JMC vLearning
"your virtual learning partner"

LKAS 02 : Inventories

AAT Level II

FCA - Financial & Costing Accounting

Kavishka Madushan
ACA, MAAT, CA Prize Winner, AAT Prize Winner

JMC ජයසේකර කළමනාකරණ මධ්‍යස්ථානය JAYASEKERA MANAGEMENT CENTRE (PVT) LTD Estd. 1972

JMC Jayasekera Management Centre (Pvt) Ltd
Pioneers in Professional Education
65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

<u>**LKAS 02 - Inventories**</u>

Definition of inventory

<u>Inventories are:</u>

- Assets held for sale ordinary course of business. For a retailer, these are items that the business sells – its stock-in trade. For a manufacturer, assets held for sale are usually referred to as '**finished goods'**
- Assets in the process of production for sale (**work-in-progress** for a manufacturer)
- Assets in the form of materials or supplies to be used in the production process (**raw materials** in the case of a manufacturer).

In most businesses the measurement of inventory is an important factor in the determination of profit. Inventory measurement is a highly subjective exercise and consequently there is a wide variety of different methods used in practice.

<u>**Initial measurement**</u>

Inventories are initially measured at **cost**

<u>Cost</u>

The cost of inventory includes all **purchase costs, conversion costs and other costs** incurred in bringing the inventories to their present condition and location.

- Purchase costs include the purchase price (less discounts and rebates), import duties, irrecoverable taxes, transport and handling costs and any other directly attributable costs.

- Conversion costs include all direct costs of conversion (materials, labour, expenses, etc), and a proportion of the fixed and variable production overheads. The allocation of fixed production overheads must be based on the normal level of activity.

- Abnormal wastage, storage costs, administration costs and selling costs must be **excluded** from the valuation and charged as expenses in the period in which they are incurred.

Measuring the cost of inventory

LKAS 2 allows different methods for measuring the cost of inventories.

- The cost of inventories that are not **ordinarily interchangeable** is usually found by specific identification of their individual costs. (Actual unit cost)
- Cost formulas (e.g. first-in, first-out (FIFO) or weighted average cost (AVCO) might be used for inventories of an identical type made in large numbers (those that would be ordinarily interchangeable).
- Cost techniques might be used (standard cost or the retail method)

Actual cost is used where items can be individually traced. This is usual for high value items. For example, cars for sale in a car dealer's showroom will normally be valued at actual cost in the financial statements of the car dealer.

Where it is not possible to identify actual cost, a choice is allowed between FIFO or AVCO. The chosen method should be applied consistently to all similar types of inventories.

Subsequent measurement

Inventories may be sold below cost if they are damaged, if there is a decline in demand, or if the market is increasingly competitive. It may also be that items or work in progress are overstated if there has been a rise in the costs required to complete the assets and make the sale.

As such, LKAS 2 requires inventories to be written down to **the lower of cost and net realizable value (NRV) on a line-by-line basis.**

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

Net realizable value (NRV)

Net realizable value (NRV) is the estimated selling price of the item minus:

- all the (estimated) costs to make the item ready for sale, and
- all the (estimated) costs necessary to make the sale.

The NRV of inventory held to satisfy a sales contract is normally evidenced by that contract price. However, in other cases, NRV must be estimated. Sales of inventory after the reporting date provide strong evidence about its NRV as at the reporting date.

Raw materials are not written down below cost if the finished good they will form a part of will be sold at a profit. However, a decline in raw material prices would suggest that their NRV has fallen below purchase cost. In such cases, the replacement cost of the raw materials provides evidence of their NRV.

Write downs to NRV

A write down of inventories normally takes place on an item-by-item basis but similar items may be grouped.

Disclosure requirements

Entities should disclose:

1. their accounting policy and cost formulae
2. the total carrying amount of inventories by category
3. details of inventories carried at net realisable value.