The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Topic wise Selected Opinions

IAS 2 - Inventories

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1. Observance of Physical Stock Check

Enquiry:

I have been appointed as auditor of the Private Limited Company as at October 31, 2016 but the predecessor auditor did not conduct the audit of the company for the year ended June 30, 2016. I have communicated the predecessor auditor and found that they had observed physical stock check as at June 30, 2016. They also agreed to share with me working papers subject to client's permission.

A query is do I still need to modify my opinion with respect to observation of stock check?

Opinion:

The Committee would like you to refer paragraphs 4 to 8 of ISA 501 '*Audit Evidence'* which specifically addresses your matter.

Auditor is responsible for giving an opinion on the financial statement prepared in the term for which he/she is appointed. In your inquired scenario, the ultimate responsibility will remain of the existing auditor, no matter whether predecessor auditor agreed to share their working papers.

The Committee is of the view that, if the auditor is unable to attend the physical inventory count due to unforeseen circumstances, the auditor should take or observe physical count on an alternative date and, when necessary, perform tests of intervening transactions.

Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation. For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

With regard to modification of opinion, the Committee would like to refer paragraph 7 of ISA 501 for guidance.

(December 14, 2016)

2. Primary and Secondary Freight Costs related to Inventory

Enquiry:

Entity 1: ABC Ltd. is a trading company which imports Product A in bulk at Karachi port, which is then distributed to various of its warehouses throughout Pakistan, from where it is sold to its customers. ABC Ltd. incurs a substantial freight cost in transporting Product A from port to warehouses (Primary Freight) and also in transporting it from warehouses to the customers (Secondary Freight).

Entity 2: DEF Ltd., a sister concern of ABC Ltd., manufactures Product A at Karachi, which is then distributed to various of its warehouses throughout Pakistan, from where it is sold to its customers. DEF Ltd. also incurs a substantial freight cost in transporting Product A from port to warehouses (Primary Freight) and also in transporting it from warehouses to customers (Secondary Freight).

Both the entities expense out the entire secondary freight costs and that part of the primary freight costs which is relevant to the inventory sold, out of the total inventory transported, under Selling and Distribution expenses. For example:

Total inventory transported (Primary Freight) = 1 million units
Total inventory sold = 0.6 million units
Total primary freight cost = Rs. 10 million
Primary freight cost expenses under Selling and Distribution = Rs. 6 million (0.6/1 X 10)

The remaining Rs. 4 million is shown as an asset under "Loans, advances, deposits, prepayments and other receivables" and expensed out when the related inventory is sold.

The following are some relevant paragraphs from IAS 2:

Para 10: *Cost of inventories:*

> *"The 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.**"*

Para 15: *"**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, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories."*

In light of the above and any other relevant technical references, the following questions arise:

1. Should the primary freight cost be included in the cost of inventories and consequently in the Cost of Goods sold?

If the answer to question 1 is yes:

2. Would this be an optional or a necessary treatment?

3. Would this apply to both the manufacturing as well as the trading entity? (considering that there is a general belief among accountants that costs should only be included in inventory if they are necessary to bring it in "saleable condition", a term not used anywhere in IAS 2)

4. Where then would secondary freight be classified in case:

a) The risk remains with the selling entity during transport to the customer, and passes onto him when the Product reaches his premises?

b) The risk passes onto the customer during transport to him, but the transport cost is borne by the seller?

5. If the entities, in addition to the warehouses, had retail units, would it then be appropriate to include the cost of transportation from the warehouse to the retails unit in inventory?

6. In a scenario where inventory is moved from Karachi to Peshawar, for planned sales there, but due to low demand or any other extraordinary circumstances, has to be moved back to Karachi again, under which head would the cost of this return trip of inventory be classified?

<u>If the answer to question 1 is no or the answer to question 2 is optional:</u>

7. Is it appropriate to defer the primary freight expenses under the Head "Loans, advances, deposits, prepayments and other receivables" till the time of sale of related inventory?

8. Would the entity's pricing at different locations affect where primary freight cost is classified? If yes, where would it be classified under the following scenarios?

a) The entities charge the same price at all locations
b) The entities charge a price varying in line with primary freight costs at all locations
c) The entities charge a price directly dependent on primary freight cost at most locations, but charge lower prices at locations where they face stiff competition.

9. If the primary freight cost is to be classified under Cost of Goods Sold because the relevant revenue (the increase in price due to the freight cost incurred) is included in sales revenue, would it then be appropriate to classify secondary freight under Cost of Goods Sold if the entity charges additionally for delivery to the customer, which is part of sales revenue?

