IFRS Accounting Standards discussion fora: Inventories

2023

Addis Ababa, Ethiopia

WORLD BANK GROUP

AABE

Accounting and Audit Board of Ethiopia

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Applicable version of IFRS Accounting Standards

Unless specified otherwise, the accounting requirements that are the subject matter of this discussion forum are IFRS Accounting Standards as issued by the International Accounting Standards Board that are applicable for annual period beginning on or after 1 January 2023 without early applying new and amended IFRS Accounting Standards that have a later mandatory application date.

Aims

» Develop a more cohesive understanding of IFRS accounting and reporting for inventories in Ethiopia.

» Enhance capacity in Ethiopia to apply IAS 2 *Inventories* more consistently.

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Classification and measurement

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Issue 1: classification and measurement of latex harvested from a rubber farmer’s rubber trees

Classification and measurement of latex at the point of harvest from the latex farmer's rubber trees

What do you think?

Latex farming is a relatively new industry in Ethiopia's agriculture sector.

Which IFRS Accounting Standard applies to latex at the point of harvest from the latex farmer's rubber trees?

What accounting is specified for harvested latex from (i.e. at and after) the point of harvest?

Classification and measurement of latex at the point of harvest

Summary of discussion

Which IFRS Accounting Standard applies to latex at the point of harvest?

Discussants' consensus view = irrespective of whether the latex farmer's growing rubber trees are bearer plants, from the point of harvest, latex (produce) detached from the growing rubber trees is likely accounted for by the farmer in accordance with IAS 2 *Inventories,* because from the point of harvest IAS 2 applies to the harvested produce unless another Standard is applicable (IAS 41.3).

What accounting is specified for harvested latex at the point of harvest?

Discussants' consensus view = the latex harvested from the rubber trees would be measured at its point-of-harvest fair value less costs to sell (IAS 41.13). This becomes the cost of the latex inventory (IAS 2).

Classification and measurement of latex after the point of harvest
Summary of discussion

What accounting is specified for harvested latex after the point of harvest?

Discussants' consensus view = it depends:

» IAS 2's lower of cost and NRV accounting "does not apply **to the measurement** of inventories held by:

(a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at **net realisable value**, changes in that value are recognised in profit or loss in the period of the change." … (IAS 2.3(a) emphasis added)

» Note: "The inventories referred to in paragraph 3(a) are measured at **net realisable value** at certain stages of production. This occurs, for example, **when** agricultural crops have been harvested or 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…" (IAS 2.4 emphasis added)

» However, if the requirements for the measurement exception above are not met, the inventory would be accounted for at the lower of its cost and NRV (IAS 2.9).

Issue 2: classification and measurement of milk harvested from a dairy farmer's dairy herd

Classification and measurement of the milk harvested from a dairy farmer's dairy herd
What do you think?

A dairy farmer's cows provides fresh milk for sale to customers on an ongoing basis.

Which IFRS Accounting Standard apply to the milk harvested from the dairy herd?

What accounting is specified for harvested milk from (i.e. at and after) the point of harvest?

Classification and measurement of milk at the point of harvest
Summary of discussion

Which IFRS Accounting Standard/s apply to the milk harvested from the dairy farmer's dairy herd?

Discussants' consensus view = from the point of harvest IAS 2 *Inventories* applies to the harvested produce (milk) unless another Standard is applicable (IAS 41.3).

What accounting is specified for harvested milk at the point of harvest?

Discussants' consensus view = the milk harvested from the cows would be measured at its point-of-harvest fair value less costs to sell (IAS 41.13). This becomes the cost of the milk inventory (IAS 2).

Classification and measurement of milk after the point of harvest

Summary of discussion

What accounting is specified for harvested milk after the point of harvest?

