

Specific items

[section 3000 — 3870]

SPECIFIC ITEMS

SECTION 3031

inventories

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PURPOSE AND SCOPE

- .01 This Section prescribes the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized. This Section provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.
- .02 This Section applies to all inventories, except:
- (a) contracts accounted for using the percentage of completion method (see REVENUE, Section 3400);
 - (b) financial instruments; and
 - (c) agricultural inventories held by agricultural producers (see AGRICULTURE, Section 3041).
- .03 Spare parts and servicing equipment are usually carried as inventory and recognized in net income as consumed. However, major spare parts and standby equipment may qualify as property, plant and equipment (see PROPERTY, PLANT AND EQUIPMENT, Section 3061).
- .04 This Section does not apply to the measurement of inventories:
- (a) held by producers of forest products, minerals and mineral products, to the extent that they are measured at net realizable value in accordance with well-established practices in those industries; when such inventories are measured at net realizable value, changes in that value are recognized in net income in the period of the change; or
 - (b) held by commodity broker-traders who measure their inventories at fair value less costs to sell; when such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognized in net income in the period of the change.

This Section does apply to products that are the result of processing after harvest such as processed foods, thread and wine.

- .05 The inventories referred to in paragraph 3031.04(a) are measured at net realizable value at certain stages of production. For example, this occurs when minerals have been extracted and sale is assured under a forward contract or a government guarantee, or when an active market exists and there is a negligible risk of failure to sell. These inventories are excluded from only the measurement requirements of this Section.
- .06 Broker-traders are those who buy or sell commodities for others or on their own account. The inventories referred to in paragraph 3031.04(b) are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this Section.

DEFINITIONS

- .07 The following terms are used in this Section with the meanings specified:
- (a) **Inventories** are assets:
 - (i) held for sale in the ordinary course of business;
 - (ii) in the process of production for such sale; or
 - (iii) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
 - (b) **Net realizable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
 - (c) **Fair value** is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.
- .08 Net realizable value refers to the net amount that an entity expects to realize from the sale of inventory in the ordinary course of business. Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace. The former is an entity-specific value; the latter is not. Net realizable value for inventories may not equal fair value less costs to sell.
- .09 Inventories encompass goods purchased and held for resale (for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale). Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process.

MEASUREMENT OF INVENTORIES

- .10 *Inventories shall be measured at the lower of cost and net realizable value.*
- Cost of inventories**
- .11 *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**
- .12 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), 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 in determining the costs of purchase.
- Costs of conversion**
- .13 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. 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, 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 labour.
- .14 The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. 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 resulting from planned maintenance. 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.
- .15 A production process may result in more than one product being produced simultaneously. For example, this is the case when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. For example, the allocation may be based on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products are

immaterial. When this is the case, they are often measured at net realizable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other costs

- .16 Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.
- .17 Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are:
 - (a) abnormal amounts of wasted materials, labour or other production costs;
 - (b) storage costs, unless those costs are necessary in the production process before a further production stage;
 - (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - (d) selling costs.
- .18 The cost of inventories that require a substantial period of time to get them ready for their intended use or sale includes interest costs when the enterprise's accounting policy is to capitalize interest costs. The cost of inventories that are ready for their intended use or sale when acquired does not include interest costs.
- .19 An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.

Techniques for the measurement of cost

- .20 Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions.
- .21 The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

Cost formulas

- .22 *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.*
- .23 Specific identification of cost means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on net income.
- .24 *The cost of inventories, other than those dealt with in paragraph 3031.22, shall be assigned 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.*
- .25 Inventories used in one business segment may have a use to the entity different from the same type of inventories used in another business segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.
- .26 The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first and, consequently, the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Net realizable value

- .27 The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realizable value is consistent with the view that assets are not carried in excess of amounts expected to be realized from their sale or use.
- .28 Inventories are usually written down to net realizable value item by item. However, in some circumstances, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on

the basis of a classification of inventory (for example, finished goods, or all the inventories in a particular industry or geographical segment).

- .29 Estimates of net realizable value are based on the most reliable evidence available, at the time the estimates are made, of the amount the inventories are expected to realize. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.
- .30 Estimates of net realizable value also take into consideration the purpose for which the inventory is held. For example, the net realizable value of the quantity of inventory held to satisfy firm sales contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realizable value of the excess is based on general selling prices. Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts.
- .31 Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.
- .32 A new assessment is made of net realizable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the write-down is reversed (i.e., the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realizable value. For example, this occurs when an item of inventory that is carried at net realizable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

RECOGNITION AS AN EXPENSE

- .33 *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 and all losses of inventories shall 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, shall be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.*
- .34 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 recognized as an expense during the useful life of that asset.

DISCLOSURE

- .35 *The financial statements shall disclose:*
- (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; and*
 - (c) the amount of inventories recognized as an expense during the period.*
- .36 Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods.
- .37 The amount of inventories recognized as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs.
- .38 Some entities adopt a format for the income statement that results in amounts being disclosed other than the cost of inventories recognized as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognized as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

EFFECTIVE DATE

- .39 Except as specified in paragraph 3031.40, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.
- .40 AGRICULTURE, Section 3041, issued in November 2019, added paragraph 3031.02(c) and amended paragraphs 3031.04-.05. An enterprise shall apply those paragraphs when it applies Section 3041.

ILLUSTRATIVE EXAMPLE

This material is illustrative only.

This example illustrates how the accounting treatment specified in this Section might be applied in a particular situation. Matters of principle relating to particular situations should be dealt with in the context of this Section.

Paragraph 3031.35(c) requires disclosure of "the amount of inventories recognized as an expense during the period." Paragraph 3031.37 indicates this requirement is often referred to as cost of sales. Paragraph 3031.38 describes that some entities present an analysis of expenses using a classification based on the nature of expenses (for example, costs recognized as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period), and provides an alternative format for complying with the requirements of paragraph 3031.35(c). The following example illustrates this alternative format for a manufacturing company.

**Analysis of Expenses Using a Classification
Based on the Nature of Expenses**

	<u>20X2</u>	<u>20X1</u>
Raw materials and consumables used	\$1,000	\$ 900
Labour costs	800	700
Other costs	500	400
Net change in inventories of finished goods and work in progress	<u>2,500</u>	<u>2,200</u>
Total expenses	\$4,800	\$4,200
	=====	=====

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