

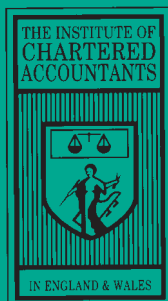
SSAP

Statement of standard accounting practice No. 9.

9

Revised September 1988

Stocks and long-term contracts



STATEMENT OF STANDARD ACCOUNTING PRACTICE

9 (Revised)

Stocks and long-term contracts

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STATEMENT OF STANDARD ACCOUNTING PRACTICE

Stocks and long-term contracts

(Issued May 1975; Part 6 added August 1980; revised September 1988)

The provisions of this statement of standard accounting practice should be read in conjunction with the Explanatory foreword to accounting standards and need not be applied to immaterial items.

Part 1 – Explanatory note

Stocks

- 1 The determination of profit for an accounting year requires the matching of costs with related revenues. The cost of unsold or unconsumed stocks will have been incurred in the expectation of future revenue, and when this will not arise until a later year it is appropriate to carry forward this cost to be matched with the revenue when it arises; the applicable concept is the matching of cost and revenue in the year in which the revenue arises rather than in the year in which the cost is incurred. If there is no reasonable expectation of sufficient future revenue to cover cost incurred (eg, as a result of deterioration, obsolescence or a change in demand) the irrecoverable cost should be charged to revenue in the year under review. Thus, stocks normally need to be stated at cost, or, if lower, at net realisable value.
- 2 The comparison of cost and net realisable value needs to be made in respect of each item of stock separately. Where this is impracticable, groups or categories of stock items which are similar will need to be taken together. To compare the total realisable value of stocks with the total cost could result in an unacceptable setting off of foreseeable losses against unrealised profits.
- 3 In order to match costs and revenue, 'costs' of stocks should comprise that expenditure which has been incurred in the normal course of business in bringing the product or service to its present location and condition. Such costs will include all related production overheads, even though these may accrue on a time basis.
- 4 The methods used in allocating costs to stocks need to be selected with a view to providing the fairest possible approximation to the expenditure actually incurred in bringing the product to its present location and condition. For example, in the case of retail stores holding a large number of rapidly changing individual items, stock on the shelves has often been stated at current selling prices less the normal gross profit margin. In these particular circumstances this may be acceptable as being the only practical method of arriving at a figure which approximates to cost.

Net realisable value

- 5 Net realisable value is the estimated proceeds from the sale of items of stock less all further costs to completion and less all costs to be incurred in marketing, selling and distributing directly related to the items in question.

Replacement cost

- 6 Items of stock have sometimes been stated in financial statements at estimated replace-

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ment cost where this is lower than net realisable value. Where the effect is to take account of a loss greater than that which is expected to be incurred, the use of replacement cost is not regarded as acceptable. However, in some circumstances (eg, in the case of materials, the price of which has fluctuated considerably and which have not become the subject of firm sales contracts by the time the financial statements are prepared) replacement cost may be the best measure of net realisable value. Also, where a company adopts the alternative accounting rules of the Companies Act 1985, items of stock may be stated at the lower of current replacement cost and net realisable value.

Long-term contracts

Separate consideration needs to be given to long-term contracts. Owing to the length of time taken to complete such contracts, to defer recording turnover and taking profit into account until completion may result in the profit and loss account reflecting not so much a fair view of the results of the activity of the company during the year but rather the results relating to contracts that have been completed in the year. It is therefore appropriate to take credit for ascertainable turnover and profit while contracts are in progress in accordance with paragraphs 8 to 11 below. 7

Companies should ascertain turnover in a manner appropriate to the stage of completion of the contracts, the businesses and the industries in which they operate. 8

Where the business carries out long-term contracts and it is considered that their outcome can be assessed with reasonable certainty before their conclusion, the attributable profit should be calculated on a prudent basis and included in the accounts for the period under review. The profit taken up needs to reflect the proportion of the work carried out at the accounting date and to take into account any known inequalities of profitability in the various stages of a contract. The procedure to recognise profit is to include an appropriate proportion of total contract value as turnover in the profit and loss account as the contract activity progresses. The costs incurred in reaching that stage of completion are matched with this turnover, resulting in the reporting of results that can be attributed to the proportion of work completed. 9