Discussants' consensus view = it depends:

- IAS 2's lower of cost and NRV accounting "does not apply **to the measurement** of inventories held by:
  - (a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at **net realisable value**, changes in that value are recognised in profit or loss in the period of the change." … (IAS 2.3(a) emphasis added)
    - Note: "The inventories referred to in paragraph 3(a) are measured at **net realisable value** at certain stages of production. This occurs, for example, **when** agricultural crops have been harvested or 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…" (IAS 2.4 emphasis added))
- However, if the requirements for the measurement exception above are not met, the inventory would be accounted for at the lower of its cost and NRV (IAS 2.9).

Issue 3: classification and measurement of dormant inventories

Classification and measurement of dormant inventories
What do you think?

Many Ethiopian entities (particularly SOEs) purport to have long-term dormant inventories that management purport could be sold for material value.

Which IFRS Accounting Standard applies to dormant inventories?

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Classification and measurement of dormant inventories
Summary of discussion

Which IFRS Accounting Standard applies to dormant inventories?

Discussants' consensus view = IAS 2 *Inventories* applies to such assets provided that the items either (IAS 2.6):

» continue to be materials or supplies that are expected to be consumed in the reporting entity's production process (or in the rendering of services); or

» continue to be held by the reporting entity for sale in the ordinary course of business (or for use in the process of production for such sale).

The entity must measure the dormant inventory at the lower of its cost and its NRV (IAS 2.9).

Put another way, to the extent that the cost of these inventories may not be recoverable (for example, because they have become wholly or partially obsolete) they must be written down to their NRV (IAS 2.28).

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Issue 4: classification and measurement of scrap material generated through normal production

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Classification and measurement of scrap material
What do you think?

Scrap material could result from normal production in different ways.

Example 1: off-cuts result from larger pieces of raw material.

Example 2: a production process results in a main product and a by-product being produced simultaneously.

Which IFRS Accounting Standard applies to scrap material?

How is scrap material measured?

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Classification and measurement of scrap material
Summary of discussion

Which IFRS Accounting Standard applies to scrap material?

Discussants' consensus view = IAS 2 *Inventories* applies to such scrap material when, for example:

» the material is raw material scrap (for example, off-cuts) that result from normal production that is either held for sale in the ordinary course of business or is to be consumed in the production process or in the rendering of services (IAS 2.6).

» the material is a by-product of normal production that is held for sale in the ordinary course of business or is in the process of production for such sale (IAS 2.6).

Classification and measurement of off-cut type scrap material
Summary of discussion

How are inventories of raw material scrap (for example, off-cuts) measured?

Discussants' consensus view = IAS 2 *Inventories* applies to the measurement of the cost and NRV of such scrap raw material.

» If material, the **cost** of the scrap raw material could be determined on a rational and consistent basis of allocation of the cost of the total raw material from which the scrap results between that which becomes part of the product and that which does not (ie the off-cut).

» To measure **NRV** of the material, management must, using the most reliable evidence available at the time the estimates are made, estimate using entity-specific assumptions (IAS 2.6 and .30):

  » If the scrap has or is to be converted into finished goods: the finished goods inventory's expected selling price in the ordinary course of business less the estimated costs to complete the inventory and the estimated costs necessary to sell the finished goods inventory.

  » If the scrap is to be sold in its raw material form: its expected selling price in the ordinary course of business less the estimated costs necessary to sell it.

Classification and measurement of by-product scrap material
Summary of discussion

How are inventories of material that is a by-product of normal production measured? Discussants' consensus view = IAS 2 *Inventories* applies to the measurement of the cost and NRV of such by-product material.

» In principle, the cost of the by-product includes an allocation (on a rational and consistent basis) of the joint conversion costs that are not separately identifiable for the main product and the by-product. (IAS 2.14).

» However, by way of rule, immaterial by-products are explicitly allowed to be measured at their NRV (and this value is deducted from the cost of the main product) (IAS 2.14).

» To measure **NRV** of the the by-product, management must, using the most reliable evidence available at the time the estimates are made, estimate using entity-specific assumptions (IAS 2.6 and .30) the expected selling price of the by-product in the ordinary course of business less the estimated costs necessary to sell it.

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Issue 5: classification and measurement of tools in storeroom

Classification and measurement of tools in storeroom
What do you think?

