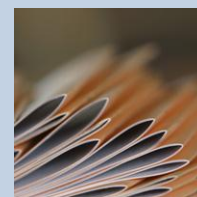


# Inventory (Section 3031)



## New Guidance on the Measurement and Disclosure of Inventories

New Section 3031 – Inventories, replaces former Section 3030 of the same name. Effective for interim and annual periods beginning on or after January 1, 2008, the section significantly enhances generally accepted accounting principles related to inventory and effectively aligns Canadian principles with those followed under international standards.

Specifically, the new section requires inventories to be measured at the lower of cost and net realizable value, and provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. The standard also provides guidance on the cost formulas used to assign costs to inventories.

### Scope

The new standards are applicable to all inventories except for contracts accounted for using the percentage of completion method, financial instruments, and contributions not recognized by not-for-profit organizations. Specific scope exemptions from the measurement requirements only, are provided for certain biological assets, producers of agricultural and mineral products, and commodity broker-traders.

### Measurement at lower of cost and net realizable value (NRV)

The requirement in Section 3031 to measure inventories at the lower of cost and NRV may result in a significant change in practice for some entities. 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



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the sale. While many entities traditionally utilize a "lower of cost and market" approach, the term "market" does not always translate into "net realizable value", and may be more representative of current replacement cost or some other fair value measurement.

Of particular interest is the **new requirement to reverse previous write-downs** of inventory items when the NRV of those items subsequently recovers. Hence a new carrying amount is established at the lower of cost and the revised NRV.

### **Cost of inventories**

Section 3031 provides extensive guidance on what should and should not be included in the cost of inventories. All costs of purchase, costs of conversion and other costs (including interest in some cases) incurred in bringing the inventories to their present location and condition should be included. Of particular note is the requirement to allocate fixed overheads on the basis of "normal capacity" of production.

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. As a result of the requirement to use 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 and any unallocated overheads are recognized 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.

The following costs would not be included in the cost of inventory, but rather expensed during the period:

- abnormal amounts of wasted materials, labour or other production costs;
- storage costs, unless those costs are necessary in the production process before a further production stage;
- administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- selling costs.

The standard also discusses the appropriateness of utilizing the standard cost method or retail method to approximate cost.

### **Cost formulas**

Gone forever is the "last-in, first-out" (LIFO) method of assigning costs to inventories. Depending on the nature of an entity's inventories, the acceptable formulas include the first-in, first-out (FIFO), weighted average, or specific identification of cost methods. Furthermore, an entity should use the same cost formula for similar types of inventory.

### **Disclosure**

As Canadian accounting standards are converged with their international counterparts, so too are their disclosure requirements and the trend of increasing disclosure requirements can be seen in new Section 3031. Now required is the disclosure of inventory measurement and costing policies, carrying amounts, amounts recognized in expense, the amount and details of write-downs and the reversals of write-downs. As mentioned in the scope discussion at the beginning of this publication, certain biological assets, producers of agricultural and mineral products, and commodity broker-traders are exempted from the measurement standards of Section 3031; however, readers should note that the carrying amounts of such inventories must be disclosed in the financial statements.

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### **Guidance for Not-for-Profit Organizations (NPOs)**

To remain consistent with the revenue recognition accounting for those organizations that choose to record contributed materials and services, the cost of contributed inventories should be accounted for at fair value on the date of the contribution.

Some NPOs may hold inventories for distribution at little or no charge, or for consumption in the production of goods to be distributed at little or no charge. These types of inventories are measured at the lower of cost and current replacement cost instead of at the lower of cost and NRV. Replacement cost better reflects the future economic benefits or service potential of such inventory to the NPO than NRV.

### **Transitional Provisions**

On adoption of Section 3031, an entity has two options. It may apply this section to opening inventory and adjust opening retained earnings by the difference in the measurement of opening inventory (i.e. prior periods are not restated); or it may apply the section retrospectively and restate prior periods.