COLLEGE OF ACCOUNTING

MANAGEMENT ACCOUNTING | INTERMEDIATE

Video Transcription: Standard Costing and Reporting (IFRS): Part 2

Good day.

In part one of this series we looked at using Standard Costing to record our inventory transactions and then at the process of closing off the temporary variance accounts. In this video we will focus specifically on the reporting process and the IFRS considerations when a company is preparing its financial statements. This is specifically where a company has used standard costing as a costing technique. IFRS prescribes how inventory must be reported on, in the financial statements.

One of the policies found in IFRS is that "Inventories shall be measured at the lower of cost and net realisable value" (IAS 2:9)

There are two important principles to understand in relation to that policy – the first is that all expenditure that is incurred in relation to acquiring inventory must either be recognised on the "statement of financial position" as inventory or on the "statement of comprehensive income" as an expense, which we know as cost of sales. The relevance of that is that the focus must be on measuring the cost of closing inventory correctly in terms of IFRS – with all the other expenditure included in cost of sales.

The second important principle is that "cost" needs to be measured in terms of IFRS for reporting purposes, irrespective of how management monitors and records costs for internal reporting purposes.

Standard costing is an internal reporting tool used to efficiently track inventory costs and also serves as a cost controlling mechanism. Using their experience, management can estimate what the standard cost of producing a unit should be, and will use those standard costs to record the transfers of raw materials and other costs to work in progress, finished goods and eventually cost of sales when sold. By comparing the costs that are actually incurred with the amount expected i.e. calculated using standard costs; management can isolate what has caused costs to be higher or lower than anticipated.

At a high level, the difference between what actually happened and what was expected to happen are known as variances, with favourable variances resulting in a lower cost or higher profit and unfavourable variances resulting in a higher cost or lower profit.

Financial statements are required to be prepared using IFRS. IFRS allows a company to use standard costing only if the standards approximate actual costs.

If we have small variances, then we can say that standard costs approximate actual costs. If variances are large, then standards do not approximate actual costs. In this case IFRS requires inventory to be recorded at actual cost.

For the rest of this video let's assume that we are dealing with the situation where variances are large and the inventory needs to be recorded at actual. Remember that inventory is originally recorded at standard cost. We therefore need to make an adjustment to our inventory accounts to get to actual costs.

In part one of this series we showed how to record the inventory transactions at standard cost. Let us recall that example:

We are looking specifically at the purchases and usage of raw materials in a company. In this scenario the company purchased 100 kilograms of raw materials at R11/kg. The actual amount of raw materials issued to the production process was 5kg per unit produced. The company originally determined a standard price of R10/kg and the standard quantity that should be used per unit produced as 6kg.

And let's also assume that at the end of a period the following information is available: The company started producing 8 units and only 7 units were finished, leaving a WIP balance of 1 unit. The company sold 5 units. This means that 2 units were on hand at the end of the reporting period.

Actual quantity purchased	100 kg
Actual price/kilogram	R11/kg
Actual quantity used per unit of output	5 kg
Standard price/kilogram	R10/kg
Standard quantity allowed per unit of output	6 kg

Actual units finished	7 units
Units sold	5 units
Units in finished goods (7 units – 5 units)	2 units
Units in WIP (8 units – 7 units)	1 unit

When recording a company's inventory transactions, one records the actual units at standard cost. Therefore when you are preparing your financial statements, you will be starting with the amounts calculated in terms of standard costs.

These will be the balances as they stand currently.

	Actual units @ Std cost
Raw materials: Actual quantity in storage at standard price	R600 [R10 x (100kg – 40kg)]
WIP: Actual number of units being produced at standard cost	R60 [R10 x 6 kg x 1 unit]
Fgoods: Actual number of finished units at standard cost	R120 [R10 x 6 kg x 2 units]
Cost of sales: Actual units sold at standard cost	R300 [R10 x 6 kg x 5 units]
	R1080

We will also have the following variance accounts:

Unfavourable Raw Materials Price variance:	R100	(dr)
Favourable Raw Materials Usage variance:	R80	(cr)

An unfavourable RM price variance and a favourable RM usage variance.

We have determined that the variances are large and inventory should be recorded at actual results according to IFRS. Therefore the inventory balances should be as follows:

	Actual units @ actual cost
Raw materials: Actual quantity in storage at actual price	R660 [R11 x (100kg – 40kg)]
WIP: Actual number of units being produced at actual cost	R55 [R11 x 5 kg x 1 unit]
Finished goods: Actual number of finished units at actual cost	R110 [R11 x 5 kg x 2 units]
Cost of sales: Actual units sold at actual cost	R275 [R11 x 5 kg x 5 units]
	R1 100

These numbers represent the actual inventory units at actual cost. We can see here the actual price of R11/kg as well as the actual quantity used in production per unit of 5kgs. The amounts calculated, using standard costing, differ from the IFRS amounts for two reasons – one is that the actual cost per kg was R11 and not R10, and the second is that 5kgs were actually used per unit instead of 6kgs.

