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Regulation of the Ministry of Finance on the
"Establishment of the Guidelines of the Accounting Standards Board"
Note 4
In force from: 01.01.2018
Applicable to the accounting periods, starting on 01.01.2017 or later.

# ASBG 4 INVENTORIES

| **TABLE OF CONTENTS** | **clauses** |
|---|---|

## OBJECTIVE AND BASIS FOR PREPARARTION

**1.** The objective of this Accounting Standards Board's guideline ASBG 4 "Inventories" is to prescribe the rules for the accounting for inventories in the financial statements prepared in accordance with the Estonian financial reporting standard (hereinafter also *the financial statement*). Estonian financial reporting standard is a body of financial reporting requirements directed at the public and based on the internationally accepted accounting and reporting principles, which principal requirements are established by the Accounting Act and which is specified by a regulation of the minister responsible for the area established on the basis of subsection 34 (4) of the Accounting Act (hereinafter *guideline of the Standards Board* or for short *ASBG*).

**2.** ASBG 4 is based on IFRS for SMEs, sections 13 "*Inventories*", 25 "*Borrowing Costs*" and 27 "*Impairment of Assets*" and on concepts defined in section 2 "*Concepts and Pervasive Principles*". The guideline contains references to the specific paragraphs of IFRS for SMEs that the requirements of the guideline are based on. The comparison of ASBG 4 with IFRS for SMEs is presented in clause 24. In areas where ASBG 4 does not specify a particular accounting policy but that are covered by IFRS for SMEs, it is recommended to abide by the accounting policy described in IFRS for SMEs.

## SCOPE

**3.** ***ASBG 4 "Inventories" shall be used to account for and report inventories in the financial statements.***

**4.** ASBG 4 shall not be used for the accounting for biological assets (see ASBG 7 "Biological Assets"), for the accounting for financial instruments held for sale (see ASBG 3 "Financial Instruments"), nor for the accounting for unfinished projects arising from long-term service agreements (see ASBG 10 "Revenue Recognition").

## DEFINITIONS

**5.** ***The following terms are used in this guideline with the meanings specified:***

***<u>Inventories</u> are assets:***

> **(A)** ***held for sale in the ordinary course of business;*****(b)** ***in the process of production for sale in the ordinary course of business;*****(c)** ***in the form of materials or supplies to be consumed in the production process or for rendering services. (IFRS for SMEs 13.1).***

***<u>Cost</u> is either cash or the fair value of non-monetary consideration given to acquire an asset at the time of its acquisition or processing. (IFRS for SMEs 2.34 (a)).***

***<u>Fair value</u> is the amount for which assets could be exchanged or liabilities settled in a transaction between knowledgeable, willing and independent parties in an arm's length transaction. (IFRS for SMEs 2.34 (b)).***

***<u>Net realisable value</u> is the estimated selling price of a product in the ordinary course of business less the estimated costs of completion and those necessary to make the sale.***

**6.** In addition to the goods bought for sale, materials, unfinished and finished goods, inventories also include such items as equipment held for sale and real estate. Inventories also include the capitalised expenses directly related to providing services on which revenue cannot yet be recognised based on the percentage of completion method (see ASBG 10 “Revenue Recognition”, example “Recognition of revenue under the stage of completion method” in the Note).

## ACCOUNTING POLICIES FOR INVENTORIES

### Initial Recognition

**7.** ***Inventories shall initially be recognised at cost which comprises costs of purchase, production costs and other costs incurred in bringing the inventories to their present location and condition. (IFRS for SMEs 13.5, 13.11).***

**8.** In addition to the purchase price, the costs of purchase also comprise import duties, other non-refundable taxes and transport costs directly related to the acquisition of inventories. (IFRS for SMEs 13.6). If the payment for inventories is deferred for longer than the normal payment date, the cost of inventories shall be recognised as the purchase price in case of a regular payment term. The difference between cost and the amount payable shall be recognised as interest expenses in the period between the acquisition and the payment. (IFRS for SMEs 13.7).

**9.** Borrowing costs are generally not included in inventory cost. Borrowing costs can be added to the cost of inventory only, if preparation of inventories takes place over a longer period of time, it is financed with a loan or another debt instrument and the impact of these costs on the cost is significant (e.g. construction of a building for sale or construction of a ship, lasting for more than one year). The accounting for borrowing costs as part of the cost of inventories is based on the rules described in clauses 15-16 of ASBG 5 “Property, Plant and Equipment and Intangible Assets”.

**10.** Production costs of inventories comprise both direct costs related to the products (e.g. the cost of materials, wages of workers) as well as the proportionate share of production overheads (e.g. depreciation of production equipment, repair costs, salary of management engaged in production). Fixed production overheads are allocated to the cost of products based on normal production capacity. If an entity operates at under-capacity, the amount of production overheads per unit of production will be larger. The portion exceeding the amount of normal overheads shall immediately be recognised as an expense for the period and it shall not be added to the cost of the product. (IFRS for SMEs 13.8, 13.9)

**11.** The following costs are not included in the cost of inventories but they are recognised as expenses for the period (IFRS for SMEs 13.13):

(a) abnormal amounts of waste in production;
(b) storage costs, unless those costs are necessary during the production process;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition
(d) distribution costs

<u>Example 1 – Recognition of Costs</u>

<u>The following costs are included in the cost of inventories (in the cost price):</u>
• cost of raw materials
• cost of packing materials
• import duties
• normal amounts of waste in production
• depreciation of production facility
• storage costs of material and unfinished goods, if those are necessary during the production process
• salary of purchase manager
• salary of production manager

<u>The following costs shall not be included in the cost of inventories but they are recognised as expenses for the period:</u>
• abnormal amounts of waste in production;
• depreciation of administrative facility
• storage costs of finished goods
• salary of sales manager
• distribution costs

**12.** If during the same production process several products are being produced simultaneously and it is not possible to clearly distinguish costs incurred for the production of each product, the entity shall establish a methodology for the rational and consistent allocation of costs incurred and follow this methodology year after year. The allocation of such costs may be based on the relative sales value of products completed during the production process. (IFRS for SMEs 13.10).

