



Manufacturing and Hi-Tech Industries

How will your company be affected by the new accounting standards for inventories?

The Canadian Institute of Chartered Accountants (CICA) regularly issues new accounting standards but few could potentially impact manufacturing companies to the same degree as the new standards of CICA Handbook Section 3031 – Inventories, which applies to fiscal years beginning on or after January 1, 2008.

These new standards provide specific guidance on the measurement of inventories and the costs of conversion to be included in determining the cost of inventories. Manufacturing companies are now required, among other things, to systematically allocate fixed and variable production overheads that are incurred in converting raw materials into finished goods, which was not previously a requirement under the former accounting standards.

The New Inventory Valuation

The new measurement standards requires inventories to include all costs of purchase, conversion and other costs incurred to bring the inventories to their present location and condition. Those costs include:

Costs of purchase

- Include all costs directly attributable to the acquisition of the goods, materials or services. Examples include the purchase price, import duties and other taxes, and shipping and handling expenses.

Trade discounts, rebates and other similar items should be deducted in determining the costs of purchase.

Costs of conversion

- Include costs directly related to the units of production, such as direct labour.

- A systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.
- Fixed production overheads are 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.
- The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities.
- 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. The actual level of production may be used if it approximates 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. 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.
- 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.
- Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

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Other costs

- Are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

Other Areas of Change

The new standards of CICA Handbook Section 3031 – Inventories also have other areas which differ from the old accounting standards which are not specific to manufacturing production.

- Inventory must now be valued at the lower of cost and net realizable value (formerly lower of cost and market).
 - Net realizable value means the estimated selling price in the ordinary course of business, less the estimated costs necessary to make the sale. Thus, if inventory is going to be sold below cost, inventory will be written down to the new selling price (i.e. the net realizable value)
- You can now reverse write-downs from cost to net realizable value incurred in prior periods if the net realizable value of those items has subsequently increased (e.g. in 2008 the inventory is going to be sold below cost because the market dictates a lower selling price, in 2010 the market has rebounded and the inventory will now be sold above cost, a write up equal to the original cost is now allowed).
- You must now disclose additional information relating to the amount of inventories recognized as an expense during the period, amount of write-downs recognized as an expense during the period and the amount of any reversal of write-downs that was recognized in the period.

As can be seen from the above, the new standards relating to inventories could have a significant impact on companies who have a manufacturing aspect to their operations. Contact your Collins Barrow advisor to assess the impact these changes will have on your company.

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Mario is a Manager at Collins Barrow Ottawa LLP and a member of the Hi-Tech and Manufacturing Industry, and Retail Industry Groups.

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