

# [The background and role of inventory in accounting](https://assignbuster.com/the-background-and-role-of-inventory-in-accounting/)

## Introduction

International accounting standard No. 2 (IAS2) “ Inventory” gives the rules which should be followed during the recording and presentation of inventory. Inventory refers to goods which are held by a firm for sale, are in the production process or are materials which will be consumed in the production process or in giving out of services. This standard does not apply to financial instruments and it gives out a guideline on how to measure an asset which is categorized as an inventory, which concept constitute of the cost and at what time an expense occurs and the information that should be disclosed while preparing the financial statements (International Accounting Standards Board, 2008, p. 977).

History

In the year 1974 during the draft of standard, the name was changed to “ inventories” from “ valuation and presentation of Inventories in the Context of the Historical Cost System” the first draft was affected on 1st of January in the year 1995 and this was 21 years after the first draft exposure. On 18th of December 2003, the standard was revised and took effect as from the strart of January 2005. In the year 2003, there was a revised IAS 2 whereby different cost formulas for inventories were incorporated into the standard. These were superseded from SIC 1 on consistency.

On December 1997, SIC 1 was issued and was effective as from 1st January 1999. sic 1 required that that the same cost formula was to be used for inventories with the same characteristics under IAS 2. 21 AND IAS 2. 23. in that case, different methods may be used where inventory items were different from other groups (International Accounting Standards Board, 2008, p. 978).

SIC stands for Standing International Committee (SIC), and it was renamed to International Financial Reporting Issues Committee (IFRIC). some of the issues in SIC were not added in IFRIC’s Agenda. This are as follows:

IAS 2 Cash Discounts

The question was whether cash discounts received should be subtracted from the cost of goods purchased. A decision was made in august of the year t 2002 that they should not be added. The reason given by IFRIC was that paragraph 8 of IAS 2 provided enough guidance and thus it was not necessary to publish on the interpretation on the issue.

IAS 2 Consumption of inventories by service organizations

The problem was on how to treat net realizable value when the inventory is consumed as part of the service rendered. A decision was made in the march of 2004 that it should not be added. It was noted that it existed for commercial bodies. It was thus concluded that the matter involved the recoverability of an asset which did not have a direct cash flow.

IAS 2 Discounts and rebates

In this part, three questions were considered, first, should the discount received for prompt payment of invoice be reduced from the cost of the inventories or seen as financing income? Second, should all other rebates be reduced from the cost of inventories or treat some of them as revenue or reduction in promotional expenses, lastly, if volume rebates should be given a recognition only when threshold volumes are achieved. The decision arrived at on November 2004 was not to add.

## Objective of IAS 2

IAS 2 has the objective of of prescribing how inventories should be treated in accounting. It provides a guideline on how to look for the cost of inventories and how to recognize an expense including any depreciation to net realizable value. It provides the formulas that should be used to assign costs to inventories. The conclusion is that, inventories should be measured at the lower between net realizable value and cost (Nikolai, Bazley, And Jones, 2009, p. 80).

Net realizable value refers to the estimated selling price in the course of normal business less the costs estimate for completing and the estimated costs required to finish the selling activity. The cost of inventory on the other hand shall comprise of all the costs of purchase, conversion in addition to other costs which are incurred in making the conditions to be in their present condition and into their present location.

The standards require that the first in first out method is used in assigning the cost of inventories or the weighted average method. The same cost formula should be used by a firm for all similar stock and stock that has the same use to the firm. Where the inventories might have different use or are of different nature, different cost formulas can be used (Nikolai, Bazley, And Jones, 2009, p. 80).

Where inventory is sold, the expenses incurred during the sale of the inventory shall be seen as an expense in that period when the expense occurred. Amount realized from any reversal of a write-down in inventories coming up from a rise in net realizable value shall be treated as a reduction in amount of inventories recognized as an expense in the time or period when that reversal took place.

## Rationale

The rationale for IAS 2 is to ensure that accounting for inventories is done in a manner which leads to the representation of the true value of the available inventory. It ensures that frequent research is done on how to present inventory in the financial statements.

Measurement, presentation and disclosure details

There are several items which need to be disclosed in the financial statements concerning inventory. One of the items that need to be disclosed includes the accounting policies that were adopted while giving value to the inventories. This includes the formula used to value the stock. In other words, the financial report should state whether first-in, first-out method was used or weighted average method was used. Secondly, the reports should show the total carrying amount for the inventories and they should be put into a classification which the entity feels fit. Thirdly, the carrying amount for the inventories that may be accounted for basing on their reasonable value minus the sale costs should also be clearly shown by the financial statement.

The fourth thing that should be disclosed is the level of inventories recognized as an expense in that certain period. Following this, the level of inventory write-downs which might have been seen as an expense in the financial period should be shown. After this, the level of reversals for the previous value write-downs which may have been achieved as a reduction in the amount of the expense on account of the period’s inventories. The activities which led to reversal should also be listed and finally, the carrying amount of inventories used as security for debt payment should also be shown (Barry and Eva, 2008, p. 27).

## Comparison with US GAAP (inventory)

As mentioned, IAS is an initioal for International Accounting Standards and it represents a set of accounting standards which are set by the international Accounting standards committee (IASC) which is in London, England. IASC has several bodies with the main one being the international Accounting Standards Board (IASB). IASB is responsible for setting standards for IASC. On the other hand, “ GAAP” is an acronomy for Generally Accepted Accounting Principles. IASC is not responsible for setting GAAP and it thus does not have any legal authority over it. IASC can be thus be seen as an influential body which makes accounting rules. Many people listen to what IASB and IASC say on accounting matters (Barry, Nach, and Bragg, 2009, p. 1337).

When an accounting rule is set by IASB, several countries consider the rule and adopt it into its accounting system. The rules thus will eventually influence of what each country adopts as its GAAP. To understand what GAAP is better, we can say that it is a set of rules which accountants follow in their countries as each country has its own GAAP. There are however not much differences in GAAP between countries although their interpretations may vary between different countries. In the United States, there is the Financial Accounting Standards Board (FASB), and this make up the rules which eventually become GAAP for the country.

## Example from annual reports

An example of an annual report which shows the usage of IAS 2 inventory is shown in the appendix. The report shows the consolidated financial statements for Prestige Brands Holdings, Inc. which is a distributor and marketer of brand name through the counter drug, personal and household products which are sold through Canada, U. S. and other international markets.

## Discussion

In the consolidated financial statements for the mentioned company, the first requirement for the IAS 2 has been met whereby the accounting policy that was used has been mentioned The reports states that the inventories have been stated at the lower of between the fair value and cost. The report has gone further to mention that the first-in, first-out method was used in valuing the inventory. The reports have explained that the company provides allowance for the goods which are slow moving and inventory which has become obsolete through the reduction of inventory for fall in value due to the obsolescence of products, damage and any other issues which might be affecting the marketability, equal to the difference that might exists between the cost of the inventory and its market value.

Another thing that the report discloses is the factors which have been utilized in the determination of estimated market value and they include; current sales data and historical return rates, the estimates for demand in future, the competitive pricing pressures, introduction of new production, expiration dates of products and obsolescence of components and packaging.