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STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Costs Necessary to Sell Inventories (IAS 2)**		
Paper topic	Comment letters on tentative agenda decision		

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Introduction

1. In February 2021, the IFRS Interpretations Committee (Committee) published a tentative agenda decision in response to a submission about the costs an entity includes as the 'estimated costs necessary to make the sale' when determining the net realisable value of inventories. In particular, the request asked whether an entity includes all costs necessary to make the sale or only those that are incremental to the sale.

2. The Committee observed that:

   (a) paragraph 6 of IAS 2 *Inventories* defines net realisable value as 'the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale'.

   (b) paragraphs 28–33 of IAS 2 include further requirements about how an entity estimates the net realisable value of inventories. Those paragraphs do not identify which specific costs are 'necessary to make the sale' of inventories. However, paragraph 28 of IAS 2 describes the objective of writing inventories down to their net realisable value—that objective is to avoid inventories being carried 'in excess of amounts expected to be realised from their sale'.

   (c) when determining the net realisable value of inventories, IAS 2 requires an entity to estimate the costs necessary to make the sale. This requirement

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does not allow an entity to limit such costs to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. Including only incremental costs could fail to achieve the objective set out in paragraph 28 of IAS 2.

3. The Committee concluded that, when determining the net realisable value of inventories, an entity estimates the costs necessary to make the sale in the ordinary course of business. An entity uses its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories.

4. Based on its analysis, the Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether the estimated costs necessary to make the sale are limited to incremental costs when determining the net realisable value of inventories. Consequently, the Committee tentatively decided not to add a standard-setting project to the work plan and, instead, published the tentative agenda decision.

5. The objective of this paper is to:

   (a) analyse comments on the tentative agenda decision (paragraphs 7–38); and

   (b) ask the Committee whether it agrees with our recommendation to finalise the agenda decision (paragraph 39).

6. Appendix A to this paper sets out the proposed wording of the agenda decision.

Comment letter summary

7. We received 21 comment letters by the comment letter deadline. All comments received, including any late comment letters, are available on our website.[1] This agenda paper includes analysis of only the comment letters received by the comment letter deadline, which are reproduced in Agenda Paper 2A.

8. Most respondents agree with the Committee's analysis and conclusions in the tentative agenda decision—that is, they agree that IAS 2 does not allow an entity to

[1] At the date of posting this agenda decision, there was one late comment letter.

limit its estimate of the costs necessary to make the sale to only such costs that are incremental.

9. Some respondents:

   (a) disagree with the Committee’s analysis and conclusions and say that, in their view, it would also be acceptable for an entity to include only incremental costs in their estimate of costs necessary to make the sale—particularly by considering requirements in other IFRS Standards.

   (b) suggest not finalising the tentative agenda decision. These respondents say:

      (i) the agenda decision, if finalised, could disrupt the established practice in some jurisdictions of including only incremental costs when estimating costs necessary to make the sale. Changing this accounting policy could be costly and complex.

      (ii) IAS 2 provides an inadequate basis for an entity to estimate the costs necessary to make the sale. Finalising the agenda decision without adding requirements on how to make such an estimate would increase, rather than reduce, diversity. These respondents suggest adding requirements or providing guidance on how to estimate the costs necessary to make the sale.[2]

   (c) express concerns about the use of the term ‘incremental costs’ in the tentative agenda decision.

10. Further details about the matters raised by respondents, together with our analysis, are presented below.

Staff analysis

Disagreement with the Committee’s technical analysis and conclusions

Respondents’ comments

11. A few respondents say it is appropriate for an entity to include only incremental costs when estimating costs necessary to make the sale. These respondents refer to the

[2] Some respondents who agree with the Committee’s analysis and conclusions also suggest adding requirements or providing guidance on how to estimate the costs necessary to make the sale.

requirements in, and explanations in the Basis for Conclusion on, other IFRS Standards.

12. Deloitte says the estimated costs necessary to make the sale when determining net realisable value *should* be limited to incremental costs. Deloitte says, unless an IFRIC Interpretation is issued, this view cannot be ruled out.

13. The Saudi Organization for Chartered and Professional Accountants (SOCPA) says when a term is defined in an IFRS Standard and appears in another IFRS Standard without a definition, it is appropriate to apply the same definition to the term in both Standards. They say:

    (a) paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires management to refer to, and consider the applicability of, the requirements in IFRS Standards dealing with similar and related issues.

