IAS 2: Cost Necessary to Sell Inventories

Extract, IFRS® Discussion Group Report on the Meeting – September 22, 2021

On June 25, 2021, the IFRS Interpretations Committee (the Interpretations Committee) published the Agenda Decision, "*Costs Necessary to Sell Inventories (IAS 2 Inventories),"* addressing which costs an entity includes as part of "estimated costs necessary to make the sale" when determining the net realizable value of inventories.

The Agenda Decision includes the following key points:

- IAS 2 *Inventories* defines "net realizable value" 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.** [Emphasis added]"
- Paragraphs 28-33 of IAS 2 include further requirements about how an entity estimates the net realizable value of inventories. Those paragraphs do not identify which specific costs are 'necessary to make the sale' of inventories. However, paragraph 28 of IAS 2 describes the objective of writing inventories down to their net realizable value – which is to avoid inventories being carried "in excess of amounts expected to be realised from their sale."
- The Interpretations Committee observed that, when determining the net realizable value of inventories, IAS 2 requires an entity to estimate the costs necessary to make the sale. This requirement **does not allow** an entity to limit such costs to those that are incremental. Including only incremental costs could fail to achieve the objective set out in paragraph 28 of IAS 2.
- The Interpretations Committee concluded that, when determining the net realizable value of inventories, an entity estimates the costs necessary to make the sale in the ordinary course of business. An entity uses its judgment to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories.

Although this Agenda Decision is clear that the entity cannot use an incremental cost approach when determining costs necessary to make the sale, it is unclear as to what additional costs should be considered. As a result, the Group considered the following Fact Pattern and discussed two issues related to applying this Agenda Decision:

1. When determining net realizable value, what are the incremental costs necessary to make the sale?
2. What costs, other than incremental costs, should be considered when determining the costs necessary to make the sale?

Fact Pattern

- Company A is a sporting goods retailer operating several retail stores in Canada. The inventory the company orders is shipped directly from the supplier to each store. The store premises are leased under long-term leases. The company does not sell merchandise online.
- Every store has a store manager, sales staff and a security guard. All sales staff are paid a fixed monthly salary. In addition, sales staff can earn a sales commission if certain products are sold. To sell slow-moving merchandise, the Company may offer point-of-sale discounts. It also undertakes marketing campaigns to promote the sale of specific products.
- At the reporting date, Company A determined that a large proportion, but not all, of the entity's inventory may not be recoverable because selling prices have declined. Accordingly, the company needs to determine the net realizable value of such inventory. In accordance with IAS 2, the company writes inventory down to the lower of cost and net realizable value on an item-by-item basis.

Issue 1: When determining net realizable value, what are the incremental costs necessary to make the sale?

Analysis

Based on the Agenda Decision, when considering "the estimated costs necessary to make the sale", it would be appropriate to start with incremental costs. Although neither the Agenda Decision nor IAS 2 defines the term "incremental costs", other IFRS Standards used the term to refer to costs that would not have been incurred if the entity had not entered a transaction. For example, paragraph 92 of IFRS 15 *Revenue from Contracts with Customers* states: "The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission)."

In the context of selling inventory, an incremental cost is one that would not be incurred if a particular sale did not occur. Therefore, a sales commission would be considered an incremental cost. In contrast, a point-of-sale discount would not be considered an incremental cost but would be factored into determining the estimated selling price when calculating net realizable value. The costs of a marketing campaign aimed at selling specific products would also not be considered an incremental cost as the cost would be incurred even if no product is sold under the campaign – that is, it is not incremental to a particular sale.

The Group's Discussion

Group members agreed with the analysis.

Issue 2: What additional costs, other than incremental costs, should be considered when determining the cost necessary to make the sale?

The Agenda Decision is clear that when determining the costs necessary to make the sale, an entity is not permitted to limit such costs to only those that are incremental. Therefore, incremental costs

are but one mandatory element of the costs necessary to make the sale. However, an entity should also determine what additional costs are necessary to make the sale.

Question 1: When determining the "costs necessary to make the sale", should an entity include direct costs necessary to make the sale?

Analysis

It would be appropriate to include some form of direct costs when determining costs necessary to make a sale. IFRS Standards do not define what a "direct cost" is. Nevertheless, in this Fact Pattern, a "direct cost" may be considered a cost that is directly related to the selling activity or is a directly attributable cost necessary to be incurred to sell Company A's products.