Where the outcome of long-term contracts cannot be assessed with reasonable certainty before the conclusion of the contract, no profit should be reflected in the profit and loss account in respect of those contracts, although, in such circumstances, if no loss is expected it may be appropriate to show as turnover a proportion of the total contract value using a zero estimate of profit. 10

If it is expected that there will be a loss on a contract as a whole, all of the loss should be recognised as soon as it is foreseen (in accordance with the prudence concept). Examples of how this can be achieved are given in Appendix 3. Initially, the foreseeable loss will be deducted from the work in progress figure of the particular contract, thus reducing it to net realisable value. Any loss in excess of the work in progress figure should be classified as an accrual within 'Creditors' or under 'Provisions for liabilities and charges' depending upon the circumstances. Where unprofitable contracts are of such magnitude that they can be expected to utilise a considerable part of the company's capacity for a substantial period, related administration overheads to be incurred during the period to the completion of those contracts should also be included in the calculation of the provision for losses. 11

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Disclosure in financial statements

- 12 A suitable description of the amount at which stocks (excluding long-term contract balances) are stated in financial statements would be 'at the lower of cost and net realisable value'.
- 13 In the case of long-term contracts:
- (a) long-term contract balances classified under the balance sheet heading of 'Stocks' are stated at total costs incurred, net of amounts transferred to the profit and loss account in respect of work carried out to date, less foreseeable losses and applicable payments on account. A suitable description in the financial statements would be 'at net cost, less foreseeable losses and payments on account'.
 - (b) cumulative turnover (ie, the total turnover recorded in respect of the contract in the profit and loss accounts of all accounting periods since inception of the contract) is compared with total payments on account. If turnover exceeds payments on account an 'amount recoverable on contracts' is established and separately disclosed within debtors. If payments on account are greater than turnover to date, the excess is classified as a deduction from any balance on that contract in stocks, with any residual balance in excess of cost being classified with creditors.
- 14 In order to give an adequate explanation of the affairs of the company, the accounting policies followed in arriving at the amount at which stocks and long-term contracts are stated in the financial statements should be set out in a note. Where differing bases have been adopted for different types of stocks and long-term contracts, the amount included in the financial statements in respect of each type will need to be stated.

Further practical considerations

- 15 The basic considerations which must be taken into account in determining cost and net realisable value in relation to stocks and long-term contracts are set out in Parts 2 and 3 of this statement. The majority of problems which arise in practice in determining these amounts result from considerations which are relevant to particular businesses and are not of such universal application that they can be the subject of a statement of standard accounting practice. Accordingly, Appendix 1 sets out in more detail some general guidelines which may be of assistance in determining cost and net realisable value and in identifying those situations in which net realisable value is likely to be less than cost. Appendix 1 also sets out considerations which need to be borne in mind in calculating the amount of profit to be taken into account in respect of long-term contracts.

Part 2 – Definition of terms

- 16 *Stocks* comprise the following categories:
- (a) goods or other assets purchased for resale;
 - (b) consumable stores;
 - (c) raw materials and components purchased for incorporation into products for sale;
 - (d) products and services in intermediate stages of completion;

