

HKAS 2
Revised October 2008 January 2010

Effective for annual periods beginning
on or after 1 January 2005

Hong Kong Accounting Standard 2

Inventories



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

COPYRIGHT

© Copyright 2011 Hong Kong Institute of Certified Public Accountants

This Hong Kong Financial Reporting Standard contains IFRS Foundation copyright material. Reproduction within Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and inquiries concerning reproduction and rights for commercial purposes within Hong Kong should be addressed to the Director, Finance and Operation, Hong Kong Institute of Certified Public Accountants, 37/F., Wu Chung House, 213 Queen's Road East, Wanchai, Hong Kong.

All rights in this material outside of Hong Kong are reserved by IFRS Foundation. Reproduction of Hong Kong Financial Reporting Standards outside of Hong Kong in unaltered form (retaining this notice) is permitted for personal and non-commercial use only. Further information and requests for authorisation to reproduce for commercial purposes outside Hong Kong should be addressed to the IFRS Foundation at www.ifrs.org.

Further details of the copyright notice form IFRS Foundation is available at <http://app1.hkicpa.org.hk/ebook/copyright-notice.pdf>

CONTENTS*paragraphs***INTRODUCTION****IN1-IN17****HONG KONG ACCOUNTING STANDARD 2
INVENTORIES**

OBJECTIVE	1
SCOPE	2-5
DEFINITIONS	6-8
MEASUREMENT OF INVENTORIES	9-33
Cost of inventories	10-22
Costs of purchase	11
Costs of conversion	12-14
Other costs	15-18
Cost of inventories of a service provider	19
Cost of agricultural produce harvested from biological assets	20
Techniques for the measurement of cost	21-22
Cost formulas	23-27
Net realisable value	28-33
RECOGNITION AS AN EXPENSE	34-35
DISCLOSURE	36-39
EFFECTIVE DATE	40-40Aa
WITHDRAWAL OF OTHER PRONOUNCEMENTS	41-42
<u>APPENDICESX:</u>	
<u>A</u>	Comparison with International Accounting Standards
<u>B</u>	Amendments to other pronouncements
<u>C</u>	<u>Amendments resulting from other HKFRSs</u>
BASIS FOR CONCLUSIONS	
TABLE OF CONCORDANCE	

Hong Kong Accounting Standard 2 *Inventories* (HKAS 2) is set out in paragraphs 1-42 and ~~the~~ Appendix C. All the paragraphs have equal authority. HKAS 2 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 2 *Inventories* (HKAS 2) replaces SSAP 22 *Inventories* (revised in 2001) and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 2

IN2 The objectives of the Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 2 were to reduce or eliminate alternatives, redundancies and conflicts within the Standards, to deal with some convergence issues and to make other improvements.

IN3 For HKAS 2 the HKICPA's main objective was to reduce alternatives for the measurement of inventories. The HKICPA did not reconsider the fundamental approach to accounting for inventories contained in HKAS 2.

The main features

IN4 The main features of HKAS 2 are described below.

Objective and scope

IN5 The words 'held under the historical cost system' included in the scope paragraphs of SSAP 22 were removed, to clarify that the Standard applies to all inventories that are not specifically excluded from its scope.

Scope clarification

IN6 The Standard clarifies that some types of inventories are outside its scope while certain other types of inventories are exempted only from the measurement requirements in the Standard.

IN7 Paragraph 3 establishes a clear distinction between those inventories that are entirely outside the scope of the Standard (described in paragraph 2) and those inventories that are outside the scope of the measurement requirements but within the scope of the other requirements in the Standard.

Scope exemptions

Producers of agricultural and forest products, agricultural produce after harvest and minerals and mineral products

IN8 The Standard does not apply to the measurement of inventories of producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established industry practices.

Inventories of commodity broker-traders

IN9 The Standard does not apply to the measurement of inventories of commodity broker-traders to the extent that they are measured at fair value less costs to sell.

Cost of inventories

Costs of purchase

IN10 HKAS 2 does not permit exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency to be included in the costs of purchase of inventories.

Other costs

IN11 Paragraph 18 was inserted to clarify that when inventories are purchased with deferred settlement terms, the difference between the purchase price for normal credit terms and the amount paid is recognised as interest expense over the period of financing.

