

Component: Assets / Inventory (IAS 2)

Short title: Types of costs attributable to inventory

Issue

What is the nature of costs that can be included in the valuation of metals inventories produced by a mill or a smelter?

Solution

The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition [IAS 2 R.10].

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 [IAS 2 R.12].

The following table highlights the types of costs that can be included in the cost of inventories:

| Description of costs | Include in inventory | | Do not include in inventory |
|--|----------------------|----------|--|
| | Direct | Indirect | |
| Production materials | ✓ | | |
| Production labour | ✓ | | |
| Employment costs of direct labour (for example, pension costs) | ✓ | | |
| Normal amounts of materials wastage | ✓ | | |
| Supervisor salaries and employment costs | | ✓ | |
| Other indirect labour | | ✓ | |
| Indirect materials | | ✓ | |
| Rent, maintenance, heat, light, some taxes (excluding income taxes) and other indirect costs of running factory | | ✓ | |
| Depreciation of production equipment and related facilities and property | | ✓ | |
| Development engineering | | ✓ | |
| Storage and handling costs for raw materials, components, other supplies and work in progress prior to a subsequent production process | | ✓ | |
| Product research | | | ✓ Selling, general and administrative |
| Abnormal amounts of wastage, labour and other costs | | | ✓ Cost of sales |
| Selling costs | | | ✓ Selling, general and administrative |
| Storage costs, after production is completed | | | ✓ Selling, general and administrative |
| General management and administration costs | | | ✓ Selling, general and administrative * |

* Note that IAS 2 specifically excludes administrative overheads that do not contribute to bringing inventories to their present location and condition from conversion costs. Other costs, and overheads, that do contribute, are allowable costs of production. Judgement is sometimes needed in making this distinction. For example, the accounts department of a production plant will normally support the following functions:

- Production – by paying direct and indirect production wages and salaries, by controlling purchases and related payments, and by preparing periodic financial statements for the production units;
- Marketing and distribution – by analyzing sales and by controlling the sales ledger; and
- General administration – by preparing management accounts and annual financial statements and budgets, by controlling cash resources and by planning investments.

Only those costs of the accounts department that can be allocated to the production function qualify to be included in the cost of conversion. The same can be said for management costs (e.g., the costs of CEO); if the costs can be related to bringing the inventory to its present location and condition, then it can be included in the inventory cost. Consequently, to include an overhead an entity must ensure it can sensibly justify its inclusion under the provisions of IAS 2 by presenting an analysis of the function and its contribution to the production process and how the cost would be allocated to the cost of inventory.