When identifying direct costs, the entity should consider the nature of its inventories, the sales channels it uses to sell products (e.g. store, online) and its cost structure. Examples of direct costs may include:

(a) costs incurred by sales staff to sell inventory;

(b) agency costs to sell inventory;

(c) costs of a specific marketing campaign to sell inventory; and

(d) transportation costs.

Given the lack of specificity in the guidance, one might consider several categories of direct costs as costs necessary to make the sale:

Category A – Direct costs related to the selling activity, incurred only at the point of sale.

Inclusion of these costs is supported by interpreting the words "costs necessary to **make** the sale" (emphasis added) as meaning those costs an entity must incur when the sale is executed (i.e., at the point of sale).

For example, if sales staff are required to sell inventory, the costs relating to the amount of time sales staff spend executing the sale (i.e., at the point of sale) would be considered a direct cost necessary to make the sale. It is directly related to the selling activity and is incurred at the point of sale. Another example of a direct cost incurred at the point of sale is the costs of packaging (e.g., bags, boxes, etc.).

Category B – Direct costs related to the selling activity, leading up to the point of sale, but excluding the point of sale.

Inclusion of these costs is supported by a broader interpretation of the words "costs necessary to **make** the sale" as being all the direct selling costs an entity must incur leading up to the point of sale.

For example, the costs would include time sales staff spent on all key steps necessary for a sale to occur (e.g., displaying product, marking down product, answering customers' questions and helping

customers select product).

Category C – Direct attributable costs necessary for inventory to be sold.

These directly attributable costs are not directly related to the selling activity but are necessary to incur for inventories to be sold.

For example, the costs of a marketing campaign directed at selling specific product would be considered a directly attributable cost because it is incurred for specific inventory to be sold. In addition, the costs to transport merchandise from one store to another store so that it is more readily available to customers would be considered a directly attributable cost as it would be a cost necessary for the sale of the product to occur.

The Group considered the following views as to which categories of direct costs should be included in determine the "costs necessary to make the sale":

View 1A: Category A costs only;

View 1B: Categories A and B costs;

View 1C: Categories A, B and C costs;

View 1D: Categories A and C costs; and

View 1E: other views

The Group's Discussion

Most Group members thought any combinations of Categories A, B, and C could be considered as costs necessary to make the sale, depending on an entity's facts and circumstances.

With that said, several Group members noted that to be included in costs necessary to make a sale, direct costs should have a clear and direct link to the inventory being sold. They observed that when assessing the link between the cost and inventory, the entity should consider various factors such as the nature of the inventory sold, the industry, and its own circumstances. Among the three categories, some Group members noted that Category A costs represent the most direct link to the inventories. Whereas, Category B and C costs would require more judgment to conclude that a direct link exists between these costs and the inventories sold. One Group member observed that operationally, following View 1C (i.e. Category A, B, and C costs) to allocate costs to inventory sold can be quite onerous and complex.

Some Group members focused on the definition of net realizable value in IAS 2 that considers "costs **necessary** to make the sale" and wording used in the Agenda Decision that specifies "costs the entity **must incur** to sell its inventories" when determining the net realizable value of inventories. (Emphasis added.) They thought that for costs to be considered necessary they would need to be unavoidable from the perspective of making the sale.

Question 2: Are the direct costs and directly attributable costs necessary to make the sale required to be allocated to all inventory?

Analysis

The direct costs and directly attributable costs are not required to be allocated to all inventory, only to the inventory for which the net realizable value is required to be determined.

In accordance with paragraph 28 of IAS 2, net realizable value is required to be determined for inventories for which the cost may not be recoverable. This may be due to damage, obsolescence, declining sales prices or an increase in the estimated costs of completion or the estimated costs to be incurred to make the sale.

If the costs necessary to make the sale contribute to the sale of other inventory items as well as those for which the net realizable value is being determined, the entity would allocate a portion of the total cost to the inventories in question. For example, if the marketing campaign was aimed at selling inventory whose selling price has declined as well as other inventory, the entity would determine the proportion of the marketing campaign costs relating to the inventory whose selling price has declined and allocate that portion of the costs to such inventory.

The Group's Discussion

Group members agreed with the analysis.

Some Group members observed that in practice, the allocation of the costs to inventories described in the analysis can be complex and subjective. Therefore, significant judgement and estimation by management may be required.

Question 3: When determining the costs necessary to make the sale, is the entity required to include an allocation of indirect costs?

Indirect costs would generally refer to costs that are not directly related to the sale of inventory but are incurred to facilitate the sale of inventory.