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- (e) long-term contract balances; and
 - (f) finished goods.
- Cost* is defined in relation to the different categories of stocks as being that expenditure which has been incurred in the normal course of business in bringing the product or service to its present location and condition. This expenditure should include, in addition to cost of purchase (as defined in paragraph 18), such costs of conversion (as defined in paragraph 19) as are appropriate to that location and condition. 17
- Cost of purchase* comprises purchase price including import duties, transport and handling costs and any other directly attributable costs, less trade discounts, rebates and subsidies. 18
- Cost of conversion* comprises: 19
- (a) costs which are specifically attributable to units of production, eg, direct labour, direct expenses and sub-contracted work;
 - (b) production overheads (as defined in paragraph 20);
 - (c) other overheads, if any, attributable in the particular circumstances of the business to bringing the product or service to its present location and condition.
- Production overheads*: overheads incurred in respect of materials, labour or services for production, based on the normal level of activity, taking one year with another. For this purpose each overhead should be classified according to function (eg, production, selling or administration) so as to ensure the inclusion, in cost of conversion, of those overheads (including depreciation) which relate to production, notwithstanding that these may accrue wholly or partly on a time basis. 20
- Net realisable value*: the actual or estimated selling price (net of trade but before settlement discounts) less: 21
- (a) all further costs to completion; and
 - (b) all costs to be incurred in marketing, selling and distributing.
- Long-term contract*: a contract entered into for the design, manufacture or construction of a single substantial asset or the provision of a service (or of a combination of assets or services which together constitute a single project) where the time taken substantially to complete the contract is such that the contract activity falls into different accounting periods. A contract that is required to be accounted for as long-term by this accounting standard will usually extend for a period exceeding one year. However, a duration exceeding one year is not an essential feature of a long-term contract. Some contracts with a shorter duration than one year should be accounted for as long-term contracts if they are sufficiently material to the activity of the period that not to record turnover and attributable profit would lead to a distortion of the period's turnover and results such that the financial statements would not give a true and fair view, provided that the policy is applied consistently within the reporting entity and from year to year. 22

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- 23 *Attributable profit*: that part of the total profit currently estimated to arise over the duration of the contract, after allowing for estimated remedial and maintenance costs and increases in costs so far as not recoverable under the terms of the contract, that fairly reflects the profit attributable to that part of the work performed at the accounting date. (There can be no attributable profit until the profitable outcome of the contract can be assessed with reasonable certainty.)
- 24 *Foreseeable losses*: losses which are currently estimated to arise over the duration of the contract (after allowing for estimated remedial and maintenance costs and increases in costs so far as not recoverable under the terms of the contract). This estimate is required irrespective of:
- (a) whether or not work has yet commenced on such contracts;
 - (b) the proportion of work carried out at the accounting date;
 - (c) the amount of profits expected to arise on other contracts.
- 25 *Payments on account*: all amounts received and receivable at the accounting date in respect of contracts in progress.

Part 3 – Standard accounting practice

Stocks

- 26 The amount at which stocks are stated in periodic financial statements should be the total of the lower of cost and net realisable value of the separate items of stock or of groups of similar items.
- 27 Stocks should be sub-classified in the balance sheet or in the notes to the financial statements so as to indicate the amounts held in each of the main categories in the standard balance sheet formats (as adapted where appropriate) of Schedule 4 to the Companies Act 1985, Schedule 4 to the Companies (Northern Ireland) Order 1986 and, in the Republic of Ireland, the Schedule to the Companies (Amendment) Act 1986.

Long-term contracts

- 28 Long-term contracts should be assessed on a contract by contract basis and reflected in the profit and loss account by recording turnover and related costs as contract activity progresses. Turnover is ascertained in a manner appropriate to the stage of completion of the contract, the business and the industry in which it operates.
- 29 Where it is considered that the outcome of a long-term contract can be assessed with reasonable certainty before its conclusion, the prudently calculated attributable profit should be recognised in the profit and loss account as the difference between the reported turnover and related costs for that contract.
- 30 Long-term contracts should be disclosed in the balance sheet as follows:
- (a) the amount by which recorded turnover is in excess of payments on account should be classified as 'amounts recoverable on contracts' and separately disclosed within debtors;

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- (b) the balance of payments on account (in excess of amounts (i) matched with turnover; and (ii) offset against long-term contract balances) should be classified as payments on account and separately disclosed within creditors;
- (c) the amount of long-term contracts, at costs incurred, net of amounts transferred to cost of sales, after deducting foreseeable losses and payments on account not matched with turnover, should be classified as 'long-term contract balances' and separately disclosed within the balance sheet heading 'Stocks'. The balance sheet note should disclose separately the balances of:
 - (i) net cost less foreseeable losses; and
 - (ii) applicable payments on account;
- (d) the amount by which the provision or accrual for foreseeable losses exceeds the costs incurred (after transfers to cost of sales) should be included within either provisions for liabilities and charges or creditors as appropriate.

