HM TREASURY

Financial Reporting Advisory Board Paper

IAS 2: Inventories

Issue:	Applying IAS 2 *Inventories* in the context of resource accounts covered by the Government Financial Reporting Manual
Impact on guidance:	The proposed text in Annex A relates to the IFRS-based FReM.
IAS/IFRS adaptation?	No
IPSAS compliant?	Yes – except for a minor difference relating to the treatment of foreign exchange gains and losses.
Interpretation for the public sector context?	Yes, guidance is provided on inventories that are specific to the public sector, i.e. stockpiled goods and military inventories, confiscated, seized and forfeited property and goods held under price support programmes
Impact on budgetary regime?	No
Alignment with National Accounts	Yes
Impact on Estimates?	No
Recommendation:	That the Board agree that IAS 2 applies in full to entities covered by the IFRS-based FReM
Timing:	Not yet known: depends on future decision on date for moving to EU-adopted IFRS.

DETAIL

Background

1. IAS 2 *Inventories* was issued so as to be effective for all periods beginning on or after 1 January 2005 replacing the 1993 version (revised) of the standard.

Objective of IAS 2

2. The objective of the standard is to prescribe the accounting treatment for inventories. IAS 2 provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the formulas that are used to assign costs to inventories.

Main features of IAS 2

3. The Main features of IAS 2 are:

   a) Inventories shall be measured at the lower of cost and net realisable value.

   b) 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.

4. IAS 2 does **not** apply to the following inventory assets which are covered by other standards:

   - work in progress under construction contracts.
   - financial instruments.
   - biological assets related to agricultural activity and agricultural produce at the point of harvest.

5. IAS 2 does also **not** apply to the measurement of inventories held by:

   - producers of agricultural and forestry 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.
   - commodity broker-traders who measure their inventories at fair value less cost to sell.

Comparison with requirements of UK GAAP

6. IAS 23 *Borrowing Costs* allows for borrowing costs to be included in the cost of inventories in certain circumstances. SSAP 9 *Stocks and Long-term Contracts* is silent on the issue of borrowing and finance costs. IAS 23 will be the subject of a separate FRAB paper.

7. IAS 2 is more prescriptive than is SSAP 9 of the formulas entities can employ to arrive at the cost value for high volume interchangeable items. IAS 2 only allows for use of the first-in, first–out (FIFO)

and the weighted average cost methods. No such restrictions exist in SSAP 9, although the use of last-in, first-out (LIFO) is not encouraged.

8. IAS 2 addresses the reversal of write-downs of inventory to net realisable value. IAS 2 requires that such reversals should be recognised as a reduction in the inventory expense (cost of sales) during the period. SSAP 9 is silent on this issue.

9. SSAP 9 includes long-term contract balances as a category of stock. IAS 2 excludes long-term contracts from its scope as IAS 11 *Construction Contracts* deals with the balance sheet treatment of construction costs, while IAS 18 *Revenue* covers long-term service contracts.

Impact of IAS 2 on the public sector

10. The accounting treatment of inventories under IAS 2 is virtually the same as that under SSAP 9. As such the application of IAS 2 will not result in a material change in the method of accounting for inventories in the public sector.

Impact on disclosures in resource and other accounts

11. The disclosure requirements in IAS 2 are far more detailed than those in SSAP 9. SSAP 9 only requires that the sub categories of stock are shown in the balance sheet (or the notes) and that narrative of the accounting policies and the method of valuation is provided. IAS 9 additionally requires disclosure of:

- the carrying amount of inventories carried at fair value less cost to sell.
- the amount of inventories recognised as an expense during the period.
- the amount of any write-down recognised as an expense in the period.
- the amount of any reversals of such write-downs.
- the circumstances or events that led to the reversal of the write-down.
- the carrying amount of inventories pledged as security for liabilities

IAS/IFRS compliance

12. The proposal in this paper is that IAS 2 is applied in full to the public sector.

IPSAS compliance

13. IAS 2 is compliant with IPSAS 12, *Inventories*, except that IPSAS 12 allows for the purchase cost of inventories to include foreign exchange differences. Such cost are explicitly excluded from IAS 2 in the introduction to the standard.

Proposed text for the IFRS-based Government Financial Reporting Manual

14. See Annex A for the proposed amendments to the IFRS-based FReM.

Impact on the budgetary regime

15. The adoption of IAS 2 will have no impact on the current budgetary treatment of inventories

Summary and recommendation

16. IAS 2 does not materially change the accounting treatment for inventories in the public sector. The Board is invited to approve the proposed text for the IFRS-based FREM at Annex A.

Financial Reporting Policy Team
21 September 2006

ANNEX A

PROPOSED TEXT FOR THE IFRS-BASED GOVERNMENT FINANCIAL REPORTING MANUAL

IAS 2 Inventories

Applicability

IAS 2 applies in full as interpreted.

Objectives of IAS 2

The objective of IAS 2 is to ensure that inventories are valued at the lower of cost and net realisable value and that their sub-classification in the balance sheet or in the notes to the financial statements indicates the amounts held in each of the main categories in the standard balance sheet formats.

Adaptation of IAS 2 for the public sector context

In the public sector financial statements are prepared under the modified historical cost convention. Under this convention stocks are held current cost.

Interpretations of IAS 2 for the public sector context

The following interpretations of IAS 2 for the public sector context apply.

In addition to the types of inventories identified in IAS 2, central government has categories of inventories for which IAS 2 may not adequately cover the necessary accounting treatment. These include:

a) stockpile goods and military reserve inventories ,

b) confiscated, seized and forfeited property;

c) goods held under price support programmes

Stockpile goods

Stockpile goods may be defined as strategic materials held for use in national defence and national emergencies. They can be further categorised as:

a) fixed assets, which should be accounted for in the same way as other assets of the same type; or

b) other non-deteriorable and deteriorable inventories (the latter possibly being turned over from time to time to avoid obsolescence). Minimum capability levels of inventories should be accounted for as fixed assets. Other inventories should be accounted for under IAS 2.

Confiscated, seized and forfeited property

The proceeds of realisations of confiscated, seized and forfeited property go to the Consolidated Fund and are not for the benefit of the collecting entity concerned. Because of this, it would be inappropriate to recognise confiscated, seized and forfeited property in financial statements. Entities should state by way of memorandum note the proceeds derived from these realisations.

The proceeds of items sold to satisfy outstanding tax liabilities, net of sale expenses, should be treated in the same way as other taxation receipts.

Goods held under price support and stabilisation programmes (intervention stocks)

Intervention buying is a method of supporting market prices for certain agricultural commodities. The Rural Payments Agency is required to buy, at prices determined by the European Commission, produce of defined quality offered to it in accordance with detailed regulations. Purchased stocks are valued at cost, adjusted by any depreciation or revaluation prescribed by the Commission to bring them into line with market values. Costs of depreciation and any losses on sales are borne by, and any profits on sales or revaluations are surrendered to, the Commission. The method of valuation for intervention stocks is based on the requirements of the Commission as such neither IAS 2 or IAS 41 *Agriculture* apply.