Cost formulas

Consistency

IN12 [Not used]

Prohibition of LIFO as a cost formula

IN13 The Standard does not permit the use of the last-in, first-out (LIFO) formula to measure the cost of inventories.

Recognition as an expense

IN14 The Standard eliminates the reference to the matching principle.

IN15 The Standard describes the circumstances that would trigger a reversal of a write-down of inventories recognised in a prior period.

Disclosure

Inventories carried at fair value less costs to sell

IN16 The Standard requires disclosure of the carrying amount of inventories carried at fair value less costs to sell.

Write-down of inventories

IN17 The Standard requires disclosure of the amount of any write-down of inventories recognised as an expense in the period and eliminates the requirement to disclose the amount of inventories carried at net realisable value.

Hong Kong Accounting Standard 2

Inventories

Objective

- 1 The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

- 2 **This Standard applies to all inventories, except:**
- (a) **work in progress arising under construction contracts, including directly related service contracts (see HKAS 11 *Construction Contracts*);**
 - (b) **financial instruments (see HKAS 32 *Financial Instruments: Presentation* and HKAS 39 *Financial Instruments: Recognition and Measurement*); and**
 - (c) **biological assets related to agricultural activity and agricultural produce at the point of harvest (see HKAS 41 *Agriculture*).**
- 3 **This Standard does not apply to the measurement of inventories held by:**
- (a) **producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.**
 - (b) **commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.**
- 4 The inventories referred to in paragraph 3(a) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or minerals have been extracted and sale is assured under a forward contract or a government guarantee, or when an active market exists and there is a negligible risk of failure to sell. These inventories are excluded from only the measurement requirements of this Standard.

- 5 Broker-traders are those who buy or sell commodities for others or on their own account. The inventories referred to in paragraph 3(b) are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this Standard.

Definitions

- 6 **The following terms are used in this Standard with the meanings specified:**

Inventories are assets:

- (a) **held for sale in the ordinary course of business;**
- (b) **in the process of production for such sale; or**
- (c) **in the form of materials or supplies to be consumed in the production process or in the rendering of services.**

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.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

- 7 Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.
- 8 Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. In the case of a service provider, inventories include the costs of the service, as described in paragraph 19, for which the entity has not yet recognised the related revenue (see HKAS 18 *Revenue*).

Measurement of inventories

- 9 **Inventories shall be measured at the lower of cost and net realisable value.**

Cost of inventories

- 10 **The 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.**

Costs of purchase

- 11 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

Costs of conversion

- 12 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.
- 13 The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.
- 14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other costs

- 15 Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

- 16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
- (a) abnormal amounts of wasted materials, labour or other production costs;
 - (b) storage costs, unless those costs are necessary in the production process before a further production stage;
 - (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - (d) selling costs.
- 17 HKAS 23 *Borrowing Costs* identifies limited circumstances where borrowing costs are included in the cost of inventories.
- 18 An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

Cost of inventories of a service provider

- 19 To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

Cost of agricultural produce harvested from biological assets

- 20 In accordance with HKAS 41 *Agriculture* inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less ~~estimated point-of-sale costs~~ to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

Techniques for the measurement of cost

- 21 Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.
- 22 The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

Cost formulas

- 23 **The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.**
- 24 Specific identification of cost means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on profit or loss.
- 25 **The cost of inventories, other than those dealt with in paragraph 23, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.**
- 26 For example, inventories used in one ~~business-operating~~ segment may have a use to the entity different from the same type of inventories used in another ~~business operating~~ segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.
- 27 The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Net realisable value

- 28 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. The practice of writing inventories down 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.
- 29 Inventories are usually written down to net realisable value item by item. 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 ~~industry or geographical-operating~~ segment. Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item.

- 30 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 cost 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.
- 31 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 HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- 32 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.
- 33 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.

Recognition as an expense

- 34 **When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.**
- 35 Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

Disclosure

- 36 **The financial statements shall disclose:**
- (a) **the accounting policies adopted in measuring inventories, including the cost formula used;**
 - (b) **the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;**
 - (c) **the carrying amount of inventories carried at fair value less costs to sell;**
 - (d) **the amount of inventories recognised as an expense during the period;**
 - (e) **the amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 34;**
 - (f) **the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34;**
 - (g) **the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34; and**
 - (h) **the carrying amount of inventories pledged as security for liabilities.**
- 37 Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may be described as work in progress.
- 38 The amount of inventories recognised as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs.
- 39 Some entities adopt a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

Effective date

- 40 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact.

