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Compliance with BAS 2 as Regards to Inventories: A Study on Some Selected Textile Companies in Bangladesh

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Abstract

Reporting of inventory is a vital issue in the area of Accounting. This paper examines the disclosure issues regarding inventories adopted and pronounced by ICAB in BAS 2 (adopted IAS 2.) In this study an attempt has been made to review the practices by some selected textile companies in Bangladesh in reportinginventories and to observe the compliance with the established criteria.

Key Words: *Inventories, carrying amount, fair value.*

Introduction

Inventories are treated as one of the most important assets in any manufacturing as well as merchandising company. According to Fraser and Ormiston (2007, p.52), inventories are the assets, which a firm holds or keeps to sale or to use in the manufacturing processand a firm produces its major revenues from inventories.

Inventory valuation depends on the assumptions about the flow of the inventories, such as FIFO (first in, first out), LIFO (last in, first out) or average costs. According to FIFO method it is assumed that the units bought first are sold or used first and consequently, the earliest cost price is used first to determine cost of goods sold. On the other hand, LIFO method implies that the items purchased last are sold first and consequently, the latest cost price is applied first to ascertain cost of goods sold; and average cost method applies average cost price in cost of goods sold calculation. The choice of a method by a firm is very crucial, because the value of inventory and the amount of cost of goods sold largely depend on it.

Objectives of the Study

The objectives of the study are as follows:

1) Review the disclosure issues about inventories in BAS 2;

11) Analyze the practices of selected companies regarding the disclosure of inventories and put forward some recommendations.

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Methodology

This study is explorative and descriptive in nature. Only secondary data have been used and the data have been analyzed manually. A checklist has been used to collect and analyze the data. The sample companies have been selected on random basis. The data have been collected from published materials like annual reports of the selected companies.

Summary of BAS 2

Objective of BAS 2

The objective of BAS 2 is to prescribe the accounting treatment for inventories. It provides guidance for determining the cost of inventories and for subsequently recognizing an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

Inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in process), and materials and supplies that are consumed in production (raw materials). [BAS 2.6]

However, BAS 2 excludes certain inventories from its arena: [BAS 2.2]

- Work in process arising under construction contracts (see BAS11*Construction Contracts*)
- Financial instruments (see BAS 39*Financial Instruments: Recognition and Measurement*)
- Biological assets related to agricultural activity and agricultural produce at the point of harvest (BAS 41 *Agriculture*).

Also, while the following are within the scope of the standard, BAS 2 does not apply to the measurement of inventories held by: [BAS 2.3]

- Producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realizable value (above or below cost) in accordance with well-established practices in those industries. When such inventories are measured at net realizable value, changes in that value are recognized in profit or loss in the period of the change
- Commodity brokers and dealers 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 recognized in profit or loss in the period of the change.

Fundamental Principle of BAS 2

Inventories are required to be stated at the lower of cost and net realizable value (NRV). [BAS 2.9]

Measurement of Inventories

Cost should include all: [BAS 2.10]

- Costs of purchase (including taxes, transport, and handling) net of trade discounts received
- Costs of conversion (including fixed and variable manufacturing overheads) and
- Other costs incurred in bringing the inventories to their present location and condition

BAS 23*Borrowing Costs* identifies some limited circumstances where borrowing costs (interest) can be included in cost of inventories that meet the definition of a qualifying asset. [BAS 2.17 and BAS 23.4]

Inventory cost should not include: [BAS 2.16 and 2.18]

- abnormal waste
- storage costs
- administrative overheads not related to production
- selling costs
- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms.

The standard cost and retail methods may be used for the measurement of cost, provided that the results approximate actual cost. [BAS 2.21-22]

For inventory items that are not interchangeable, specific costs are attributed to the specific individual items of inventory. [BAS 2.23]

For items that are interchangeable, BAS 2 allows the FIFO or weighted average cost formulas. [BAS 2.25] The LIFO formula, which had been allowed prior to the 2003 revision of BAS 2, is no longer allowed.