Consequent upon the application of this revised standard, the corresponding amounts in the financial statements will need to be restated on a comparable basis. 31

Statement of accounting policies

The accounting policies that have been applied to stocks and long-term contracts, in particular the method of ascertaining turnover and attributable profit, should be stated and applied consistently within the business and from year to year. 32

Date from which effective

The accounting practices set out in this statement should be adopted as soon as possible and regarded as standard in respect of financial statements relating to accounting periods beginning on or after 1 July 1988. 33

Part 4 – Note on legal requirements in Great Britain and Northern Ireland

All paragraph references unless otherwise indicated are to Schedule 4 to the Companies Act 1985 and Schedule 4 to the Companies (Northern Ireland) Order 1986.

Paragraph 22 requires that, under the historical cost accounting rules, 'the amount to be included in respect of any current asset shall be its purchase price or production cost'. Paragraph 23(1) provides for the inclusion of the asset at net realisable value if lower than purchase price or production cost. 34

Paragraph 90 [paragraph 89 of Schedule 4 to the Companies (Northern Ireland) Order 1986] provides that 'the purchase price of any asset ... includes any consideration (whether in cash or otherwise) given by the company in respect of that asset'. Counsel's opinion, obtained by the ASC, has indicated that one purpose of this paragraph is to enable debtors to be stated at face value, that is, at amounts which include a profit element, and that this does not conflict with paragraph 22. 35

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- 36 Paragraph 26 requires expenses incidental to the acquisition of an asset to be included in the purchase price. It also requires the inclusion of directly attributable production overheads in the production cost of an asset and permits the inclusion of overheads which are only indirectly attributable to the production of an asset and interest on borrowed capital. In cases where interest is included the fact must be stated and the amount of interest included must be disclosed in a note to the financial statements. Paragraph 26 also prohibits the inclusion of distribution costs.
- 37 Paragraph 27 allows the following methods for valuation of stocks (but requires that the method chosen must be one which appears to the directors to be appropriate in the circumstances of the company):
- (a) the method known as 'first in, first out' (FIFO);
 - (b) the method known as 'last in, first out' (LIFO);
 - (c) a weighted average price; and
 - (d) any other method similar to any of the methods mentioned above.
- 38 This standard requires the use of a method which provides a fair approximation to the expenditure actually incurred. The use of some of the methods allowed by paragraph 27 of the Schedule will not necessarily meet this requirement.
- 39 In particular, the use of the LIFO method can result in the reporting of current assets at amounts that bear little relationship to recent costs. This may result in not only a significant misstatement of balance sheet amounts but also a potential distortion of current and future results. This places a special responsibility on the directors to be assured that the circumstances of the company require the adoption of such a valuation method in order for the accounts to give a true and fair view.
- 40 Paragraph 27(3) requires a company to state in a note to the accounts the difference between the replacement cost of stocks and their book amount – as determined by 37(a) to (d) above – where this difference is material.
- 41 It is further provided in paragraph 27(5) that if the most recent actual purchase price or production cost before the balance sheet date appears to the directors of the company to constitute a more appropriate standard of comparison, then that amount may be used as a surrogate for replacement cost.
- 42 Paragraph 31(5) provides that, where a company adopts the alternative accounting rules, 'stocks may be included at their current cost'.
- 43 Paragraph 89 [paragraph 88 of Schedule 4 to the Companies (Northern Ireland) Order 1986] provides that provisions are amounts 'retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise'.
- 44 Paragraph 91 [paragraph 90 of Schedule 4 to the Companies (Northern Ireland) Order 1986] declares that realised profits are 'such profits of a company as fall to be treated as realised profits for the purposes of those accounts in accordance with principles generally

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accepted with respect to the determination for accounting purposes of realised profits'. It is a 'generally accepted principle' that it is appropriate to recognise profit on long-term contracts when the outcome can be assessed with 'reasonable certainty'. The principle of recognising profit on long-term contracts under this standard, therefore, does not contravene this paragraph.

