LKAS 2 - Inventories

Introduction

The objective of this Standard is to prescribe accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognized. This Standard 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.

Definition of inventory

Inventories are assets:

a) held for sale in the ordinary course of business, (Finished goods)
b) in the process of production for such sale, or (Work-In-Progress)
c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. (Materials and supplies)

Measurement of inventories

Inventories shall be measured at the lower of cost and net realizable value.

Cost of inventories

The cost of inventories comprises the following costs.

a) Costs of purchase
b) Costs of conversion
c) Other costs incurred in bringing the inventories to their present location and condition

a) Costs of purchase

Cost of purchase can be calculated as follows.

Purchase price	xx
Trade discounts	(x)
Rebates	(x)
Import duties	x
Other taxes (non-refundable from the taxing authorities)	x
Transport, handling and other costs are directly attributable to the acquisition of finished goods, materials and services.	x
Cost of purchase	**xx**

b) Costs of conversion

The costs of conversion of inventories include costs directly related to the units of production. This means the cost that is incurred to convert materials into finished goods. Conversion cost consists of the following costs.

Direct labour cost	xx	
Variable production overheads	xx	
Fixed production overheads	xx (allocated based on normal capacity of the production facilities)	

c) **Other costs**

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, designing products for specific customers in the cost of inventories.

Costs excluded from the cost of inventories

The following costs are excluded from the cost of inventories.

- Abnormal amounts of wasted materials, labour or other production costs
- Storage costs, unless those costs are necessary in the production process before a further production stage
- Administrative overheads that do not contribute to bringing inventories to their present location and condition
- Selling costs

Techniques for the measurement of cost

The following techniques for the measurement of the cost of inventories can be used.

a) **Standard cost method** - Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. Here, the standard cost of an unit of inventory is calculated and based on this cost, the cost of inventories can be calculated. This method is usually used by manufacturing entities.

b) **Retail method** - 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.

Sales value of the inventory	xx
Gross margin	(xx)
Cost of inventory	xx

c) **Cost formulas**

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.

Specific identification of cost means that specific costs are attributed to identified items of inventory.

Example: Cost of inventory of a vehicle trading business can be specifically identified with reference to the purchase cost of each vehicle.

The cost of inventories, which cannot be specifically identified, should be assigned by using the following cost formula.

- First-in, first-out (FIFO) **or**
- Weighted average cost (WAC)

Example: Cost of inventory soaps of a retail shop can be calculated using FIFO or WAC method.

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.

First-in, first-out (FIFO)

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.

Weighted average cost (WAC)

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.

Net Realizable Value (NRV)

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.

NRV = estimated selling price - estimated costs of completion - estimated selling costs

The cost of inventories may not recover if those inventories are:

- Damage,
- If they have become wholly or partially obsolete,
- If their selling prices have declined,
- if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased.

Methods to write down the cost of inventory to net realizable value

a) **Item by item method** -Inventories are usually written down to net realizable value item by item.
b) **Group by group method** -In some circumstances, however, it may be appropriate to group similar or related items.

Recognition as an expense

Inventories are treated as expenses in following situations.

- 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.

Disclosure

A few disclosures to be made in financial statements in relation to inventories are as follows:

- the accounting policies adopted in measuring inventories, including the cost formula used;
- the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
- the amount of inventories recognized as an expense during the period;
- the amount of any write-down of inventories recognized as an expense in the period