

Educational material

Presentation of Inventory write-offs and costs as a result of the civil unrest in South Africa

Issued 02 November 2021



Contents

Introduction	2
Background	3
Analysis of expenses	3
Conclusion.....	5

Introduction

The civil unrest that occurred in Kwazulu Natal and Gauteng between 9-17 July 2021 had a devastating effect on the South African economy. Reports reveal that as many as 300 people tragically lost their lives, with more than 3 000 stores being looted and/or completely destroyed. It is also reported by treasury that it could take 2 years to recover economically from the devastation, bearing in mind that the South African economy has experienced significant distress due to multiple lockdowns and restrictions as a result of COVID–19.

Between March and May 2020, after the outbreak of the COVID-19 pandemic in South Africa, SAICA’s Accounting Practices Committee (APC) published a total of 13 educational guidance papers relating to the impact of COVID–19.

While these documents may have been published in response to the pandemic, it is the APC’s view that the guidance provided in the educational guidance documents is appropriate and suitable to assist members involved in the preparation of financial statements of entities that have been affected by the civil unrest. Members are urged to revisit the educational materials published to understand how the guidance provided to entities may be applied in preparing its financial statements.

However, the afore-mentioned published documents did not contain guidance on the requirements of IFRS when considering the appropriate profit or loss presentation for inventory losses and other costs directly associated with inventory losses and delays. This educational material seeks to provide guidance on the presentation of inventory losses which were directly attributable to the civil unrest as noted above.

This material issued by SAICA’s APC is prepared for educational purposes and highlights the requirements within IFRS Standards when considering the appropriate profit or loss presentation for inventory losses, other costs directly associated with inventory losses and delays due to the unrest. Entities are reminded to consider the impact of the events related to the unrest on both interim and annual financial statements.

This educational material does not change, remove nor add to, the requirements in IFRS Standards. It is intended to support the sound, consistent and robust application of requirements in IFRS Standards. It is of importance that IFRS Standards are applied



consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

Background

The accounting treatment for most types of inventories is prescribed in IAS 2 Inventories, which provides guidance for determining the cost of inventories and for subsequently recognising an expense, including any write-down to net realisable value. It also outlines acceptable methods of determining cost of inventories.

IAS 2 paragraph 34 states that “The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.”

Prior to the unrest, affected entities had inventories on hand that may have consisted of finished goods, work in progress, raw materials, consumables etc., all of which are accounted for and measured under IAS 2. As a result of the unrest, affected entities suffered losses ranging from stolen finished goods; damage to and destruction of finished goods and work in progress; along with varying degrees of business activity disruption which may have resulted in additional costs that were incurred. These losses represent expenses for these affected entities.

IAS 2 paragraph 38 states that “The amount of inventories recognised as an expense during the period, which is often referred to as **cost of sales**, consists of those **costs previously included in the measurement of inventory that has now been sold** and **unallocated production overheads** and **abnormal amounts of production costs** of inventories. The circumstances of the entity may also warrant the inclusion of **other amounts**, such as distribution costs.”

Analysis of expenses

Some of the expenses that may have been incurred by affected entities are as follows (this is not an exhaustive list):

1. Additional unplanned costs to transport finished goods from unaffected locations to affected locations to meet demand;
2. Unplanned costs to protect and secure inventory warehouses and sites in the affected locations during the unrest period. For example, security costs or additional labour costs incurred by affected entities;



3. Sunk costs due to the production of inventory being interrupted or stopped during the manufacturing process. For example, fixed overheads¹ incurred; or
4. Write-offs of finished goods, work-in-process, raw materials or consumables that were stolen and damaged during the unrest period.

Affected entities should take note of the requirements in paragraph IAS 2.34 and IAS 2.38 which provides guidance in determining the classification of an expense as cost of sales in the statement of profit or loss which is a required line item for presentation utilising the 'function of expense' method per IAS 1.103. Further, an entity classifying expenses by function should disclose additional information on the nature of expenses per IAS 1.104.

IAS 2 paragraph 34 refers to an adjustment to the amount of inventories recognised as an expense for reversals of write-down of inventories to net realisable value. In addition the requirements of IAS 2.38 provide 3 instances when expenses should be included in cost of sales. These are:

- a) Costs previously included in items of inventory that have now been sold

This instance specifically references inventories that have been sold. Affected entities should consider whether any expenses that had arisen due to the unrest, specifically relating to finished goods which can no longer be sold in the ordinary course of business, could meet the requirements of IAS 2.38 and be included in cost of sales.

- b) Unallocated production overheads and abnormal costs incurred during production

This instance refers to costs incurred during the production process which are unallocated or represent abnormal costs.

Affected entities should apply judgement to determine whether any expenses incurred represent "abnormal costs of production" in IAS 2.38. IAS 2 does not provide any definition of what constitutes abnormal costs of production. Therefore, in applying this judgement, entities should consider the nature of the costs incurred. Entities should specifically consider whether these are abnormal in nature and whether it applies to items in the production process.

For example, for retailers, it may be unlikely that the inventory damaged, destroyed or stolen during the July unrest were in a "production process", however these may be considered abnormal inventory losses. Similarly, for producers, inventory in the process of production may have been damaged or destroyed. Thus, judgment would need to be applied as to whether these abnormal costs of production could be included as part of cost of sales.

- c) Other costs incurred

¹ Fixed overheads are costs that do not vary as a result of changes in activity. These are generally costs needed to operate a business, such as rental expenses. Since fixed overhead costs do not change substantially, they are easy to predict and should rarely vary from the budgeted amount.



IAS 2.38 also refers to certain circumstances of the entity which may also warrant the inclusion of other amounts, such as distribution costs, in cost of sales.

For example, entities may have incurred additional product handling costs or additional production costs during the period as a consequence of the civil unrest.

Affected entities should consider whether any further expenses that were incurred due to the unrest which relate to inventory and is not dealt with in (a) or (b) above may warrant inclusion in cost of sales.

Conclusion

Due to the fact that there is no clear definition of what constitutes cost of sales, entities, in applying their judgement, should consider the requirements per IAS 2 paragraphs 34 and 38 noted above in determining the appropriate presentation of the inventory write-down expense as a result of the unrest.

In the event this may be a significant judgement applied, entities should consider the requirements related to IAS 1.122 and disclose any significant judgements applied.

SAICA continues to monitor the impact of the civil unrest on the accounting and audit profession.

Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.