- 40~~a~~A If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

Withdrawal of other pronouncements

- 41 This Standard supersedes SSAP 22 *Inventories*, revised in 2001.
- 42 [Not used]

Appendix A

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 9 March 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 2.

The International Accounting Standard comparable with HKAS 2 is IAS 2 *Inventories*.

There are no major textual differences between HKAS 2 and IAS 2.

Appendix B

Amendments to other pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments shall be applied for that earlier period

* * *

The amendments contained in this appendix when this Standard was issued have been incorporated into the relevant Standards.

Appendix C

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted. In the amended paragraphs shown below, new text is underlined and deleted text is struck through.

HKFRS 9 *Financial Instruments* (issued in November 2009) - effective for annual periods beginning on or after 1 January 2013

Paragraph 2(b) is amended and paragraph 40A added as follows:

- 2** This Standard applies to all inventories, except:
- ...
- (b) **financial instruments (see HKAS 32 *Financial Instruments: Presentation*, ~~and~~ HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 9 *Financial Instruments*); and**
- ...
- 40A** HKFRS 9, issued in November 2009, amended paragraph 2(b). An entity shall apply that amendment when it applies HKFRS 9.

Basis for Conclusions on HKAS 2 Inventories

This Basis for Conclusions accompanies, but is not part, of HKAS 2.

HKAS 2 is based on IAS 2, *Inventories*. In approving HKAS 2, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 2 (as revised 2003). Accordingly, there are no significant differences between HKAS 2 and IAS 2. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 2 referred to below generally correspond with those in HKAS 2.

Introduction

- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 2 *Inventories* in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 2. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.
- BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for inventories established by IAS 2, this Basis for Conclusions does not discuss requirements in IAS 2 that the Board has not reconsidered.

Scope

Reference to historical cost system

- BC4 Both the objective and the scope of the previous version of IAS 2 referred to 'the accounting treatment for inventories under the historical cost system.' Some had interpreted those words as meaning that the Standard applied only under a historical cost system and permitted entities the choice of applying other measurement bases, for example fair value.
- BC5 The Board agreed that those words could be seen as permitting a choice, resulting in inconsistent application of the Standard. Accordingly, it deleted the words 'in the context of the historical cost system in accounting for inventories' to clarify that the Standard applies to all inventories that are not specifically exempted from its scope.

Inventories of broker-traders

- BC6 The Exposure Draft proposed excluding from the scope of the Standard inventories of non-producers of agricultural and forest products and mineral ores to the extent that these inventories are measured at net realisable value in accordance with well-established industry practices. However, some respondents disagreed with this scope exemption for the following reasons:
- (a) the scope exemption should apply to all types of inventories of broker-traders;
 - (b) established practice is for broker-traders to follow a mark-to-market approach rather than to value these inventories at net realisable value;
 - (c) the guidance on net realisable value in IAS 2 is not appropriate for the valuation of inventories of broker-traders.
- BC7 The Board found these comments persuasive. Therefore it decided that the Standard should not apply to the measurement of inventories of:
- (a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value (as in the previous version of IAS 2), or
 - (b) commodity broker-traders when these inventories are measured at fair value less costs to sell.
- BC8 The Board further decided that the measurement of the effect of inventories on profit or loss for the period needed to be consistent with the measurement attribute of inventories for which such exemption is allowed. Accordingly, to qualify under (a) or (b), the Standard requires changes in the recognised amount of inventories to be included in profit or loss for the period. The Board believes this is particularly appropriate in the case of commodity broker-traders because they seek to profit from fluctuations in prices and trade margins.

Cost formulas

- BC9 The combination of the previous version of IAS 2 and SIC-1 *Consistency—Different Cost Formulas for Inventories* allowed some choice between first-in, first-out (FIFO) or weighted average cost formulas (benchmark treatment) and the last-in, first-out (LIFO) method (allowed alternative treatment). The Board decided to eliminate the allowed alternative of using the LIFO method.
- BC10 The LIFO method treats the newest items of inventory as being sold first, and consequently the items remaining in inventory are recognised as if they were the oldest. This is generally not a reliable representation of actual inventory flows.
- BC11 The LIFO method is an attempt to meet a perceived deficiency of the conventional accounting model (the measurement of cost of goods sold expense by reference to outdated prices for the inventories sold, whereas sales revenue is measured at current prices). It does so by imposing an unrealistic cost flow assumption.