    (b) the term ‘costs necessary to make the sale’ is not defined in IAS 2 and is arguably synonymous with the terms ‘costs to sell’ (as defined in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 41 *Agriculture*) and ‘costs of disposal’ (as defined in IAS 36 *Impairment of Assets*).

14. In SOCPA’s view, because these other Standards require an entity to consider only incremental costs when applying these terms, an entity should consider only incremental costs when estimating ‘costs necessary to make the sale’.

15. Deloitte and Petrobras refer to paragraphs of the Basis for Conclusions on IAS 36:

    (a) paragraphs BCZ31–BCZ36 explain the rationale for requiring entities to include incremental selling costs when determining ‘net selling price’.[3] These paragraphs explain that including incremental selling costs is consistent with the purpose of the impairment test, which is ‘to determine the net amount that an enterprise could recover from the sale of an asset’. Deloitte says the rationale set out in these paragraphs is equally relevant

[3] The term ‘net selling price’ was later replaced in IAS 36 by ‘fair value less costs to sell’.

when, applying IAS 2, an entity determines the net realisable value of inventories.

(b) paragraphs BCZ37–BCZ39 discuss potential differences between ‘net realisable value’ in IAS 2 and ‘net selling price’ in IAS 36. Deloitte and Petrobras say those paragraphs do not identify ‘costs to sell’ as a potential difference. In addition, paragraph BCZ39 states ‘in most cases, net selling price and net realisable value will be similar’. Petrobras says it is therefore possible to draw an analogy between the two terms.

Staff analysis

16. Paragraph 7 of IAS 8 states ‘when an IFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS’. Paragraphs 10–11 of IAS 8 apply only ‘in the absence of an IFRS that specifically applies to a transaction, other event or condition’. IAS 2 includes requirements that specifically apply to the measurement of inventories. In our view, an entity applies paragraph 7 of IAS 8—not paragraphs 10–11 of that Standard—and applies the requirements in IAS 2 in determining the net realisable value of inventories.

17. Respondents have raised the same or similar points to those the Committee already considered. As discussed in paragraphs 35–49 of Agenda Paper 3 for the February 2021 meeting, in our view an entity does not refer to the requirements in IAS 36 (or in other IFRS Standards) when estimating the ‘costs necessary to make the sale’ within IAS 2’s definition of net realisable value. This is because:

(a) the term used in IAS 2 (costs necessary to make the sale) is not the same as those used in other IFRS Standards (costs of disposal or costs to sell); and

(b) the requirements in other IFRS Standards were designed to apply to the specific assets within their scope. In particular, IAS 36 was not designed to apply to the measurement of assets that an entity sells in its ordinary course of business—referring to the requirements in that Standard in the context of determining the net realisable value of inventories could fail to achieve the objective described in paragraph 28 of IAS 2 (that is, to ensure that

inventories are not carried 'in excess of amounts expected to be realised from their sale').

18. Paragraphs BCZ31–BCZ36 explain the International Accounting Standards Committee (IASC)'s basis for its definition of 'net selling price' and, in particular, its response to stakeholders' suggestions that incremental costs of disposal should *not* be deducted in determining net selling price. In our view, these paragraphs explain the IASC's conclusion in the context of the requirements in IAS 36, and should not be read as extending to the requirements in other IFRS Standards.

19. The Committee also already considered the explanations included in paragraphs BCZ37–BCZ39 of the Basis for Conclusion on IAS 36.[4] We continue to think these paragraphs:

    (a) clarify that there are *intended* differences between the measurement requirements in IAS 2 and IAS 36 because of the particular characteristics of inventories vis-à-vis other assets. These paragraphs explain that the IASC considered, but decided *against*, (i) using 'net realisable value'—as defined in IAS 2—in IAS 36; and (ii) changing the definition of net realisable value in IAS 2 at the time of developing IAS 36.

    (b) cannot be read to imply that the IASC considered 'costs necessary to make the sale' as equivalent to 'costs of disposal'.

Concerns about the outcome of finalising the agenda decision

Respondents' comments

20. Some respondents say the conclusions reached in the tentative agenda decision contradict many entities' current practice. For example, the Australian Accounting Standards Board (AASB) and David Hardidge say there is no significant diversity in Australia—entities in that jurisdiction include only estimated direct and incremental costs necessary to make the sale when determining net realisable value. They say the agenda decision, if finalised, could cause many entities to amend their practice and

[4] See paragraphs B6–B9 of Agenda Paper 3 for the February 2021 meeting.

include costs that are not incremental but necessary to make the sale when estimating the net realisable value of inventories.

