 hours
Total fixed production overhead	1,500 CU
Total variable production overhead	2,600 CU
Total opening inventory Total units produced in a year Total units sold in a year Total ending inventory	2,500 units 6,500 units 6,700 units 2,300 units

The total cost of inventories is assigned by using FIFO cost formula. Compute overhead amounts absorbed to ending inventory and recognized as an expense during the year.



# Measurement

#### Fixed POAR:

=	Total Fixed POH
_	Normal capacity
	1,500 CU
-	7,500 hours in a year
=	0.20 CU per hour

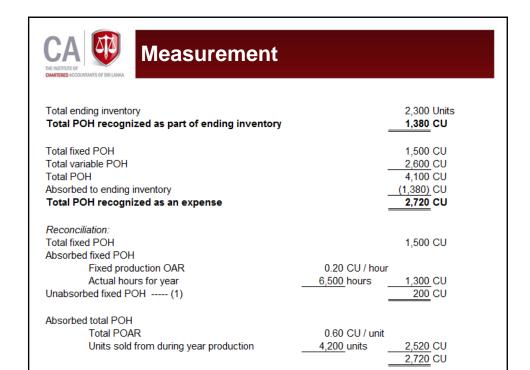
#### Number of hours taken to produce each unit

= -	Actual hours for current period
	Total units produced in a year
_	6,500 hours in a year
_	6,500 units
=	1.00 hours per unit

#### Total POH recognized absorbed per unit of inventory:

- = [0.20 CU per hour x 1 hour p.u.] + [ 0.40 CU per hour x 1 hour p.u.]
- = <u>0.60</u> CU p.u.

=	0.40 CU per hour
=	6,500 hours in a year
	2,600 CU
=	Actual hours
	Total Variable POH





#### **Cost formulas:**

#### (i) Specific identification

Specific costs are attributed to identified items of inventory

#### (ii) First In First Out (FIFO)

Assumes oldest inventories are used up first, so that the cost attached to those items still held at the balance sheet date is at the most recent cost incurred.

#### (iii) Weighted Average Cost

Cost is based on an average price computed by dividing the total cost of units by the total number of such units.



- ➤ The cost of inventories of items that are **not ordinarily interchangeable** and goods or services produced and segregated for **specific projects** shall be assigned by using **specific identification** of their individual costs.
- ➤ The cost of inventories, other than those dealt with above, shall be assigned by using the 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



### Measurement

#### Scenario 1:

Pencil Company Ltd manufactures pencils and produced the following brushes in the period: three units at a cost of Rs 20/- each, then five units at Rs 30/- and a final batch of four at Rs 40/- p.u. There are six units left at balance sheet date. Calculate the cost of inventory using the following cost formula:

- (i) FIFO
- (ii) Weighted Average
- (iii) LIFO



#### Solution:

- (i) FIFO: (2 units at Rs 30 p.u.) + (4 units at Rs 40 p.u.) = Rs 220 / -
- (ii) Weighted Average Cost:

(3 units at Rs 20 p.u.) + (5 units at Rs 30 p.u.) + (4 units at Rs 40 p.u.) = Rs 30.83 p.u. 12 units

Six pencils remain: 6 units at Rs 30.83 p.u. = Rs 185/-

(iii) LIFO: (3 units at Rs 20 p.u.) + (3 units at Rs 30 p.u.) = Rs 150 / -



## Measurement

#### **Net Realizable Value**

Net realizable value is the estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessary to make the sale

Evaluation of net realizable vale is critical if inventories –

- (1) are damaged,
- (2) have become wholly or partially **obsolete**,
- (3) selling prices have declined, or(4) if the estimated costs of completion orthe estimated costs to be incurred tomake the sale have increased.



#### Does NRV and fair value have the same meaning?

**No; Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.)

NRV refers to the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business. Therefore, **NRV** is an **entity-specific value**. NRV for inventories may not equal fair value less costs to sell.



### Measurement

#### Scenario 2:

Per unit details relating to item A is as follows. What would be the valuation of inventory of item A?

Cost Rs 900 / Selling price Rs 1,200/ Estimated modification cost to enable sale Rs 300/Estimated marketing costs Rs 200/Units held 150



#### Solution:

Cost = Rs 900 / - p.u.

	Rs p.u.
Selling price	1,200
Less: Estimated modification costs to enable sale	(300)
Less: Estimated marketing costs	(200)
NRV	700/-

Lower of cost and NRV = NRV = Rs 700 /- p.u.

Number of units = 150 units at Rs 700 / - p.u. = Rs 105,000/-



## Measurement

Disclosures include the following:

- Accounting policy
- > Statement of Financial Position (SoFP)
  - (i) Carrying amount of inventories (on face of SoFP)
  - (ii) Analysis of inventories by classification
- > Statement of Comprehensive Income
  - (i) Cost of inventories expensed in period
- Other

