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Approval by the Board of IAS 2 issued in December 2003

International Accounting Standard 2 *Inventories* (as revised in 2003) was approved for issue by the fourteen members of the International Accounting Standards Board.

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Basis for Conclusions on IAS 2 *Inventories*

This Basis for Conclusions accompanies, but is not part of, IAS 2.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 2 *Inventories* in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 2. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.
- BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for inventories established by IAS 2, this Basis for Conclusions does not discuss requirements in IAS 2 that the Board has not reconsidered.

Scope

Reference to historical cost system

- BC4 Both the objective and the scope of the previous version of IAS 2 referred to 'the accounting treatment for inventories under the historical cost system.' Some had interpreted those words as meaning that the Standard applied only under a historical cost system and permitted entities the choice of applying other measurement bases, for example fair value.
- BC5 The Board agreed that those words could be seen as permitting a choice, resulting in inconsistent application of the Standard. Accordingly, it deleted the words 'in the context of the historical cost system in accounting for inventories' to clarify that the Standard applies to all inventories that are not specifically exempted from its scope.

Inventories of broker-traders

- BC6 The Exposure Draft proposed excluding from the scope of the Standard inventories of non-producers of agricultural and forest products and mineral ores to the extent that these inventories are measured at net realisable value in accordance with well-established industry practices. However, some respondents disagreed with this scope exemption for the following reasons:
- (a) the scope exemption should apply to all types of inventories of broker-traders;
 - (b) established practice is for broker-traders to follow a mark-to-market approach rather than to value these inventories at net realisable value;
 - (c) the guidance on net realisable value in IAS 2 is not appropriate for the valuation of inventories of broker-traders.
- BC7 The Board found these comments persuasive. Therefore it decided that the Standard should not apply to the measurement of inventories of:
- (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 (as in the previous version of IAS 2), or
 - (b) commodity broker-traders when their inventories are measured at fair value less costs to sell.
- BC8 The Board further decided that the measurement of the effect of inventories on profit or loss for the period needed to be consistent with the measurement attribute of inventories for which such exemption is allowed.

Accordingly, to qualify under (a) or (b), the Standard requires changes in the recognised amount of inventories to be included in profit or loss for the period. The Board believes this is particularly appropriate in the case of commodity broker-traders because they seek to profit from fluctuations in prices and trade margins.

Cost formulas

- BC9 The combination of the previous version of IAS 2 and SIC-1 *Consistency—Different Cost Formulas for Inventories* allowed some choice between first-in, first-out (FIFO) or weighted average cost formulas (benchmark treatment) and the last-in, first-out (LIFO) method (allowed alternative treatment). The Board decided to eliminate the allowed alternative of using the LIFO method.
- BC10 The LIFO method treats the newest items of inventory as being sold first, and consequently the items remaining in inventory are recognised as if they were the oldest. This is generally not a reliable representation of actual inventory flows.
- BC11 The LIFO method is an attempt to meet a perceived deficiency of the conventional accounting model (the measurement of cost of goods sold expense by reference to outdated prices for the inventories sold, whereas sales revenue is measured at current prices). It does so by imposing an unrealistic cost flow assumption.
- BC12 The use of LIFO in financial reporting is often tax-driven, because it results in cost of goods sold expense calculated using the most recent prices being deducted from revenue in the determination of the gross margin. The LIFO method reduces (increases) profits in a manner that tends to reflect the effect that increased (decreased) prices would have on the cost of replacing inventories sold. However, this effect depends on the relationship between the prices of the most recent inventory acquisitions and the replacement cost at the end of the period. Thus, it is not a truly systematic method for determining the effect of changing prices on profits.
- BC13 The use of LIFO results in inventories being recognised in the balance sheet at amounts that bear little relationship to recent cost levels of inventories. However, LIFO can distort profit or loss, especially when ‘preserved’ older ‘layers’ of inventory are presumed to have been used when inventories are substantially reduced. It is more likely in these circumstances that relatively new inventories will have been used to meet the increased demands on inventory.
- BC14 Some respondents argued that the use of LIFO has merit in certain circumstances because it partially adjusts profit or loss for the effects of price changes. The Board concluded that it is not appropriate to allow an approach that results in a measurement of profit or loss for the period that is inconsistent with the measurement of inventories for balance sheet purposes.
- BC15 Other respondents argued that in some industries, such as the oil and gas industry, inventory levels are driven by security considerations and often represent a minimum of 90 days of sales. They argue that, in these industries, the use of LIFO better reflects an entity’s performance because inventories held as security stocks are closer to long-term assets than to working capital.
- BC16 The Board was not convinced by these arguments because these security stocks do not match historical layers under a LIFO computation.
- BC17 Other respondents argued that in some cases, for example, when measuring coal dumps, piles of iron or metal scraps (when stock bins are replenished by ‘topping up’), the LIFO method reflects the actual physical flow of inventories.
- BC18 The Board concluded that valuation of these inventories follows a direct costing approach where actual physical flows are matched with direct costs, which is a method different from LIFO.
- BC19 The Board decided to eliminate the LIFO method because of its lack of representational faithfulness of inventory flows. This decision does not rule out specific cost methods that reflect inventory flows that are similar to LIFO.
- BC20 The Board recognised that, in some jurisdictions, use of the LIFO method for tax purposes is possible only if that method is also used for accounting purposes. It concluded, however, that tax considerations do not provide an adequate conceptual basis for selecting an appropriate accounting treatment and that it is not acceptable to allow an inferior accounting treatment purely because of tax regulations and advantages in particular jurisdictions. This may be an issue for local taxation authorities.
- BC21 IAS 2 continues to allow the use of both the FIFO and the weighted average methods for interchangeable inventories.

Cost of inventories recognised as an expense in the period

- BC22 The Exposure Draft proposed deleting paragraphs in the previous version of IAS 2 that required disclosure of the cost of inventories recognised as an expense in the period, because this disclosure is required in IAS 1 *Presentation of Financial Statements*.
- BC23 Some respondents observed that IAS 1 does not specifically require disclosure of the cost of inventories recognised as an expense in the period when presenting an analysis of expenses using a classification based on their function. They argued that this information is important to understand the financial statements. Therefore the Board decided to require this disclosure specifically in IAS 2.