21. Deloitte and the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) say implementing the change may be costly and complex for many entities. Deloitte says because in practice entities generally include only incremental costs, they may not have systems in place to apply an approach that would require an allocation of all costs (including a broad range of overheads) necessary to make the sale. The ICAI says the cost of doing so may outweigh the benefits.

22. The Accounting Standards Board of Japan (ASBJ) and David Hardidge say requiring entities to change current practice without adding requirements or providing guidance on which costs to include within 'costs necessary to make the sale' could increase, rather than reduce, diversity in the way entities determine the net realisable value of inventories. For that reason, the ASBJ suggests not finalising the agenda decision.

Staff analysis

23. We continue to agree with the Committee that IAS 2 does not allow an entity to limit 'costs necessary to make the sale' to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. In our view, the Board would have to amend IAS 2 to require or permit entities to limit costs necessary to make the sale to only those that are incremental to a particular sale.

24. The tentative agenda decision notes that an entity uses its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories. Paragraphs 26–31 of this paper discuss comments from respondents requesting further guidance and examples on such costs.

25. We acknowledge that the finalisation of the agenda decision may result in some entities determining that they need to change how they estimate net realisable value. A change in accounting policy for at least some entities is a consequence of many agenda decisions. In that respect, paragraph 8.6 of the *Due Process Handbook* states that it is expected that an entity would be entitled to sufficient time to determine

whether it needs to change an accounting policy and to implement any such change (for example, an entity may need to obtain new information or adapt its systems to implement a change). With that said, entities are expected to implement any change on a timely basis.

Additional requirements to determine cost necessary to make the sale

Respondents' comments

26. A few respondents say that neither IAS 2 nor the tentative agenda decision clearly prescribe which costs to include as 'costs necessary to make the sale'. The ASBJ and EY say, because of the lack of requirements, finalising the agenda decision may not resolve any differences in how entities estimate costs necessary to make the sale. The ASBJ says the principles and requirements in IAS 2 do not provide an adequate basis for an entity to estimate those costs; in its view, standard-setting is needed.

27. Some respondents suggest providing guidance and examples to help entities determine which costs to include as 'costs necessary to make the sale'. For example, Universidad Loyola Andalucía mentions incremental costs (for example, sales commissions), direct costs (for example, salaries of sales staff for a product line) and indirect costs (for example, annual costs associated with setting up an e-commerce site). A few of these respondents also ask for guidance on allocating costs that might relate to multiple items.

28. In contrast:

    (a) the Association of National Accountants of Nigeria (ANAN) disagrees with providing specific examples of costs necessary to make the sale—it says the principle-based nature of IFRS Standards requires entities to use their judgement and consider all relevant facts and circumstances, such as the nature of inventories.

    (b) Vasu Goyal says providing guidance specifically addressing cost estimation may not be suitable given the wide variety of industries and inventories.

Staff analysis

29. We continue to agree with the Committee's conclusion that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether the estimated costs necessary to make the sale are limited to incremental costs when determining the net realisable value of inventories—that is, to answer the question asked in the submission.

30. The tentative agenda decision notes that IAS 2 does not identify which costs are 'necessary to make the sale' of inventories. However, it refers to paragraph 28 of IAS 2, which describes the objective of writing inventories down to their net realisable value (that is, to avoid inventories being carried 'in excess of amounts expected to be realised from their sale'). The tentative agenda decision also says an entity uses its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of inventories. Providing guidance on how to apply the term 'costs necessary to make the sale' or to add examples of such costs would, in our view, add or change requirements in IFRS Standards.[5]

31. In March 2021, the Board issued a Request for Information as part of its Third Agenda Consultation. The Board is seeking stakeholders' views on financial reporting issues that could be added to the Board's work plan. The consultation document includes a list of financial reporting issues suggested by stakeholders, one of which describes aspects of the accounting for inventories that stakeholders suggest could be improved, including impairment of inventories (see paragraphs B27–B30 of the Request for Information). That Request for Information provides an opportunity for stakeholders to share their views on whether the Board should add a project to its work plan to address the accounting for inventories (including estimating 'costs necessary to make the sale').

[5] Paragraph 8.4 of the *Due Process Handbook* states: 'Agenda decisions (including any explanatory material contained within them) *cannot add or change requirements in IFRS Standards*. Instead, explanatory material explains how the *applicable principles and requirements in IFRS Standards* apply to the transaction or fact pattern described in the agenda decision.' (emphasis added).