Manufacturer keeps a store of tools that its servicing engineers source tools from as and when required to service Manufacturer's machinery. Each such tools is expected to be used for less than a year before replacement.

Which IFRS Accounting Standard applies to the store of tools?

How are the tools in the storeroom measured?

Classification and measurement of tools in storeroom
Summary of discussion

Which IFRS Accounting Standard applies to the store of tools? Discussants' consensus view = IAS 2 *Inventories* applies to such tools because they are not PPE as they are expected to be used for less than a year. (IAS 16.6 and .8).

How are the tools in the storeroom measured measured?
Discussants' consensus view = IAS 2 applies to the measurement of the cost and NRV of the inventory of such tools in the storeroom.

Government grants and other forms of government assistance

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» Issue 1: import duty waiver

Issue 1: import duty waiver

Import duty waiver
What do you think?

Government allows some businesses to import particular items of inventory (for example, some raw materials) duty free.

Should the duty-free benefit provided by the government be accounted as a government grant in accordance with IFRS Accounting Standards (IAS 20)?

Import duty waiver
Summary of discussion

Should the duty-free benefit provided by the government be accounted as government grant in accordance with IFRS Accounting Standards (IAS 20)?

Discussants' consensus view = no, it is not a government grant. However, it likely is government assistance that must be disclosed.

Note: PwC conclude, albeit in the context of business rates reliefs during the covid pandemic, "The charge will not be levied so there is simply no expense to recognise. There is no transfer of resources so the relief will not be a government grant, but it will represent a form of government assistance for disclosure purposes."
Source www.pwc.co.uk/covid-19/accounting-for-government-assistance-in-response-to-covid-19-pandemic.pdf.

Historical cost

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» Issue 3: measuring point-of-harvest fair value less costs to sell of produce

Issue 1: inventories granted free from charge by philanthropist

Free from charge inventories received from philanthropist
What do you think?

IAS 20 specifies accounting for government grants.

An entity receives inventories free from charge from a philanthropist.

How to account for inventories granted by a philanthropist free from charge?

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Free from charge inventories received from philanthropist
Summary of discussion

How to account for inventories granted by the philanthropist free from charge?
Discussants' consensus view:

- Because no IFRS Accounting Standard explicitly specifies accounting for grants from philanthropists, the reporting entity must determine and apply its accounting policy for grants from philanthropists in accordance with paragraphs 10–12 of IAS 8 (sometimes called the IAS 8 hierarchy).
- Applying the IAS 8 hierarchy likely results in using the accounting specified for government grants in IAS 20, because its likely concluded to be similar and related.
- Applying IAS 20 accounting, by analogy, allows the receiving company to account for the grant (and the associated item of inventory) at a nominal value, for example, ETB1. Electing to use this accounting alternative for the grant obviates the need to determine the fair value of the grant received and the timing of the release to income of the resulting liability (deferred income).
  - Alternatively, in accordance with IAS 20, at initial recognition measure the grant liability (deferred income) and the inventory asset at fair value. Subsequently, release the grant liability to profit or loss to match the expenses the grant was designed to compensate the grant recipient for. Account for the item of inventory in accordance with IAS 2 *Inventories*.

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Issue 2: foreign currency exchange rate gain/loss when importing inventory

Foreign currency exchange rate gains/losses on imported inventory
What do you think?

The cost of inventory comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventory to its present location and condition. (IAS 2.10)

How to account for foreign currency exchange rate gains/losses when importing inventory?

Foreign currency exchange rate gains/losses on imported inventory

Summary of discussion

How to account for Foreign currency exchange rate gains/losses when importing inventory? Discussants' consensus view—IFRIC 22 specifies use of the exchange rate on the date on which an entity initially recognises the non-monetary asset arising from the payment of advance consideration. (IFRIC 22.8) For example, inventory is purchased for $10 million. Spot exchange rate = ETB55:$1 when control of the inventory passes to reporting entity.

