Educational material 8

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

Inventories

Issued 30 April 2020

Ref: #763282

CONTENTS

Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending on or after 31 December 2019.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This educational material does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Application of IAS 2 - Inventory write downs and net realisable value

This educational material sets out the financial reporting considerations arising from COVID-19 for inventory write downs and the impact on net realisable value in terms of IAS 2 paragraph 9.

Net realisable value 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 paragraph 6).

The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. Costs may also not be able to be recovered if production of these goods are unable to be completed or if during the WIP phase during lockdown, the condition of the (idle) goods may have eroded requiring more inputs post lock down. This may result in the WIP being potentially impaired too as a result of COVID-19. The practice of writing inventories down (impairing) below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use (IAS 2 paragraph 28).

Inventories are usually written down to net realisable value on an item by item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating 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. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment. (IAS 2 paragraph 29).

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or costs directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period (IAS 2 paragraph 30). In addition, IAS10 paragraph 9(b)(ii) provides clarity that information received after year end provides an indicator about impairment of the asset at the end of the period. With relevance to this guidance, the sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period. To determine whether the events linked to COVID-19 are adjusting or non- adjusting refer to SAICA's Educational Material 1 - *Application of IFRS Standards in Light of the Coronavirus Disease (Covid-19) Uncertainty - Events after the reporting period and Going Concern.*

Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices. Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts. Such provisions are dealt with under IAS 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 2 paragraph 31).

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value (IAS 2 paragraph 32).

A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist, or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write-down is reversed (ie the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realisable value. This occurs, for example, when an item of inventory that is carried at net realisable value, because its selling price has declined, is still on hand in a subsequent period and its selling price has increased (IAS 2 paragraph 33).

The impact of the declaration of a national lockdown on 23 March 2020 including the extended lockdowns as announced by the Government in South Africa, the local and global changes in the demand of the products due to various factors associated with COVID-19 and any further restrictions may impact the valuation of inventory. The assessment and determination of net realisable value of inventory could be impacted by various factors. The following factors may impact the net realisable value of inventory due to their impact on the estimated selling price and the costs to complete the products:

Factors that may impact costs of inventory:

- An increase in the costs of manufacturing of the inventory due to limited supply of the raw materials or having to source substitute materials.
- The costs of imported goods and raw materials may have increased due to adverse exchange rate movements. (For example the USD/ZAR has moved form $1/R15 in mid-March 2020 to $1/R19 mid-April 2020).
- An increase in the costs of bringing the inventories to locations due to limited transportation.
- The increase in abnormal costs due to expenses incurred during the lock down period such as labour (as businesses are expected to meet their obligations to employees in terms of regulations), rentals, storage, utilities during lock down.
- Wastage occurring due to production being interrupted or stopped where the manufacturing process had not completed during the production cycle.
- The allocation of fixed overhead costs may be affected by the unplanned shutdown or closure not previously being considered in estimating costs of inventory. For example, the normal production based on planned shutdown is 10 000 and the overhead costs of R150 000 will result in allocated costs of R15 per unit. Due to lockdown the production has reduced to 8 000 units which may result in allocation of R18.75, However, the entity should still have allocated the overheads of R15 and regard the difference as abnormal to be expensed directly.
- Consideration of the capitalisation of borrowing costs to the extent that the inventory is a qualifying asset and borrowing costs are capitalised, suspension of capitalisation of borrowing costs may be considered appropriate. To determine

whether capitalization of borrowing costs should be suspended, refer to SAICA's educational material 4 - *Application of IFRS Standards in light of the Coronavirus Disease (COVID-19) Uncertainty – Borrowing Costs IAS 23.*

Factors that may impact selling prices of inventory:

- Wastage due to items of inventory reaching their expiry date as a result of reduced/delayed sales during the lockdown or inventory becoming obsolete for whatever reason; and
- The post lockdown environment may indicate depressed prices for certain products resulting in selling prices not increasing in line with the increase in costs.

Therefore, an impact on net realisable value can occur due to increase in costs of inventory above the price for which the item can be sold or due to the items of inventory being damaged, becoming obsolete and the prices for which the item can be sold reducing below the costs incurred.

Disclosure requirements

IAS1 paragraph 98 requires separate disclosure of write downs of inventories to net realisable value as well as reversals of such write-downs. Further IAS 2 paragraph 36 provides guidance on the required disclosures for inventory write downs and reversals of such write downs.