Part 5 – Note on legal requirements in the Republic of Ireland

The legal requirements in Great Britain and Northern Ireland are mirrored, in respect of the Republic of Ireland, in the Schedule to the Companies (Amendment) Act 1986. The following table indicates the corresponding paragraphs in respect of all of the references contained in Part 4 of this statement. 45

<i>Schedule 4 to the Companies Act 1985</i>	<i>Schedule 4 to the Companies (Northern Ireland) Order 1986</i>	<i>The Schedule to the Companies (Amendment) Act 1986</i>
Paragraph 22	Paragraph 22	Paragraph 10
Paragraph 23(1)	Paragraph 23(1)	Paragraph 11(1)
Paragraph 26	Paragraph 26	Paragraph 14
Paragraph 27	Paragraph 27	Paragraph 15*
Paragraph 27(4)	Paragraph 27(4)	Paragraph 15(4)*
Paragraph 27(5)	Paragraph 27(5)	Paragraph 15(5)
Paragraph 31(5)	Paragraph 31(5)	Paragraph 19(5)
Paragraph 89	Paragraph 88	Paragraph 70
Paragraph 90	Paragraph 89	Paragraph 71
Paragraph 91	Paragraph 90	Paragraph 72

Part 6 – Compliance with International Accounting Standard No 2 'Valuation and presentation of inventories in the context of the historical cost system' and No 11 'Accounting for construction contracts'

The requirements of International Accounting Standard No 2 'Valuation and presentation of inventories in the context of the historical cost system' and International Accounting Standard No 11 'Accounting for construction contracts' accord very closely with the content of the United Kingdom and Irish Accounting Standard No 9 (Revised) 'Stocks and long-term contracts' and accordingly compliance with SSAP 9 will ensure compliance with both IAS 2 and IAS 11 in all material respects. 46

*There is no provision for the LIFO method of stock valuation in paragraph 15 of the Schedule to the Companies (Amendment) Act 1986.

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Appendix 1

This appendix is for general guidance and does not form part of the statement of standard accounting practice.

Further practical considerations

Many of the problems involved in arriving at the amount at which stocks and long-term contracts are stated in financial statements are of a practical nature rather than resulting from matters of principle. This appendix discusses some particular areas in which difficulty may be encountered.

The allocation of overheads

- 1 Production overheads are included in cost of conversion (as defined in Part 2) together with direct labour, direct expenses and sub-contracted work. This inclusion is a necessary corollary of the principle that expenditure should be included to the extent to which it has been incurred in bringing the product 'to its present location and condition' (paragraph 17 of Part 2). However, all abnormal conversion costs (such as exceptional spoilage, idle capacity and other losses) which are avoidable under normal operating conditions need, for the same reason, to be excluded.
- 2 Where firm sales contracts have been entered into for the provision of goods or services to customer's specification, overheads relating to design, and marketing and selling costs incurred before manufacture, may be included in arriving at cost.
- 3 The costing methods adopted by a business are usually designed to ensure that all direct material, direct labour, direct expenses and sub-contracted work are identified and charged on a reasonable and consistent basis but problems arise on the allocation of overheads which must usually involve the exercise of personal judgement in the selection of an appropriate convention.
- 4 The classification of overheads necessary to achieve this allocation takes the function of the overhead as its distinguishing characteristic (eg, whether it is a function of production, marketing, selling or administration), rather than whether the overhead tends to vary with time or with volume.
- 5 The costs of general management, as distinct from functional management, are not directly related to current production and are, therefore, excluded from cost of conversion and, hence, from the cost of stocks and long-term contracts.
- 6 In the case of smaller organisations whose management may be involved in the daily administration of each of the various functions, particular problems may arise in practice in distinguishing these general management overheads. In such organisations the cost of management may fairly be allocated on suitable bases to the functions of production, marketing, selling and administration.