Clarification of 'incremental costs'

Respondents' comments

32. A few respondents say the tentative agenda decision does not define 'incremental costs', which could lead to different interpretations of the term. They therefore suggest:

    (a) clarifying that the agenda decision refers to 'incremental costs' as defined in IFRS 15 *Revenue from Contracts with Customers* (PwC);[6]

    (b) replacing 'incremental costs' with other 'suitable' terms (Petrobras); or

    (c) defining or providing examples of 'incremental costs' (the South African Institute of Professional Accountants (SAIPA)).

33. David Hardidge says the tentative agenda decision uses 'incremental costs' in a very narrow sense—as including only costs that would not have been incurred if the sale had not occurred—and contrasts this with a broader interpretation, which includes costs involved in the 'process of attempting to sell the inventory' (which may or may not result in a sale). David Hardidge suggests clarifying that:

    (a) 'incremental costs' in the tentative agenda decision reflects the narrower interpretation; and

    (b) the broader interpretation of 'incremental costs' is acceptable if those costs meet the definition of 'costs necessary to make the sale'.

34. EY and Petrobras, however, understand the Committee's decision not to define the term 'incremental costs' to avoid implying that there is a specific definition of the term that must be used in the context of IAS 2 and other Standards.

Staff analysis

35. At its February 2021 meeting, the Committee specifically discussed whether to include a definition of 'incremental costs' in the tentative agenda decision. While acknowledging that stakeholders may have different understandings of 'incremental costs', it was noted that including a definition could imply that there is a specific

[6] Paragraph 92 of IFRS 15 states that 'the incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).'

definition of 'incremental costs' to be used in the context of other Standards (such as IAS 36).

36. We continue to agree with the Committee's decision not to define 'incremental costs'. We think defining the term could have unintended consequences, for example, on how the term is applied in the context of IAS 36. Further, the tentative agenda decision—although not including a definition of the term—states that it is referring to costs that are 'incremental *to a particular sale*'. In our view, this is sufficient to make the agenda decision understandable.

37. The tentative agenda decision appropriately focuses on the requirements in IAS 2—that is, that an entity is required to estimate the 'costs necessary to make the sale'. Regardless of how an entity interprets 'incremental costs', excluding costs the entity must incur to sell its inventories would be inconsistent with these requirements.

Other comments

38. The following table summarises respondents' comments on other matters together with our analysis of these comments.

Respondents' comments	Staff analysis and conclusions
1. Inconsistency with IAS 37 The AASB says the conclusions reached in the tentative agenda decision are inconsistent with the requirement to determine the 'costs of fulfilling a contract' in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Paragraph 68A of IAS 37 states that 'costs of fulfilling a contract' include an allocation of other costs that *relate directly* to fulfilling contracts. The AASB says the tentative agenda decision suggests that, when estimating costs necessary to make the sale, entities are required to consider costs more	*We recommend no change.* We disagree. The tentative agenda decision concludes only that IAS 2 does not allow an entity to *limit* its estimate of the costs necessary to make the sale to only those that are incremental—in our view, it does not suggest that, in estimating such costs, entities are required to consider costs more broadly than those that relate directly to the sale. The agenda decision refers only to the requirements in IAS 2 to estimate the 'costs necessary to make the sale'; an entity would not consider requirements in IAS 37 or other Standards in doing so.

Respondents' comments	Staff analysis and conclusions
broadly than only those that relate directly to the sale.	
2. Use of judgement A few respondents say the agenda decision, if finalised, could require entities to use considerable judgement in determining which costs are necessary to make the sale. The AASB says this may lead to inconsistent accounting outcomes. PwC and SAIPA suggest emphasising in the tentative agenda decision that the judgement used in estimating costs necessary to make the sale could be significant. In such a case, an entity should provide applicable disclosures as required by IAS 1 *Presentation of Financial Statements*.	*We recommend no change.* The tentative agenda decision notes that IAS 2 does not identify which specific costs are 'necessary to make the sale' and that an entity uses judgement in making this determination. The use of judgement is inherent in preparing financial statements, as noted in the *Conceptual Framework for Financial Reporting*.[7] Estimating the costs necessary to make the sale is one part of determining the net realisable value of inventories—arguably estimating the selling price and, for some inventories, the costs of completion could involve more judgement than estimating the costs necessary to make the sale. We therefore think adding a reference to the disclosure requirements in IAS 1 is unnecessary.

[7] Paragraph 1.11 of the *Conceptual Framework* states that 'to a large extent, financial reports are based on estimates, judgements and models rather than exact depictions'.

