

# [Analysis of the international accounting standards on inventory](https://assignbuster.com/analysis-of-the-international-accounting-standards-on-inventory/)

This eassy mainly introduced the information about the International Accounting standards of Inventory(IAS 2). First, we introduced the background of the IAS 2; then we discussed the major requirements of the standards and the importance of these requirements; after that we critically evaluate the IAS 2.

## Background

The IASs, International Accounting Standards, which issued with the IASC setting up in 1973, are the common standards followed by accountancy bodies. Then, the IASB with new accounting standards (IFRS) and more member countries was founded to replace the IASC. Both of the two committees concerned with the regulation improvement and global harmonisation of international accounting.

Inventory valuation plays a vital role in the profit calculation and assets valuation process. However, method differences and controversy still exist in stock valuation among different companies. In terms of that, a consistent benchmark seems necessary to eliminate them and compare companies’ profit on the same basis. IAS 2 is such an international standard to offer regulation and method for inventory. Its first draft of Valuation and Presentation of Inventories came out in 1974, and was brought into the IAS one year later. The former standard of stock (IAS 2(1993)) set up in 1993 and it took effect on the date of January 1st 1995. Since IASB replaced of IASC, the modified version was published in 2003 and it took effect in 2005.

Aiming to obtain the accurate calculation result of cost and subsequently expense of inventory, IAS2 mainly concern with the write-down to Net Realizable Value. In order to allocate cost to stocks, it provides cost principle as well. To be more specific, IAS2 classifies that the inventory includes finished products, goods in process and raw material. Furthermore, it also contains measurement of inventory, fundamental principle of IAS2, write-down to Net Realizable Value, expense recognition and the required disclosures as well.

## Requirements and importance of IAS 2

There are many requirements of the inventories in International Accounting Standard, in terms of IAS 2 regulate how to analysis the cost of inventories, how to measure inventories, how to assign inventories etc.

The first requirement is that the cost of inventories is the total cost to deliver inventories to their present location and condition. According to IAS 2 (2005) “ cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.”

The second requirement of IAS 2 is that inventories should be measured at the lower of net realisable value and cost on an item by item basis

Once measured, the lower of net realisable value and cost must be used as an asset in the balance sheet. When the inventories’ net realizable value below its cost, it means that the future economic benefits will less than its carrying amount, which are brought to the companies by inventories. Therefore this part of the loss should be deducted from the value of assets, and included in accounting subjects of current profit and loss. Otherwise, there will be the phenomenon of virtual assets. Thus, we should use the lower of the net realisable value and cost in the stocktaking process.

The third requirement of IAS 2 is that the cost of inventories should be assigned by using the First-in First-out (FIFO) or weighted average cost formula unless there are some special inventories. IAS 2 does not require that the fairest possible approximation to the cost should be reflected by the formula used. Therefore, the Standard gives the FIFO, as well as the weighted average cost formula for free choice. Accounting to Wikipedia (2009), FIFO is an abstraction ways of organizing and manipulation of data relative to time and prioritization. This method describes the principle of what comes in first should be handled first, what comes in next waits until the first is finished. FIFO is the formula, which is frequently-used, to bear the cost of inventories which are out and which are still in. Weighted average cost formula is easier than others, also when the market price rising up or falling down, this formula is easy to calculate the average unit cost of inventories, in order to share the cost of inventory is more trade-offs and objective.

## Options

IAS 2 offers some optional rules for companies to choose. These options, to a certain extent, affect the internationally implement of IAS. The following essay will list three primary options.

Firstly, IAS 2 stipulates two alternative formulas for measuring the cost of inventories, which are first in, first out (FIFO) and weighted average. FIFO assumes that goods sold are those produced earlier. That is to say, the cost of inventories is those produced later. This approach may lead to underestimate cost and overestimate gross profit in the year of inflation. Weighted average is “ the average cost of all units currently in stock at the time of reporting”. (kcsi) IAS 2 is not mandatory for which formulas companies should choose. Obviously, these two optional formulas would measure different cost of inventories.

Secondly, IAS 2 stipulates that normally expenditure incurred is not recognized as cost of inventories. Nevertheless, IAS 2 supplies option of including some expense of inventories or not in the cost. For example, it is appropriate that non-productive indirect expense could be part of the cost of inventories if they are for special projects. Apart from that borrowing cost of inventories could be included in the cost under special circumstances.

Thirdly, there are two optional techniques in the inventories cost measurement, standard cost method and retail method. IAS 2 requests retail industry use retail method to measuring the cost of inventories. However, other industry could apply either retail or standard cost method, which may result in discrepancy between companies that use different methods.

## Applicability

At present, IAS 2 is widely implemented in Asia and Europe, while US GAAP plays a significant role in North America. This becomes a critical restriction factor of the applicability of IAS 2 internationally.

Most stock exchanges in the world incline that quote companies should treat IAS 2 as financial report benchmark. It could improve the transparency and reliability of inventories information if listed companies apply IAS 2.

Besides, more and more multinational corporations apply IAS 2 on their own, such as Air France, Nestle and Adidas. Owning to multinational corporations have companies in more than one country, it would be convenient for parent companies to consolidate statement if parent and subsidiary companies all implement IAS 2.