The same cost formula should be used for all inventories with similar characteristics as to their nature and use to the entity. For groups of inventories that have different characteristics, different cost formulas may be justified. [BAS 2.25]

Write-down to Net Realizable Value

NRV is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale. [BAS 2.6] Any write-down related to NRV should be recognized as an expense in the period in which the write-down occurs. Any reversal should be recognized in the income statement in the period in which the reversal occurs. [BAS 2.34]

Expense Recognition

BAS 18*Revenue* addresses revenue recognition for the sale of goods. When inventories are sold and revenue is recognized, the carrying amount of those inventories is recognized as an expense (often called cost-of-goods-sold). Any write-down to NRV and any inventory losses are also recognized as an expense when they occur. [BAS 2.34]

Disclosure

Required disclosures: [BAS 2.36]

- accounting policy for inventories
- carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classification depends on what is appropriate for the entity
- carrying amount of any inventories carried at fair value less costs to sell
- amount of any write-down of inventories recognized as an expense in the period
- amount of any reversal of a write-down to NRV and the circumstances that led to such reversal
- carrying amount of inventories pledged as security for liabilities
- cost of inventories recognized as expense (cost of goods sold).

Analysis and Findings

Secondary data regarding inventories have been collected from ten textile companies through analyzing annul reports. Ten textile companies have been selected on random basis. The selected companies are Saiham Textile Mills Limited, Rahim Textile Mills Limited, Square Textiles Limited, Metro Spinning Limited, H.R. Textile Mills Limited, Desh Garments Limited, Apex Spinning and Knitting Mills Limited, Family Textile Limited, Tallu Spinning Mills Limited, and Generation Next Fashions Limited.

A checklist regarding the disclosure requirements of inventories has been used to collect and analyze the data. The checklist follows:

SL. No.	Title	Complied	Not Complied	Remarks (if any)
1	The accounting policies adopted in measuring inventories, including the cost formula used;			
2	The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;			
3	The carrying amount of inventories carried at fair value less costs to sell;			
4	The amount of inventories recognized as an expense during the period;			
5	The amount of any write-down of inventories recognized as an expense in the period in accordance with paragraph 34;			
6	The amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the			

	period in accordance with paragraph 34;			
7	The circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34;			
8	The carrying amount of inventories pledged as security for liabilities;			

Disclosure Requirement 1: The accounting policies adopted in measuring inventories, including the cost formula used. In this regard, all the ten companies (100%) complied with this requirement.

Disclosure Requirement 2: The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity. In this regard, all the ten companies (100%) complied with this requirement.

Disclosure Requirement 3: The carrying amount of inventories carried at fair value less costs to sell. In this regard, all the ten companies (100%) complied with this requirement.

Disclosure Requirement 4: The amount of inventories recognized as an expense during the period. In this regard, all the ten companies (100%) complied with this requirement.

Disclosure Requirement 5: The amount of any write-down of inventories recognized as an expense in the period in accordance with paragraph 34. This requirement was not applicable for HR Textile Mills Limited, Apex Spinning and Knitting Mills Limited, Family Textile Limited, and Generation Next Fashions Limited and all othersix companies (60%) complied with this requirement.

Disclosure Requirement 6: The amount of any reversal of any write-down that is recognized as a reduction in the amount of inventories recognized as expense in the period in accordance with paragraph 34. Desh Garments Limited and Tallu Spinning Mills Limited complied with this requirement and in case of all other eight companies (80%), this requirement was not applicable.

Disclosure Requirement 7: The circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34. This requirement was not applicable for all the ten companies (100%).

Disclosure Requirement 8: The carrying amount of inventories pledged as security for liabilities. This requirement was not applicable for H.R. Textile Mills Limited, Desh Garments Limited. All other eight companies (80%) complied with the requirement.

Conclusion and Recommendation

In each organization the item which is commonly seen is inventory. Most of the firms specially the manufacturing organizations have to maintain a large amount of inventory. The value of inventory is significantly affected by the choice of the cost flow assumption of inventory. Henceforth, disclosure of inventory is of concern to the management as well as other external users of accounting information.

Based on the analysis, it is seen that the compliance with the disclosure requirements of inventory is satisfactory. In spite of that there may be some sort of manipulations in the valuation of inventory which can be detected by the in-depth analysis. The application of forensic accounting can be recommended in this respect.

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