Respondents' comments	Staff analysis and conclusions
3. Potential 'day-one loss' for agricultural produce The AASB and PwC say the Committee's conclusions could lead to a 'day-one loss' being recognised when an entity applies IAS 2 to agricultural produce after harvest. Paragraph 13 of IAS 41 requires an entity to measure agricultural produce at its fair value less costs to sell at the point of harvest—the costs included in this measurement are limited to those that are incremental. This amount becomes the cost of the harvested produce when it is 'reclassified' to inventories. Applying paragraph 9 of IAS 2, an entity measures inventories at the lower of cost and net realisable value. If costs necessary to sell inventories are not limited to those that are incremental, an entity may need to recognise a loss immediately upon reclassification.	*We recommend no change.* Paragraph 7 of IAS 2 states: 'Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business. Fair value reflects the price at which an orderly transaction to sell the same inventory in the principal (or most advantageous) market for that inventory would take place between market participants at the measurement date. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.' As explained in this paragraph, there are differences between *net realisable value* and *fair value less cost to sell* other than potential differences that might result from how an entity applies 'costs necessary to make the sale' and 'costs to sell'—for example, there could be differences between the estimated selling price in the ordinary course of business and fair value. Such differences may—or may not—result in a loss when an entity first applies IAS 2 to agricultural produce. The potential for such a loss does not change the requirements in IAS 2.

Respondents' comments	**Staff analysis and conclusions**
4. Wording suggestions EY suggests: (a) explicitly stating that entities may appropriately reach different conclusions about which costs to include in their estimate of the 'costs necessary to make the sale'; and (b) revising the second sentence of the third paragraph of the tentative agenda decision as follows: 'This requirement does not allow an entity to limit such costs to only those that are incremental if doing so would exclude other costs the entity must incur to sell its inventory~~, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale~~.'	*We recommend no change.* In our view: (a) it is unnecessary to state that entities may reach different conclusions about which costs to include in their estimate of the 'costs necessary to make the sale'—the tentative agenda decision already notes that an entity uses its judgement to determine which costs are necessary to make the sale; and (b) the current wording conveys the same message as the wording suggested by EY—we therefore think it is unnecessary to change the wording.
5. Further clarifications Masahiro Hoshino suggests developing an IFRIC Interpretation to clarify various aspects of IAS 2, including the objective of net realisable value, the unit of account in determining net realisable value and the definition of estimated selling price.	*We recommend no change.* We think clarifying these other aspects of IAS 2 is outside the scope of the matter discussed by the Committee.

Staff recommendation

39. Based on our analysis, we recommend finalising the agenda decision as published in IFRIC *Update* in February 2021, with no changes. If the Committee agrees with our recommendation, we will ask the Board whether it objects to the agenda decision at the first Board meeting at which it is practicable to present the agenda decision.

Question for the Committee
Does the Committee agree with our recommendation to finalise the agenda decision as explained in paragraph 39 of this paper?

Appendix A—proposed wording of the tentative agenda decision

A1. We propose the following wording for the final agenda decision, which is unchanged from the tentative agenda decision except to remove the square brackets in the last paragraph.

Costs Necessary to Sell Inventories (IAS 2 *Inventories*)

The Committee received a request about the costs an entity includes as the 'estimated costs necessary to make the sale' when determining the net realisable value of inventories. In particular, the request asked whether an entity includes all costs necessary to make the sale or only those that are incremental to the sale.

Paragraph 6 of IAS 2 defines net realisable value as 'the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale'. Paragraphs 28–33 of IAS 2 include further requirements about how an entity estimates the net realisable value of inventories. Those paragraphs do not identify which specific costs are 'necessary to make the sale' of inventories. However, paragraph 28 of IAS 2 describes the objective of writing inventories down to their net realisable value—that objective is to avoid inventories being carried 'in excess of amounts expected to be realised from their sale'.

The Committee observed that, when determining the net realisable value of inventories, IAS 2 requires an entity to estimate the costs necessary to make the sale. This requirement does not allow an entity to limit such costs to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. Including only incremental costs could fail to achieve the objective set out in paragraph 28 of IAS 2.

The Committee concluded that, when determining the net realisable value of inventories, an entity estimates the costs necessary to make the sale in the ordinary course of business. An entity uses its judgement to determine which costs are necessary to make the sale considering its specific facts and circumstances, including the nature of the inventories.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether the estimated costs necessary to make the sale are limited to incremental costs when determining the net realisable value of

inventories. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.