Opinion:

The Committee would like to refer following paragraphs of IAS 2 'Inventories':

11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and <u>transport,</u> handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

16 Examples of <u>costs excluded from the cost of inventories</u> and recognized as expenses in the period in which they are incurred are:

a) abnormal amounts of wasted materials, labour or other production costs;

b) storage costs, unless those costs are necessary in the production process before a further production stage;

c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

d) <u>selling costs.</u>

The cost of inventory includes all necessary expenditures in bringing the inventory to its desired condition and location for sale or for use in the manufacturing process. For raw material and inventory that are purchased outright and not intended for further conversion, cost identification is straight forward. The cost of these inventories will include all expenditures incurred in bringing the goods to the point of sale and capable of being sold. These costs include purchase price, transportation (freight), insurance and handling cost.

Freight-in costs are part of the cost of goods purchased. The cost of goods includes all costs necessary to get an asset in place and ready for use. Freight-in costs are allocated to the products purchased and will cling to the products. Those products in inventory (items not yet sold) will include their share of the freight-in costs (as part of the inventory cost). The products that have been sold will include their share of the freight-in costs (as part of the cost of goods sold).

Freight-out i.e. Distribution costs and the costs of transporting goods to customers are not product costs and are not to be included in the cost of the inventories. However, transport and distribution costs that are necessary to get the inventory to its present location or condition for sale form part of the cost of inventory. The following are examples of costs that are allocated to inventory:

- the cost of transporting goods from the supplier;
- transport or distribution costs that are incurred at an intermediate stage in the production process; and
- transport or distribution costs to get the inventory from a central warehouse to the point of sale.

Similarly, packaging costs incurred to prepare inventory for sale are part of the cost of inventory.

(February 11, 2015)

3. Change in Inventory Valuation Method

Enquiry:

This is with reference to two different views over change in inventory valuation method (cost formula) from weighted average to first-in first-out (FIFO) basis or vice versa.

In this connection, one of view is that change in cost formula from weighted average to FIFO or vice versa is a change in accounting estimate as International Accounting Standard (IAS) 2, 'Inventories' ("IAS-2 ") do not state that the selection of a cost formula under IAS-2 falls under the ambit of accounting policies. Therefore, change in the cost formula would not be attributed as change in accounting policy. To support this view, following paras (32 to 37) of IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors' ("IAS-8 ") are relevant:

"32. As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. For example, estimates may be required of:

a) bad debts;
b) inventory obsolescence;
c) The fair value of financial assets or financial liabilities;
d) useful lives of, or expected pattern of consumption of the future economic Benefit embodies in depreciable assets; and
e) warranty obligations.

33. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

34. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

35. A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

36. <u>The effect of a change in an accounting estimate, other than a change to which paragraph 37 applies, shall be recognised prospectively</u> by including it in profit or loss in:

a) the period of the change, if the change affects that period only;' or
b) the period of the change and future periods, if the change affects both.

37. <u>To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.</u> "

Another view in this regard is that <u>the change in inventory valuation method from weighted average to FIFO or vice versa is a **change in accounting policy**</u> instead of change in accounting estimate. Basis for this view are given as under:

- The change of cost formula does not fall under the definition of ' change in accounting estimate', defined below, as it cannot be construed as the assessment of the present status of, and expected future benefits of assets. Therefore, the change of cost formula of inventory valuation is to be considered as change in accounting policy under IAS-8. However, it falls under the definition of accounting policies defined below.
- Moreover, change in measurement basis is a change in accounting policy rather a change in accounting estimate.

Para 35 of the IAS-8 states that;

> *"A change in the measurement basis applied is a change in an accounting policy and is not a change in an accounting estimate. When it is difficult distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate. "*

- In chapter 18, 'Accounting Policies, Estimates and Errors' of Gripping IFRS (Pakistan Edition 2008), in the last paragraph of the overview section, it is clearly stated that change in inventory valuation method will be a change in accounting policy. The referred para from the book is reproduced below:

  "It should be noted, however, that a change in measurement basis is considered to be a change in policy and not a change in estimate ***(e.g. with respect to inventories, a change from the FIFO method to the WA method would be a change in accounting policy rather a change in estimate). "***

Change in accounting estimate and accounting policies have been defined in IAS-8 as follows:

> *"A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status or / and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information or new developments and accordingly are not corrections of errors."*
>
> *"Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements."*

Your valuable opinion is solicited as to whether the change of cost formula of inventory valuation from FIFO to Weighted Average or vice versa will be a change is accounting policy or change in accounting estimate.