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Problems may also arise in allocating the costs of central service departments, the allocation of which should depend on the function or functions that the department is serving. For example the accounts department will normally support the following functions: 7

- (a) production – by paying direct and indirect production wages and salaries, by controlling purchases and by preparing periodic financial statements for the production units;
- (b) marketing and distribution – by analysing sales and by controlling the sales ledger;
- (c) general administration – by preparing management accounts and annual financial statements and budgets, by controlling cash resources and by planning investments.

Only those costs of the accounts department that can reasonably be allocated to the production function fall to be included in the cost of conversion.

The allocation of overheads included in the valuation of stocks and long-term contracts needs to be based on the company's normal level of activity, taking one year with another. The governing factor is that the cost of unused capacity should be written off in the current year. In determining what constitutes 'normal' the following factors need to be considered: 8

- (a) the volume of production which the production facilities are intended by their designers and by management to produce under the working conditions (eg, single or double shift) prevailing during the year;
- (b) the budgeted level of activity for the year under review and for the ensuing year;
- (c) the level of activity achieved both in the year under review and in previous years.

Although temporary changes in the load of activity may be ignored, persistent variation should lead to a revision of the previous norm.

Where management accounts are prepared on a marginal cost basis, it will be necessary to add to the figure of stocks so arrived at, the appropriate proportion of those production overheads not already included in the marginal cost. 9

The adoption of a conservative approach to the valuation of stocks and long-term contracts has sometimes been used as one of the reasons for omitting selected production overheads. In so far as the circumstances of the business require an element of prudence in determining the amount at which stocks and long-term contracts are stated, this needs to be taken into account in the determination of net realisable value and not by the exclusion from cost of selected overheads. 10

Methods of costing

It is frequently not practicable to relate expenditure to specific units of stocks and long-term contracts. The ascertainment of the nearest approximation to cost gives rise to two problems: 11

- (a) the selection of an appropriate method for relating costs to stocks and long-term contracts (eg, job costing, batch costing, process costing, standard costing);
- (b) the selection of an appropriate method for calculating the related costs where a number of identical items have been purchased or made at different times (eg, unit cost, average cost or FIFO).

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- 12 In selecting the methods referred to in paragraphs 11(a) and (b) above, management must exercise judgement to ensure that the methods chosen provide the fairest practicable approximation to cost. Furthermore, where standard costs are used they need to be reviewed frequently to ensure that they bear a reasonable relationship to actual costs obtaining during the period. Methods such as base stock and LIFO are not usually appropriate methods of stock valuation because they often result in stocks being stated in the balance sheet at amounts that bear little relationship to recent cost levels. When this happens, not only is the presentation of current assets misleading, but there is potential distortion of subsequent results if stock levels reduce and out of date costs are drawn into the profit and loss account.
- 13 The method of arriving at cost by applying the latest purchase price to the total number of units in stock is unacceptable in principle because it is not necessarily the same as actual cost and, in times of rising prices, will result in the taking of a profit which has not been realised.
- 14 One method of arriving at cost, in the absence of a satisfactory costing system, is the use of selling price less an estimated profit margin. This is acceptable only if it can be demonstrated that the method gives a reasonable approximation of the actual cost.
- 15 In industries where the cost of minor by-products is not separable from the cost of the principal products, stocks of such by-products may be stated in accounts at their net realisable value. In this case the costs of the main products are calculated after deducting the net realisable value of the by-products.
- The determination of net realisable value**
- 16 The initial calculation of provisions to reduce stocks from cost to net realisable value may often be made by the use of formulae based on predetermined criteria. The formulae normally take account of the age, movements in the past, expected future movements and estimated scrap values of the stock, as appropriate. Whilst the use of such formulae establishes a basis for making a provision which can be consistently applied, it is still necessary for the results to be reviewed in the light of any special circumstances which cannot be anticipated in the formulae, such as changes in the state of the order book.
- 17 Where a provision is required to reduce the value of finished goods below cost, the stocks of the parts and sub-assemblies held for the purpose of the manufacture of such products, together with stocks on order, need to be reviewed to determine if provision is also required against such items.
- 18 Where stocks of spares are held for sale, special consideration of the factors in paragraph 16 of this appendix will be required in the context of:
- (a) the number of units sold to which they are applicable;
 - (b) the estimated frequency with which a replacement spare is required;
 - (c) the expected useful life of the unit to which they are applicable.
- 19 Events occurring between the balance sheet date and the date of completion of the financial statements need to be considered in arriving at the net realisable value at the balance

