

CHEAT SHEET

MANUFACTURED INVENTORIES: IMPACTS OF THE NEW LEASE STANDARD

BACKGROUND

For 2020 reporting dates, the long awaited new accounting standard on leases (NZ IFRS 16 *Leases*) comes into effect for *for-profit entities* who apply NZ IFRS.

As we have covered in previous *Cheat Sheets*, NZ IFRS 16 results in a fundamental change in the way that lessees will need to account for most of their lease agreements.

In our experience, one often overlooked area of the new requirements is how this change in accounting treatment in one area, may actually have a consequential impact to another area of accounting... the carrying value of manufactured inventories (and thereby, *Cost of goods sold (CoGS)*, and *Gross profit*).

This is because NZ IFRS 16 decrease the expenses that are (can be) included in overheads to be allocated to the cost of manufactured inventories – thereby **(i)** decreasing CoGS, and **(ii)** increasing Gross Profit

Where an entity is working through the adoption of NZ IFRS 16 at the end of the year, this will mean that the inventory cost accounting that has been determined on pre-NZ IFRS 16 accounting treatments, will need to be “unpicked” to bring these in.

This *Cheat Sheet* has been produced as a high-level overview of the impact of NZ IFRS 16 on inventory cost accounting.

NEED ASSISTANCE WITH YOUR ADOPTION OF NZ IFRS 16?

BDO *IFRS Advisory* is a dedicated service line available to assist entities in adopting NZ IFRS 16. Further details are provided on the following page for your information.



WHAT IS COVERED IN THE CHEAT SHEET

In order to navigate through these areas of accounting, this *Cheat Sheet* is broken down into the following sections:

1. **Reminder of the changes in expenses as a result of NZ IFRS 16**
2. **Costs that can be included in manufactured inventories**
3. **Resulting impact**
4. **What needs to be done?**

1. Reminder of the changes in expenses as a result of NZ IFRS 16

From our previous [Cheat Sheet](#) in July 2018, readers will remember that NZ IFRS 16 changes the look and feel of an entity's income statement – as well as bringing new asset and liability balances onto the balance sheet.

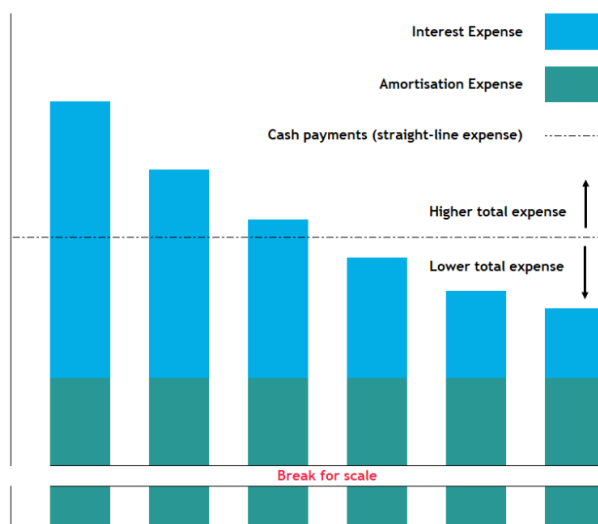
Rent expenses (reflected by the “dashed” line in the adjacent graph), are replaced with different (and unequal) amounts of:

- *Interest expense* (charged on the new *Lease liability* balance)
- *Amortisation expense* (unwinding of the new *Right-of-use Asset* balance).

Accordingly, subtotals, financial metrics, and other financial statement areas that incorporate these amounts will also change as a consequence of NZ IFRS 16.

Cue our discussion with respect to manufactured inventories

Income Statement



2. Costs that can be included in manufactured inventories

The cost of inventories includes three components:



When it comes to manufactured inventories, the **conversion costs** above are a fundamental part of the "cost build".

Conversion costs include an allocation of fixed costs that relate to the production of inventory. So where inventory is being produced in leased premises, and/or with leased equipment, conversion costs would have previously included (a portion of) the rental expense for these items.

This is still the case when NZ IFRS 16 is adopted... however the value of the amounts, and which amounts you can allocate to conversion costs, change.

3. Resulting impact

So from the above it is important to note that in terms of the new NZ IFRS 16 expenses (if the associated Right-of-use asset is being used in the production of inventory):

- (i) *Amortisation expense* can be included in **conversion costs** (where *Rent expense* was previously)
- (ii) *Interest expense* CANNOT be included in **conversion costs**.
This is because for accounting purposes, interest expense is considered a financing cost, rather than an operating cost¹.

So, because the *Amortisation expense* is (typically) lower than the previous *Rent Expense* (see graph above)²:



4. What needs to be done?

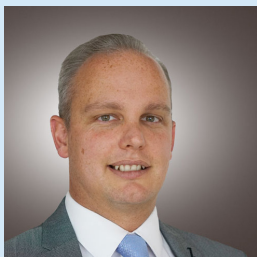
If your entity is going through the adoption of the NZ IFRS 16 as part of the 2020 year end process (i.e. after the fact), then you will need to ensure that your overhead cost allocation to cost of inventory and cost of goods sold is based on NZ IFRS 16 numbers.

If you have yet to perform the overhead cost allocation, then the process is simple, wait to the NZ IFRS 16 numbers are finalised, and perform the allocation.

If you have already performed the overhead cost allocation on non-NZ IFRS 16 numbers (including any year-end wash-up), then you will need to reverse out the previous allocation, and re-performed the allocation once the NZ IFRS 16 numbers have been finalised.

BDO IFRS ADVISORY

Members of BDO's *IFRS Advisory* department come ready with real life experience in adopting NZ IFRS 16 and are therefore well placed to provide entities with the expertise and assistance they require.



For more information as to how BDO Accounting Advisory Services might assist with your entity in navigating this and other areas of IFRS application, please contact James Lindsay at BDO *IFRS Advisory* (james.lindsay@bdo.co.nz) +64 21 166 0844, and visit our webpage below.

<https://www.bdo.nz/en-nz/ifrs-advisory>

Also, visit our dedicated "Adopting NZ IFRS 16 webpage" for more information and resources on NZ IFRS 16.

<https://www.bdo.nz/en-nz/nz-ifrs-16>

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¹ Note, that if the inventory is a "qualifying asset" under NZ IAS 23 (i.e. one that takes a substantial period of time to prepare – being usually those with a "maturing" process involved – e.g. certain cheese, wine, spirits etc.) then a portion of interest costs is required to be capitalised to the cost of inventory.

² The only time this might not be the case is if the useful life of the asset is less than the lease term over which payments are being made – i.e. higher *Amortisation expense* over a shorter period.