- BC12 The use of LIFO in financial reporting is often tax-driven, because it results in cost of goods sold expense calculated using the most recent prices being deducted from revenue in the determination of the gross margin. The LIFO method reduces (increases) profits in a manner that tends to reflect the effect that increased (decreased) prices would have on the cost of replacing inventories sold. However, this effect depends on the relationship between the prices of the most recent inventory acquisitions and the replacement cost at the end of the period. Thus, it is not a truly systematic method for determining the effect of changing prices on profits.
- BC13 The use of LIFO results in inventories being recognised in the balance sheet at amounts that bear little relationship to recent cost levels of inventories. However, LIFO can distort profit or loss, especially when 'preserved' older 'layers' of inventory are presumed to have been used when inventories are substantially reduced. It is more likely in these circumstances that relatively new inventories will have been used to meet the increased demands on inventory.
- BC14 Some respondents argued that the use of LIFO has merit in certain circumstances because it partially adjusts profit or loss for the effects of price changes. The Board concluded that it is not appropriate to allow an approach that results in a measurement of profit or loss for the period that is inconsistent with the measurement of inventories for balance sheet purposes.
- BC15 Other respondents argued that in some industries, such as the oil and gas industry, inventory levels are driven by security considerations and often represent a minimum of 90 days of sales. They argue that, in these industries, the use of LIFO better reflects an entity's performance because inventories held as security stocks are closer to long-term assets than to working capital.
- BC16 The Board was not convinced by these arguments because these security stocks do not match historical layers under a LIFO computation.
- BC17 Other respondents argued that in some cases, for example, when measuring coal dumps, piles of iron or metal scraps (when stock bins are replenished by 'topping up'), the LIFO method reflects the actual physical flow of inventories.
- BC18 The Board concluded that valuation of these inventories follows a direct costing approach where actual physical flows are matched with direct costs, which is a method different from LIFO.
- BC19 The Board decided to eliminate the LIFO method because of its lack of representational faithfulness of inventory flows. This decision does not rule out specific cost methods that reflect inventory flows that are similar to LIFO.
- BC20 The Board recognised that, in some jurisdictions, use of the LIFO method for tax purposes is possible only if that method is also used for accounting purposes. It concluded, however, that tax considerations do not provide an adequate conceptual basis for selecting an appropriate accounting treatment and that it is not acceptable to allow an inferior accounting treatment purely because of tax regulations and advantages in particular jurisdictions. This may be an issue for local taxation authorities.
- BC21 IAS 2 continues to allow the use of both the FIFO and the weighted average methods for interchangeable inventories.

Cost of inventories recognised as an expense in the period

- BC22 The Exposure Draft proposed deleting paragraphs in the previous version of IAS 2 that required disclosure of the cost of inventories recognised as an expense in the period, because this disclosure is required in IAS 1 *Presentation of Financial Statements*.
- BC23 Some respondents observed that IAS 1 does not specifically require disclosure of the cost of inventories recognised as an expense in the period when presenting an analysis of expenses using a classification based on their function. They argued that this information is important to understand the financial statements. Therefore the Board decided to require this disclosure specifically in IAS 2.

Table of Concordance

This table shows how the contents of the superseded SSAP 22 and the current HKAS 2 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded SSAP 22 paragraph	Current HKAS 2 paragraph
Introduction	1
1	2,3
2	4
3	6
4	8
5	9
6	10
7	11
8	12
9	13
10	14
11	15
12	16
13	17
14	19
15	21
16	22
17	23
18	24
19	25

Superseded SSAP 22 paragraph	Current HKAS 2 paragraph
20	27
21	28
22	29
23	30
24	31
25	32
26	33
27	34
28	None
29	35
30	36
31	37
32	36
33	38
34	39
35	None
36	40
37	None
None	3
None	5
None	7
None	18
None	20
None	25, 26
None	41
None	42