**13.** If the production process of some products results also in a by-product (e.g. low value product that is not the objective of the production process), then simplified accounting may be used for it, recognising it in the balance sheet at net realisable value. The net realisable value of a by-product shall also be deducted from the cost of the main product. (IFRS for SMEs 13.10).

<u>Example 2 – Recognition of a By-product</u>

In addition to the main product (timber), a wood processing entity produces also sawdust as a by-product which is also sold. Since the market value of sawdust is relatively insignificant when compared with the market value of the main product, then its cost is not accounted for separately but it is reported in the balance sheet at its net realisable value. The net realisable value of sawdust is deducted from the cost of timber.

**14.** An entity may also use techniques such as the standard cost method, the retail method or most recent purchase price for measuring the cost of inventories if the result approximates actual cost. Standard cost method takes 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. The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin. (IFRS for SMEs 13.16).

**Cost Formulas**

**15.** ***If separate inventory items are clearly distinguishable from each other, then the expensing of their costs shall be based on costs incurred specifically for the acquisition of each separate item (individual cost method). (IFRS for SMEs 13.17) If separate inventory items are not clearly distinguishable from each other, then either the FIFO or weighted average cost formula shall be used. The same method shall be used for inventories similar in nature and usage. (IFRS for SMEs 13.18).***

**16.** For example, the expensing of cost for each inventory item based on costs incurred specifically for the given item is appropriate if each item is being produced separately under a particular project or agreement. If the number of produced (or purchased) products is large and the items are not clearly distinguishable from each other, then the individual assessment method is inappropriate and the FIFO or weighted average cost formula shall be used instead.

**17.** The FIFO (first-in, first-out) formula assumes that the products that are sold (or used) in the order of their acquisition (i.e. the opening balance is expensed first, then the cost of the shipment arriving first, etc.). In applying the FIFO formula, closing inventory balances are reported in the balance sheet at the cost of shipments that have arrived last and have not yet been sold (used).

**18.** When applying the weighted average cost formula, the cost of each separate item is the weighted average of the cost of the period's opening balance and the cost of items acquired during the period. The weighted average can be recalculated after the arrival of each additional shipment or once at the end of a certain period (e.g. the end of a week or month). The procedure for and frequency of calculating the weighted average is set out in the accounting policies and procedures of an entity.

**Subsequent Measurement**

**19.** ***Inventories shall be measured in the balance sheet at the lower of cost or net realisable value. (IFRS for SMEs 2.49 (b), 13.4) Commodity brokers and dealers of publicly traded inventories (e.g. grains, oil) shall measure inventories at fair value less costs to sell through profit or loss. (IFRS for SMEs 13.3).***

**20.** At the end of each accounting period, the list of inventories shall be critically reviewed in order to identify inventory items whose net realisable value may have fallen below their cost. (IFRS for SMEs 13.19, 27.2) The entity's management shall consider the need for writing down inventories if:

(a) the physical inventory has established that inventories have either been damaged or their physical condition has deteriorated;

(b) the market value of similar inventory items has fallen;

(c) it has not been possible to sell or use certain inventory items during an extended period of time and there exists doubt whether they can be sold within a reasonable amount of time.

**21.** Materials and unfinished products shall be written down if the estimated cost of the products made of out them exceeds the net realisable value of the same products.

**22.** The write-down of inventories to their net realisable value is recorded as expenses for the accounting period. If the net realisable value of inventories that have previously been written down increases in later periods, the write-down shall be reversed. (IFRS for SMEs 27.2, 27.4).

**Consignment Goods**

**23.** If one entity (distributor) sells the inventories of another entity (supplier) (consignment sales), these inventories shall be recognised in the balance sheet of the entity bearing the main risks related to inventories (e.g. risk of spoilage of goods, risk of a change in the market value, risks and costs related to financing goods, etc.). If most of the risks related to the goods held on consignment remain with the supplier, these goods shall be recognised in its balance sheet. If the distributor assumes most of the risks related to the sale of the goods, these goods shall be recognised in its balance sheet.

## COMPARISON WITH IFRS FOR SMES

**24.** The accounting policies prescribed in ASBG 4 for inventories are in compliance with the accounting policies of sections 13, 25 and 27 of IFRS for SMEs , except for recognition of borrowing costs, in which case the Board considered it necessary to enable adding them to the cost of inventories if preparation of inventories takes place over a longer period of time and their impact on the cost of inventories is significant (pursuant to clauses 13.7 and 25.2 of IFRS for SMEs, borrowing costs are recognised under expenses in the income statement). The option to add borrowing costs to the acquisition cost was considered justified, as it enables the entities to comply with the principles of IFRS (e.g. if the entity forms a part of a bigger group preparing its statements based on IFRS). Also, adding borrowing costs to the cost of inventories may become material, if large part of the entity’s inventories is composed by ab object of inventories to be built over a long time and financed with external capital.