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sheet date (eg, a subsequent reduction in selling prices). However, no reduction falls to be made when the realisable value of material stocks is less than the purchase price, provided that the goods into which the materials are to be incorporated can still be sold at a profit after incorporating the materials at cost price.

The application of net realisable value

The principal situations in which net realisable value is likely to be less than cost are where there has been: 20

- (a) an increase in costs or a fall in selling price;
- (b) physical deterioration of stocks;
- (c) obsolescence of products;
- (d) a decision as part of a company's marketing strategy to manufacture and sell products at a loss;
- (e) errors in production or purchasing.

Furthermore, when stocks are held which are unlikely to be sold within the turnover period normal in that company (ie, excess stocks), the impending delay in realisation increases the risk that the situations outlined in (a) to (c) above may occur before the stocks are sold and needs to be taken into account in assessing net realisable value.

Long-term contracts

In ascertaining costs of long-term contracts it is not normally appropriate to include interest payable on borrowed money. However, in circumstances where sums borrowed can be identified as financing specific long-term contracts, it may be appropriate to include such related interest in cost, in which circumstances the inclusion of interest and the amount of interest so included should be disclosed in a note to the financial statements. 21

In some businesses, long-term contracts for the supply of services or manufacture and supply of goods exist where the prices are determined and invoiced according to separate parts of the contract. In these businesses the most appropriate method of reflecting profits on each contract is usually to match costs against performance of the separable parts of the contract, treating each such separable part as a separate contract. In such instances, however, future revenues from the contract need to be compared with future estimated costs and provision made for any foreseen loss. 22

Turnover (ascertained in a manner appropriate to the industry, the nature of the contracts concerned and the contractual relationship with the customer) and related costs should be recorded in the profit and loss account as contract activity progresses. Turnover may sometimes be ascertained by reference to valuation of the work carried out to date. In other cases, there may be specific points during a contract at which individual elements of work done with separately ascertainable sales values and costs can be identified and appropriately recorded as turnover (eg, because delivery or customer acceptance has taken place). This accounting standard does not provide a definition of turnover in view of the different methods of ascertaining it as outlined above. However, it does require disclosure of the means by which turnover is ascertained. 23

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- 24 In determining whether the stage has been reached at which it is appropriate to recognise profit, account should be taken of the nature of the business concerned. It is necessary to define the earliest point for each particular contract before which no profit is taken up, the overriding principle being that there can be no attributable profit until the outcome of a contract can reasonably be foreseen. Of the profit which in the light of all the circumstances can be foreseen with a reasonable degree of certainty to arise on completion of the contract, there should be regarded as earned to date only that part which prudently reflects the amount of work performed to date. The method used for taking up such profits needs to be consistently applied.
- 25 In calculating the total estimated profit on the contract, it is necessary to take into account not only the total costs to date and the total estimated further costs to completion (calculated by reference to the same principles as were applied to cost to date) but also the estimated future costs of rectification and guarantee work, and any other future work to be undertaken under the terms of the contract. These are then compared with the total sales value of the contract. In considering future costs, it is necessary to have regard to likely increases in wages and salaries, to likely increases in the price of raw materials and to rises in general overheads, so far as these items are not recoverable from the customer under the terms of the contract.
- 26 Where approved variations have been made to a contract in the course of it and the amount to be received in respect of these variations has not yet been settled and is likely to be a material factor in the outcome, it is necessary to make a conservative estimate of the amount likely to be received and this is then treated as part of the total sales value. On the other hand, allowance needs to be made for foreseen claims or penalties payable arising out of delays in completion or from other causes.
- 27 The settlement of claims arising from circumstances not envisaged in the contract or arising as an indirect consequence of approved variations is subject to a high level of uncertainty relating to the outcome of future negotiations. In view of this, it is generally prudent to recognise receipts in respect of such claims only when negotiations have reached an advanced stage and there is sufficient evidence of the acceptability of the claim in principle to the purchaser, with an indication of the amount involved also being available.
- 28 The amounts to be included in the year's profit and loss account will be both the appropriate amount of turnover and the associated costs of achieving that turnover, to the extent that these amounts exceed corresponding amounts recognised in previous years. The estimated outcome of a contract which extends over several accounting years will nearly always vary in the light of changes in circumstances and for this reason the result of the year will not necessarily represent the proportion of the total profit on the contract which is appropriate to the amount of work carried out in the period; it may also reflect the effect of changes in circumstances during the year which affect the total profit estimated to accrue on completion.