The increase in price would result in the actual costs being higher than standard costs. This means that actual profit will be lower than standard profit, and gives rise to an unfavourable variance.

The quantity of raw materials used was less than the standard, which results in actual cost being lower than standard costs. This means that actual profit will be higher than standard profit, and gives rise to a favourable usage variance.

Notice that the two variance accounts reconcile our balances at standard and our balances at actual. It is therefore these variance accounts that will need to be allocated to the inventory accounts for us to get our balances to actual costs in terms of IFRS.

How are we going to identify and process the adjustments required to the amounts calculated in terms of standard costing to get the IFRS amounts?

The answer to that question lies in understanding the first principle we referred to – that is, correctly identifying the cost of the closing inventory and taking all other amounts to cost of sales. What this implies is that we have to look carefully at the variances that we have calculated and determine the extent to which they relate to inventory items on hand, whether as raw materials, work in progress or finished goods. To the extent that they do, the amounts calculated for raw materials, work in progress or finished goods in terms of standard costing will be adjusted up or down, depending on whether the variances are favourable or unfavourable, to correctly measure the inventory at cost.

The price variance was unfavourable, which means the standard costs were lower than the actual. If we want the inventory balances to be equal to actual then we will need to increase our inventory accounts by allocating the variance proportionately. The following journal entry should be processed.

The journal entry will be

Dr Raw materials	R60
Dr WIP	R6
Dr Finished Goods	R12
Dr Cost of Sales	R30
Cr Raw materials usage variance	R8
Cr Raw materials price variance	R100

To understand how these numbers were calculated please look at part one.

Let's allocate the Raw Materials usage variance. Remember we allocated some of the price variance to the usage variance and therefore we now have a balance of R88.

The Raw Materials usage variance is caused by, using a different amount of raw materials in the production process than indicated by the estimated or standard amount. In this case the usage variance is favourable meaning we used less than originally expected. We need to decrease our inventory accounts to get back to the actual costs.

The journal entry will be:

Dr Raw materials usage variance	R88
Cr WIP	R11
Cr Finished Goods	R22
Cr Cost of Sales	R55

To understand how these numbers were calculated please look at part one.

After this process the variance accounts will no longer have any balances as they would have been closed off either to cost of sales or to the various inventory related accounts. We can also see that the inventory accounts are now recorded at actual cost. As such, the inventory balance and, consequently, the financial statements are prepared according to IFRS.

	Standard	Price variance	Usage variance	Actual
Raw materials:	600	60		660
WIP:	60	6	-11	55
Finished goods:	120	12	-22	110
Cost of sales:	300	30	-55	275

In our example, both our variance accounts were closed-off by adjusting our inventory balances where appropriate, as well as cost of sales for those units that were sold. We have effectively decided that those costs should be included in the cost of inventory. Will this always be the case? IFRS specifically states that certain expenses are not allowed to be included in the cost of inventory. Two instances, which we need to be aware of, is abnormal amounts of wasted materials, labour and other production costs as well as any costs related to idle capacity.

Abnormal spoilage is the spoilage over and above spoilage we expect under normal operating conditions. This means that more inputs were used than what was expected, which will result in a higher actual cost and an unfavourable variance. It occurs when our inputs are used in the production process. We will, therefore, only consider our material usage variance or the efficiency variances to identify abnormal spoilage and not the price/rate variances. Next, we know that standards are mostly set at practical levels, which incorporate normal spoilage. Therefore any unfavourable usage or efficiency variance will represent abnormal spoilage and should be taken to cost of sales.

IFRS identifies **idle capacity** where the company's actual production levels are below the normal/budgeted production levels. IFRS states that where fixed manufacturing overheads are under-allocated due to idle capacity, the amount should be expensed to cost of sales. When using Standard Costing this under-allocation of fixed manufacturing overheads due to idle capacity can be identified by an unfavourable fixed manufacturing overheads volume variance.

This video illustrated that there are two important principles to understand in relation to reporting inventory in our financial statements – the first is that all expenditure that is incurred in relation to acquiring inventory must either be recognised on the statement of financial position as inventory or on the statement of comprehensive income as an expense, which we know as cost of sales. The relevance of that is that the focus must be on measuring the cost of closing inventory correctly in terms of IFRS – with all the other expenditure included in cost of sales.

The second important principle is that "cost" needs to be measured in terms of IFRS for reporting purposes irrespective of how management monitors and records costs. Therefore when management uses a standard costing system, one must still make sure that inventory will be correctly reported according to IFRS.