Although IAS 2 has been applied by most countries worldwide, during the process of applicability IAS 2 internationally, some deficiencies still have arisen inevitably. Take net realizable value as an example. IAS 2 prescribes it 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”(Birzeit Consulting). With regard to costs of completion and costs necessary to make the sale, IAS 2 does not list exact items, which implies lacking comparability between companies. The defects cause that some countries apply their own national accounting standard which are related to their national conditions.

Opportunities for creative accounting

The item “ inventory” plays a significant role in companies’ operation and financial performance since it is not only determines the computation of profit, but also impacts the valuation of assets which displayed on the balance sheet. IAS 2 probably is a comprehensive guidance which prescribes systematic accounting treatments for inventory in terms of the determination of inventory’s cost, the recognition of correlative expense, and the formulas for assigning costs to inventory. Despite the constraint of IAS 2, it is acknowledged that there are several stratagems for those unethical companies to manipulate their valuation of inventory, thereby expressing a fictitious favourable performance to the authorities and public.

A study from Committee of Sponsoring Organizations of the Treadway Commission (COSO) described that there is no area of accounting provides more opportunities for subjectivity and creative accounting than the valuation of inventory. More precisely, because of the close relationship between the inventories and revenues, companies often tend to inflate their revenues by overstating the value of inventories which is a direct and effective measure.

There are a number of approaches to manipulate the value of inventory and those methods are mainly categorized into three aspects which are time horizon, NRV and overhead.

Firstly, because IAS 2 do not have detailed guidance in respect of time dimension, companies usually like to employ tricks at the end of fiscal year by utilizing cut-off procedures. Assume that goods are delivered to a company at the last day of fiscal year 200X but the invoice date is at the first day of next fiscal year. In this situation, the company probably takes the goods into inventory immediately but not records the purchase invoice. The premature recording of inventory leads to the automatic increase of revenue which displays a false boost on the financial report. Furthermore, companies can falsify a transfer of non-existent inventory at the year-end which is difficult to confirm by auditors. Thus, the overstated value of inventory will generate from these fictitious “ in transit” inventories.

Secondly, IAS 2 adopted a specific method which is use the lower figure of net reliable value and cost to measure inventory. This measurement concerned the true value of inventory in a large extent and let this valuation reflects the real market appropriately; on the other hand, it also provides opportunities for frauds because the calculation of NRV is largely depends on accountants’ anticipations. More specifically, it is obvious that the extent of provisions should be reduce to NRV are highly subjective and manipulative. Just like Barry Elliott argued that a provision is an effective smoothing device and allows overcautious write-downs to be made in profitable years and consequent write-backs in unprofitable ones.

Thirdly, although IAS 2 provides guidelines for allocating appropriate overhead into the cost of inventory, the distinctions between diverse of overhead are still hardly to be distinguished exactly. Companies might find opportunities of manipulation and include those overhead which indirectly attributable to production in the inventory valuation, thereby differing the influence of overhead and so rising profits.

## Weaknesses and Improvement

Overall, the statements about the inventory at the International Accounting Standards (IAS) are understandable and comprehensive. However, it seems that problems still obviously exist in the inventory standards.

Firstly, the calculation methods for the same industry are not unified. Although IAS2 has cancelled LIFO method, two different methods are still available: FIFO and weighted average method. Different methods of calculation will produce different results. Thus, it makes no sense for the companies of the same industry to compare the ratio results. Therefore, the standard should be more detailed. First, it should select the most appropriate measurement based on the characteristics and nature of various industries. Second, it should be clearly defined that all the companies in the same industry should adopt the same measurement method. These two measures help to eliminate difference, and subsequently to promote development of harmonisation.

Secondary, it offers the opportunities for creative accounting. There are many cases about listed companies involved in the stock fraud, and the most famous one is the U. S. Fallmo’s case. Its creativer Monas first get a pharmacy located in Ohio, and in the subsequent decades, he acquired another 299 stores, then he formulated a company called Fallmo. Unfortunately, all of these brilliants are fraud based on the overestimation of the inventory. Such a fraud ultimately led to the bankruptcy of Monash and his company as well. At the same time, the “ Big Five” firm who provided audit services to it also lost millions of dollars. From these cases, it seems that fraud happened owing to the inadequate inventory management system. In order to prevent companies from cheating by inventory, the standards should require the audit firm to check the company’s inventories regularly.

The third one is that the International Accounting Standards failed to keep pace with the times process. With the development of enterprises, it generates a lot of new inventory management methods, such as the Just-In-Time (JIT) method. JIT originated from Toyoda in Japan, it was created by Sakichi Toyoda, the founder of Toyota, his son Kiichiro Toyoda and the engineer Taiichi Ohno. Toyota implemented the “ Kanban management” which runs with the physical. For example, when an order which includes the requirements of the delivery time is proposed, Toyota’s workers entered these information on the “ Kanban”. The ordering department get the ordering information through “ Kanban” and give the new order to the production department through “ Kanban”, and so forth; all orders will be connected to the entire department. Aiming to eliminate waste, reduce costs and improve economic efficiency, its core is to seek a non-stock production system or to minimize inventory production system. In that case, it is the reverse order of the traditional mode which product first then looking for customers. Although the demands of JIT are high, many companies have adopted this approach, such as Dell Inc. In the JIT, the “ zero inventory” is the main goal. Thus, the traditional methods such as FIFO and weighted average method lost the meaning of their existence, and the traditional fields of the closing stock inventory system and the perpetual inventory system also appears to be meaningless.