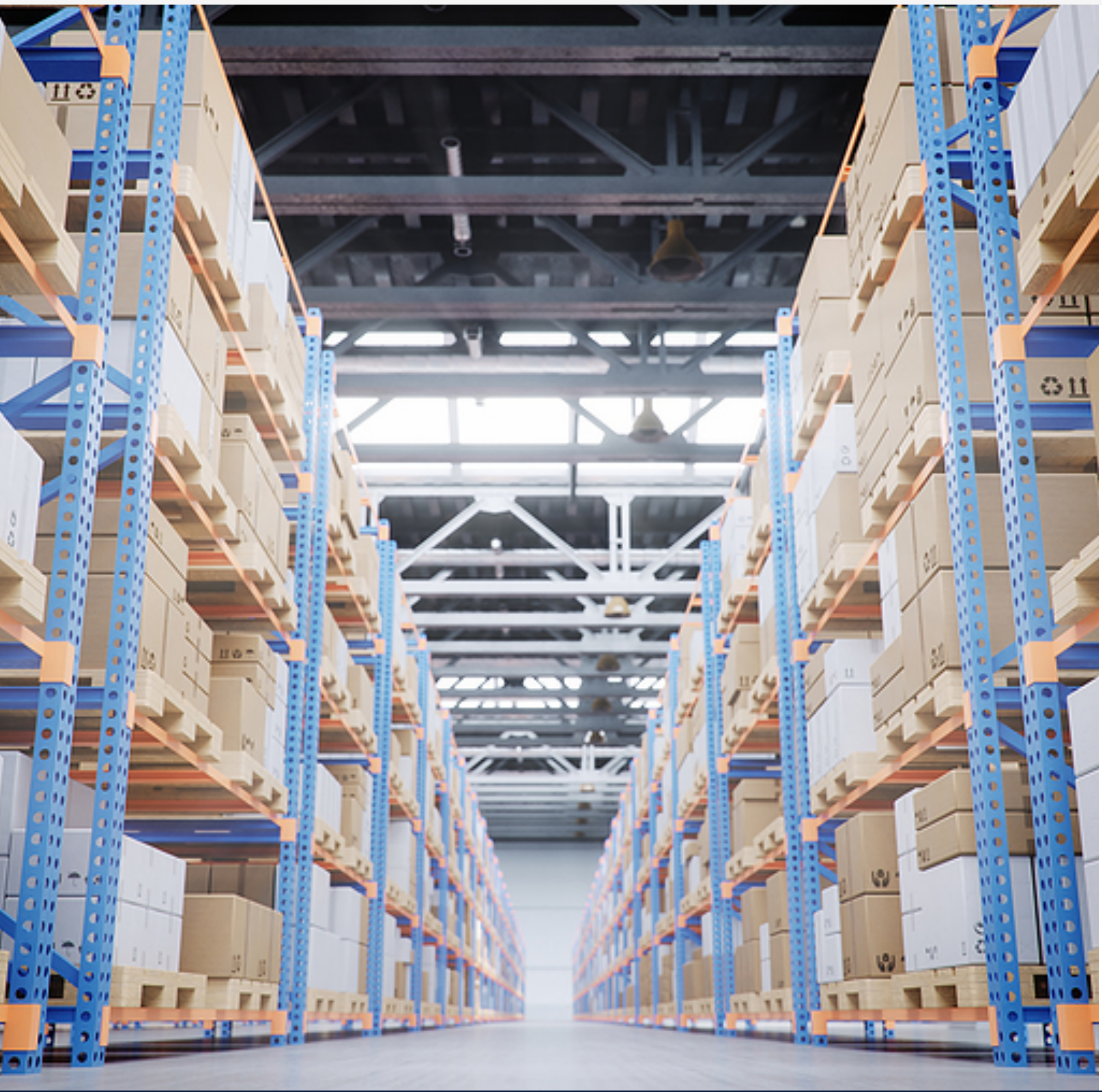
Inventory write-downs: Estimated costs to sell



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IAS 2 *Inventories* requires that items of inventory must be measured at the lower of cost or net realisable value. Net realisable value is determined as the estimated selling price in the ordinary course of business less the estimated costs of completion and estimated costs necessary to make the sale. The IFRS Interpretations Committee recently considered the meaning of 'estimated costs necessary to make the sale' in this context. This article provides a brief overview of the agenda decision and some practical considerations from the IFRIC staff paper.

IAS 2 *Inventories* ('IAS 2') requires that items of inventory must be measured at the lower of cost or net realisable value ('NRV'). One of the inputs to determine NRV is the estimated costs necessary to make the sale. The IFRS Interpretations Committee ('IFRIC') recently issued an agenda decision whether these estimated costs include all costs to sell or only additional (incremental) costs. This article provides a brief overview of the agenda decision.

The principle of inventory write-down

Items of inventory must be measured at the lower of cost or NRV. NRV is defined as:

> 'the estimated selling price in the ordinary course of business less the estimated costs of completion and estimated costs necessary to make the sale.'

The practice to write inventories down to their NRV reflects the principle that the carrying amount of an asset should not exceed the amount expected to be realised from its sale or use.

IAS 2 makes it clear that NRV is an entity specific value - in other words, the value that the specific entity expects to realised from the inventory in the ordinary course of its business from the specific purpose for which the entity holds that inventory. Write-downs may arise if the inventory has become obsolete for the entity, the selling prices have declined or the costs to make the sale have increased.

Estimated costs necessary to make the sale

IAS 2 does not provide any specific guidance on the type of costs to be included in the *estimated costs necessary to make the sale* that must be taken into account to determine NRV. The application question put to the IFRIC in this regard was whether these costs include all costs to needed to make the sale (the submission listed the cost of ordinary sales staff and advertising costs attributable to the inventory) or only additional or incremental costs (the submission provided the cost of a special promotion campaign as an example).

The IFRIC concluded that:

- IAS 2 does not explicitly limit the costs to incremental costs (unlike other standards that only refer to directly attributable or incremental costs).
- Applying a restrictive reading that excludes some of the costs involved in selling inventory in the ordinary course business could result in an entity failing to achieve the objective of inventory write-downs.

The agenda decision indicates that when determining the NRV of inventories, an entity estimates the costs necessary to make the sale in the ordinary course of business. An entity should use its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories.

Practical implications

An entity should develop a policy to determine costs to sell inventory items for purposes of determining NRV based on its business operations and distribution activities. In principle, these costs should not result in the recognition of future operating losses. If one considers the reasoning in the accompanying IFRIC staff paper, the policy should be developed to only reflect the effect of changes in conditions that have occurred during the reporting period. If the policy has the effect of accelerating the recognition of future operating losses, this may suggest that the costs taken into account contribute not only to the sale of the items in question but also to the sale of other items. In that case it is appropriate to only allocate a portion these costs as costs necessary to make the sale of the inventory items that are written down.

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