Examples of indirect costs would include a portion of the:

(a) store manager's costs

(b) head office costs for the merchandising/sales department

(c) depreciation for the store (e.g., store, fixtures)

(d) store operating costs (e.g., heat, light, security)

(e) general advertising and marketing costs for the company

View 3A – Yes, indirect costs are required to be included.

Proponents of this view think that in determining costs "necessary to make the sale", an entity should include an allocation of indirect costs related to the selling effort. The indirect costs are

"necessary to make the sale" of inventory as they facilitate the sale even though they are not tied to the sale of any inventory. In fact, these costs may be incurred even if the store is closed and no inventory is sold.

Proponents of this view note that to comply with the objective in paragraph 28 of IAS 2 that inventories "should not be carried in excess of amounts expected to be realised from their sale or use," a portion of these indirect costs should be allocated to the individual items of inventory when determining their net realizable value.

View 3B – No, indirect costs are not required to be included.

Proponents of this view think these costs are not necessary to make the sale because they are not costs directly associated with the sale of any specific inventory.

In addition, proponents of this view note the tentative Agenda Decision was amended from "… an entity includes **all** costs necessary to make the sale in the ordinary course of business" to "an entity estimates **the** costs necessary to make the sale" in the final Agenda Decision. (Emphasis added.) While not explicit, proponents of this view interpret the amendment as support that an entity would not be required to include indirect costs in determining the costs necessary to make the sale.

Proponents of this view also question the interaction between IAS 2 and IAS 36 *Impairment of Assets* and whether the allocation of depreciation (or the carrying amount of a long-lived asset) should factor into the net realizable test for inventory when such asset is tested for impairment under IAS 36.

The Group's Discussion

Group members supported View 3B. Some Group members noted that costs necessary to make the sale refers to the sale of specific inventories. Therefore. since indirect costs are not associated with the sales under consideration, they should not be included in the cost necessary to make the sale.

Question 4: What key steps should an entity consider when implementing this Agenda Decision?

Analysis

The entity should start with reviewing its existing accounting policy for measuring the net realizable value of inventories and determine:

(a) Which types of costs have been identified as the "costs necessary to make the sale"?

(b) Are the costs limited to "incremental costs" only?

(c) Are there non-incremental costs that are necessary to make the sale that should also be included in the determination of the "costs necessary to make the sale"?

(d) In determining the "costs necessary to make the sale", has the entity considered the nature of its inventories, the sales channels used, and other relevant factors?

Given the judgment involved in determining the costs necessary to make the sale, the entity is encouraged to start the process early and engage with its auditors.

If the entity concludes that its accounting policy does not comply with the Agenda Decision, for example, because it excluded non-incremental costs that are necessary to make the sale when determining net realizable value, the entity needs to change its accounting policy. Any change in accounting policy is required to be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The Agenda Decision is effective for financial statements with reporting periods ending on or after June 25, 2021, subject to entities having "sufficient time" to implement an Agenda Decision. Entities should refer to the IASB article, "Agenda decisions – time is of the essence" and Sections 8.2-8.7 in its Due Process Handbook for guidance on the timely implementation of Agenda Decisions.

Where the impacts of the Agenda Decision are still being analyzed and may be significant, entities should consider applying the requirements in paragraphs 30-31 of IAS 8 to disclose information on the expected timing and the possible impact that applying the Agenda Decision will have on the entity's financial statements.

The Group's Discussion

Group members agreed with the analysis. One Group member commented that given the judgment involved in determining costs to be included in the costs necessary to make a sale in some industries, entities should disclose significant judgments made in the process of applying their accounting policies in accordance with paragraph 122 of IAS 1 *Presentation of Financial Statements*.

One Group member observed that an entity in the agricultural industry may recognize a "day-one loss" when applying this Agenda Decision to measure agricultural inventory after harvest. This is because IAS 41 *Agriculture* requires agricultural produce to be measured at its fair value less costs to sell at the point of harvest, which are limited to incremental costs. When these products are reclassified as inventories, the net realizable value may be lower. As a result, the inventory may have to be written down to the net realizable value. Another Group member noted that this issue was also raised by some respondents in their comment letters to the tentative agenda decision. The description of this issue and the IASB technical staff's analysis are included in the agenda paper for the June 2021 Interpretations Committee meeting.

The Group's discussion of these issues raises awareness about the Interpretations Committee's agenda decision on which costs an entity includes in estimated costs necessary to make a sale. No further action was recommended to the AcSB.