Inventories are assets:

* held for sale in the ordinary course of business;
* in the process of production for such sale; or
* in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory can be a significant figure for some businesses, e.g. manufacturing companies.

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It affects the financial statement in two ways:

1. Statement of financial position: it is included as a current asset
2. Statement of profit or loss:

opening and closing inventory have a direct impact on cost of sales and therefore profits.

(The cost of goods sold is calculated as: Opening inventory + Purchases – Closing inventory).

All businesses must therefore ensure that their financial statements account for inventory accurately in terms of:

1. the accounting adjustment
2. its valuation

### **Opening Inventories**

These are the goods held by the business at the beginning of the year.

However, such goods will normally have been sold during the year.

They are no longer an asset of the entity but will form part of the costs that should be matched against sales revenue when determining profit.

Therefore, opening inventories brought forward in the inventory account are transferred to the trading account.

The accounting entry is:  
 **Dr Cost of sales (I/S)  
Cr Inventories**

#### Closing Inventories

Goods might be unsold at the end of an accounting period and so still be held in inventory.

The value of closing inventories is accounted for in the nominal ledger by debiting an inventory account and crediting the trading account at the end of an accounting period.

Inventory will therefore have a debit balance at the end of a period, and this balance will be shown in the statement of financial position as a current asset.

The accounting entry is:  
 **Dr Inventories (SOFP)  
Cr Cost of sales (I/S)**

### **The alternative methods of valuing inventory**

The inventories figure is made up of two elements

1. Quantity

The quantity of inventories held at the year end is established by means of a physical count of inventory in an annual counting exercise, or by a 'continuous' inventory count.

1. Valuation

The basic rule as per IAS 2 “Inventories” states that:   
 **Inventories should be measured at the lower of cost and net realisable value**  
The value of inventories is calculated at the lower of cost and net realisable value for each separate item or group of items.

Here, the prudence concept is being applied in presenting financial information.

#### Other methods

There are other methods which, in theory, might be used for the valuation of inventory

* Inventories might be valued at their expected selling price.
* Inventories might be valued at their expected selling price, less any costs still to be incurred in getting them ready for sale and then selling them. This amount is referred to as the net realisable value (NRV) of the inventories.
* Inventories might be valued at their historical cost (ie the cost at which they were originally bought).
* Inventories might be valued at the amount it would cost to replace them. This amount is referred to as the current replacement cost of inventories

### **IAS 2**

IAS 2 lays out the required accounting treatment for inventories under the historical cost system.

The major area of contention is the cost value of inventory to be recorded.

This is recognised as an asset of the enterprise until the related revenues are recognised (i.e. the item is sold) at which point the inventory is recognised as an expense (i.e. cost of sales).

Part or all of the cost of inventories may also be expensed if a write-down to net realisable value is necessary.

### **Cost**

The cost of inventories will consist of all the following costs

1. Purchase
2. Costs of conversion
3. Other costs incurred in bringing the inventories to their present location and condition, e.g. carriage inwards

#### Costs of purchase

IAS 2 lists the following as comprising the costs of purchase of inventories

* Purchase price; plus
* Import duties and other taxes; plus
* Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials; less
* Trade discounts, rebates and other similar amounts

#### Costs of conversion

Costs of conversion of inventories consist of two main parts

1. Costs directly related to the units of production, e.g. direct materials, direct labour
2. Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, e.g. 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, e.g. indirect materials and labour. (IAS 2)

### **Net Realisable Value**

The net realisable value of an item is essentially its net selling proceeds after all costs have been deducted.

It is calculated as:

|  |  |
| --- | --- |
|  | **$** |
| estimated selling price | x |
| less: estimated costs of completion | (x) |
| less: estimated selling and distribution costs | (x) |
|  | ---- |
|  | **x** |
|  | === |

As a general rule, assets should not be carried at amounts greater than those expected to be realised from their sale or use.

In the case of inventories this amount could fall below cost when items are damaged or become obsolete, or where the costs to completion have increased in order to make the sale.

### **Inventories held at the year end**

The quantity of inventories held at the year end is established by means of a physical count of inventory in an annual counting exercise, or by a 'continuous' inventory count.

In simple cases, when a business holds easily counted and relatively small amounts of inventory, quantities of inventories on hand at the reporting date can be determined by physically counting them in an inventory count.

In more complicated cases, where a business holds considerable quantities of varied inventory, an alternative approach to establishing quantities is to maintain continuous inventory records.

This means that a card is kept for every item of inventory, showing receipts and issues from the stores, and a running total.

A few inventory items are counted each day to make sure their record cards are correct – this is called a 'continuous' count because it is spread out over the year rather than completed in one count at a designated time.

#### FIFO (first in, first out)

FIFO assumes that materials are issued out of inventory in the order in which they were delivered into inventory, i.e. issues are priced at the cost of the earliest delivery remaining in inventory

#### AVCO (average cost)

AVCO calculates a weighted average price for all units in inventory. Issues are priced at this average cost, and the balance of inventory remaining would have the same unit valuation.

A new weighted average price is calculated whenever a new delivery of materials into store is received.

LIFO is no longer permitted under IAS 2.

### **Accounting assumption of accruals**

The fundamental accounting assumption of accrual requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year end must be carried forward in the statement of financial position and matched against future revenues.

In valuing inventory, we also follow the prudence concept which states that a profit cannot be anticipated before it is realised.

A. If inventory is expected to be sold at a profit:

(i) value at cost  
(ii) do not anticipate profit.

B. If inventory is expected to be sold at a loss:

(i) value at net realisable value  
(ii) do provide for the future loss

### **Inventory valuation methods**

Each method of valuation produces different costs both of closing inventories and also of material issues.

Since raw material costs affect the cost of production, and the cost of production works through eventually into the cost of sales, it follows that different methods of inventory valuation will provide different profit figures.

In times of rising prices, using FIFO method will mean the financial statements show higher inventory values and higher profit.