Opinion:

The Committee considered your enquiry and in the absence of any specific guidance to the contrary in the standards and based on practices generally followed for treatment of changes in methods of determining cost of inventory, agrees with the second view described in note 3 of your letter that change in the cost formula from a weighted average cost formula to FIFO-based cost formula or vice versa is a change in accounting policy.

The change in a cost formula represents a change in the bases on which the value of the inventory has been determined. Therefore, a change in the cost formula represents a change in specific bases and hence will be treated as a change in accounting policy.

(March 19, 2014)

4. Request from a Company for Exemption from application of IAS-2

Enquiry:

The Commission has been approached by a Company requesting exemption from the application of International Accounting Standard (IAS- 2) “Inventories" in the financial statements for the year to be ended on June 30, 2013 and onwards.

Extracts of the information received from the Company’s consultant is as follows:

> *“On behalf of our above client "XYZ" we would like to inform you that XYZ was Setup in 1957, and acted as a public sector trade house for exporting of agriculture and consumer goods and import of essential commodities under the specific directives of the Government.*
>
> *XYZ is a wholly owned Company of Government of Pakistan and its all above activities are carried out in accordance with the directions of Government.*
>
> *By virtue of SRO 23 (1)/ 2012 dated January 16, 2012, XYZ has become a significant economic entity and, therefore, the application of IFRS as applicable to listed companies is applicable to XYZ.*
>
> *XYZ capitalized its financial charges in the carrying cost of inventories purchased which draw the attention of their external auditor who objected such treatment in contravention of IAS 2, which prohibit capitalization of borrowing cost in the value of inventory.*

Quote from Auditors' Report:

> *The mark up on overdraft amounting to PKR XXX million is included in cost of sales instead of financial cost and the gross profit is reduced by the same amount.*

Un Quote:

Quote from IAS 2 - Measurement of Inventories:

> *10. The 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.*

Other costs:

> *15. 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, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.*
>
> *16. Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are:*
>
> *a. abnormal amounts of wasted materials, labour or other production costs;*
> *b. storage costs, unless those costs are necessary in the production process before a further production stage;*
> *c. administrative overheads that do not contribute to bringing inventories to their present location and*
> *d. selling costs.*

17. *IAS-23 'Borrowing Costs' identifies limited circumstances where borrowing costs are included in the cost of inventories.*

Un Quote:

This treatment of capitalization is justifiable in the case of XYZ as it sell and purchase on behalf of the Government, and resultantly claims subsidy on the differential amount of this activity. In order to calculate the subsidy from the differential amount of sell/purchase it is essential to calculate the cost of financing XYZ pays to the financial institution in order to comply with the directions of Government.

It is imperative for the XYZ to make the financial charges part of the inventory in order to claim correct value of subsidy calculated from the Government.

We, therefore, request you to kindly allow exemption from the applicability of IAS 2 in case of XYZ to extent of capitalization of financial charges to carrying cost of inventories by virtue of the powers of the Commission."

As the Company is requiring permanent exemption in the matter and is acting as the agent of the Government, the Commission requests your comments in the matter before arriving at any final decision.

Opinion:

The Committee would like to draw attention to the following paragraphs of IAS 23 'Borrowing Costs': (underline is ours)

5. "A qualifying asset is an asset that necessarily takes a <u>substantial period of time to get ready for its intended use or sale."</u>

7. "Depending on the circumstances, any of the following <u>may</u> be qualifying assets:

   a. inventories
   b. manufacturing plants
   c. power generation facilities
   d. intangible assets
   e. investment properties.

Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. <u>Assets that are ready for their intended use or sale when acquired are not qualifying assets."</u>

It is clear from the above reading that the Company is engaged in the trading of commodities ready for intended use or sale when acquired, which do not come under the definition of qualifying asset. The Committee is of the view that the inclusion of financial charges in the cost of inventory may conflict with the matching principle, and would not only understate the gross profit but also overstate inventory cost; resultantly increasing the amount of subsidy claimed by the Company. The Committee strongly believes, on the facts illustrated in the enquiry, that such a treatment is not justified and may mislead the user.

However, the Committee reiterates that the final decision to provide exemption lies with the regulator, whatever may be the reason for such an exemption. The Committee would like to draw attention that where such an exemption is granted, additional disclosures are required, as described in the following paragraphs of IAS 1 'Presentation of Financial Statements':

"19 In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure."

"20 When an entity departs from a requirement of an IFRS in accordance with paragraph 19, it shall disclose:

a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

b) that it has complied with applicable IFRSs, except that it has departed from a particular requirement to achieve a fair presentation;

c) the title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted; and

d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement."

(May 28, 2013)