

IFRS Developments

Costs necessary to sell inventories

What you need to know

- ▶ The IFRS IC has issued an agenda decision on what costs to include in determining the net realisable value of inventories.
- ▶ IAS 2 does not define 'costs necessary to sell inventories'.
 - ▶ Entities may not limit the costs to those that are only incremental. However, 'incremental' is not defined in IAS 2.
 - ▶ Judgement will be needed to estimate such costs and the specific facts and circumstances, including the nature of the inventory, should be considered.
- ▶ Entities may need time to reassess current policies.

Highlights

The International Financial Reporting Standards (IFRS) Interpretations Committee (the IFRS IC or the Committee) has issued an agenda decision on what costs to include when determining net realisable value (NRV) of inventories, in particular what costs are necessary to sell inventories under IAS 2 *Inventories*. On 23 June 2020, the International Accounting Standards Board (the IASB or the Board) agreed to publish the agenda decision in accordance with the new due process for agenda decisions.

The Committee was asked whether an entity includes all costs necessary to make the sale or only those that are incremental to the sale when determining the net realisable value of inventories in accordance with IAS 2. In considering this issue, the Committee agreed that, while the standard does not specify which costs to consider, an entity cannot limit the costs it includes to those that are only incremental (the incremental approach).

Entities will need to use judgement, considering the specific facts and circumstances (including the nature of inventories) to determine which of its costs are necessary to sell its inventories. Many entities currently have a policy of using incremental costs to estimate the costs necessary to sell inventories and will need to reassess their policies in light of the Committee's agenda decision.

Background

IAS 2 requires an entity to measure its inventories at the lower of cost and NRV. NRV is defined as "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".¹ While the standard provides detailed guidance on determining NRV, it does not specify or further define the "estimated costs necessary to make the sale".²

Without detailed requirements or guidance on which costs to include, entities need to apply judgement, which may include considering the nature of their products, sales channel (e.g., in-store, online) and industry. This has led to diversity in practice. Incremental costs are often the starting point before considering whether additional costs need to be included and, in some cases, entities may have only considered those costs that are incremental.

The Committee's conclusion

The Committee concluded that, when determining the NRV of inventories, the principles and requirements in IFRS provide an adequate basis for an entity to determine whether the estimated costs necessary to make the sale are limited to those that are incremental. In reaching this conclusion, the Committee noted that:

- ▶ The requirements in IAS 2 do not permit an entity to limit costs necessary to sell inventories to those that are only incremental, "thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale".³
- ▶ The objective of writing inventories down to their NRV is to avoid them being carried "in excess of amounts expected to be realised from their sale".⁴ The agenda decision states that were an entity to include only incremental costs, it could fail to achieve this objective.
- ▶ Judgement will be needed to determine which costs are necessary to sell inventories and an entity should consider the specific facts and circumstances, including the nature of the inventory.

How we see it

In effect, the incremental cost approach will no longer be permitted if it would exclude non-incremental costs that must be incurred to sell inventories. We do not think it would be possible to limit which other approaches might be considered appropriate, depending on the specific facts and circumstances. This is because IAS 2 does not specify which costs to consider.

There is a range of possibilities beyond the incremental cost approach: from direct costs at the point of sale (which might include, for example, a portion of the cost of internal sales staff or the cost of a special promotion campaign) to full costs (which might include costs such as depreciation or amortisation). Furthermore, within that range, direct costs at the point of sale may be quite similar to incremental costs. Which costs are considered necessary to sell inventories may vary by entity, depending on the nature of the inventories, the applicable industry, sales channel and cost structure. Given the judgement involved and the diverse business models of entities, the agenda decision is unlikely to eliminate all diversity, but may help to reduce it.

Agenda decisions do not add to, or change, existing IFRS Standards. Therefore, the guidance included in this agenda decision is immediately applicable, subject to entities having sufficient time to implement it. Entities may need time to reassess their current policies.⁵ Entities may need to explain their implementation process and, if material, consideration should be given as to whether disclosure related to the accounting policy change is required, taking into account regulatory requirements.

¹ IAS 2.6.

² See IAS 2.28-33.

³ Addendum to June 2021 *IFRIC Update*, available on the [IASB's website](#).

⁴ IAS 2.28.

⁵ For further discussion, refer to the article on the IASB's website: [IFRS - Feature: Agenda decisions—time is of the essence](#).

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