» **Scenario 1:** payment of ETB550 million ($10 million) is made when control over the inventory passes to the reporting entity. Historical cost of inventory = ETB550 million.

» **Scenario 2:** payment of ETB540 million ($10 million) is made some month in advance of control over the inventory passing to the reporting entity. Historical cost of inventory = ETB540 million (ie using exchange rate on the date the non-monetary asset—right to receive inventories—arises in exchange for the payment of advance consideration).

» **Scenario 3:** payment of ETB560 million ($10 million) is made a few months after control over the inventory passed to the reporting entity. Historical cost of inventory = ETB550 million. (Note: ETB10 million exchange loss is a currency exchange expense on foreign creditor monetary liability.)

Issue 3: measuring point-of-harvest fair value less costs to sell of produce

Measuring the point of harvest fair value less costs to sell of produce
What do you think?

"Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying IAS 2 *Inventories* or another applicable Standard." (IAS 41.13).

IFRS 13 *Fair Value Measurement* specifies how to measure fair value.

How is the point-of-harvest fair value less costs to sell of produce measured in practice?

Measuring the point of harvest fair value less costs to sell of produce: market approach. *Observed practice example: MHP Agro & Industrial Holdings 2022 Annual Financial Statements*

21. AGRICULTURAL PRODUCE

The balances of agricultural produce were as follows as of 31 December 2022 and 2021:

SEGMENT	THOUSAND TONNES 2022	CARRYING AMOUNT 2022	THOUSAND TONNES 2021	CARRYING AMOUNT 2021
Grain	1,050	224,550	1,201	372,343
Chicken meat	70.6	127,908	72.3	128,757
Other various crops		8,967		9,181
Other various meat		2		986
		361,427		**511,267**

The fair value of Agricultural produce was estimated based on market price as of date of harvest and is within Level 2 of the fair value hierarchy.

As of 31 December 2022, agricultural produce in amount of USD 38,260 thousand was pledged as collateral to secure bank borrowings (2021: USD 38,188 thousand).

Net realisable value

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Issue 1: measuring NRV

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Measuring NRV
What do you think?

NRV 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." (IAS 2.6)

How is NRV measured in accordance with IAS 2 *Inventories*?

Measuring NRV
Summary of discussion

How is NRV measured in accordance with IAS 2 *Inventories*? Discussants' consensus view:

» Because NRV is an entity-specific measure, management is well placed to estimate it. (Note: NRV is different from fair value. Unlike NRV fair value is a market price).

» To measure NRV, management must, using the most reliable evidence available at the time the estimates are made, estimate using entity-specific assumptions (IAS 2.6 and .30):

  » the inventory's expected selling price in the ordinary course of business;
  » estimated costs to complete the inventory, if any; and
  » estimated costs necessary to sell the inventory.

» NRV must be measured item-by-item unless the criteria for grouping items are met, ie the items relate 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 (IAS 2.29).

Issue 2: accounting for the impairment of inventories

Accounting for the impairment of inventories
What do you think?

Consistently with the view that assets should not be measured at an amount in excess of the amounts expected to be realised from their sale or use, inventories are measured at the lower of their cost and NRV (IAS 2.9 and .28).

NRV 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." (IAS 2.6)

How are impairments of inventories accounted for in accordance with IAS 2 *Inventories*?

Accounting for the impairment of inventories
Summary of discussion

How are impairments of inventories accounted for in accordance with IAS 2 *Inventories*? Discussants' consensus view

- In financial position (sometimes called the balance sheet), inventories are measured at the lower of their cost and NRV (i.e. estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale (IAS 2.6 and .9).
- In financial performance (sometimes called the income statement):
  - the amount of any write-down/write-off of inventories to NRV (including write-offs, if any) is presented as an expense in profit or loss of the period in which the write-down/write-off occurs (IAS 2.34).
  - the amount of any reversal of prior period write-down/write-off of inventories is presented as a reduction in the amount of inventories recognised as an expense in profit or loss of the period in which the reversal occurs (IAS 2.34).