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Appendix 2

This appendix is for general guidance and does not form part of the statement of standard accounting practice.

Glossary of terms

The use of the following terms in describing the accounting policies adopted in arriving at the amount at which stocks and long-term contracts are stated in financial statements should be restricted in conformity with the definitions given to each. Where these definitions are inapplicable, alternative expressions should be used and explained.

- Average cost:* the calculation of the cost of stocks on the basis of the application to the unit of stocks on hand of an average price computed by dividing the total cost of units by the total number of such units. This average price may be arrived at by means of a continuous calculation, a periodic calculation or a moving periodic calculation. 1
- Base stock:* the calculation of the cost of stocks on the basis that a fixed unit value is ascribed to a predetermined number of units of stock, any excess over this number being valued on the basis of some other method. If the number of units in stock is less than the predetermined minimum, the fixed unit value is applied to the number in stock. 2
- Completed long-term contract:* a long-term contract on which no further work, apart from maintenance work, is expected to take place. 3
- Current cost* of stock is the lower of: 4
- (a) its net current replacement cost; and
 - (b) its net realisable value.
- FIFO (first in, first out):* the calculation of the cost of stocks on the basis that the quantities in hand represent the latest purchases or production. 5
- LIFO (last in, first out):* the calculation of the cost of stocks on the basis that the quantities in hand represent the earliest purchases or production. 6
- Replacement cost:* the cost at which an identical asset could be purchased or manufactured. 7
- Standard cost:* the calculation of the cost of stocks on the basis of periodically predetermined costs calculated from management's estimates of expected levels of costs and of operations and operational efficiency and the related expenditure. 8
- Unit cost:* the cost of purchasing or manufacturing identifiable units of stocks. 9

STATEMENT OF STANDARD ACCOUNTING PRACTICE

Appendix 3

This appendix is for general guidance and does not form part of the statement of standard accounting practice.

Long-term contracts: further consideration of financial statement presentation

- 1 The classification of an 'amount recoverable on contracts' within debtors is a somewhat unfamiliar concept which needs careful consideration.
- 2 The determination of the point at which ownership of completed work passes from the contractor to the customer is a complex matter of legal form and industry practice.
- 3 An 'amount recoverable on contracts' may not have the contractual status of a debtor in strict legal form. However, it is well established under the accruals concept of revenue and cost recognition that this should not preclude debtors and creditors from being recorded, where this is necessary to reflect the substance of a transaction.
- 4 An essential test for an 'amount recoverable on contracts' to be recorded as an asset is that it should be realisable. This applies equally whether the balance is classified as a debtor or as an element of work in progress.
- 5 An 'amount recoverable on contracts' represents an excess of the value of work carried out to date (which has been recorded as turnover) over cumulative payments on account. The amount and realisability of the balance therefore depend on the value of work carried out being ascertained appropriately. The balance arises as a derivative of this process of contract revenue recognition and is directly linked to turnover. In substance, it represents accrued revenue receivable and has the attributes of a debtor.
- 6 Accordingly, the standard concludes that 'amounts recoverable on contracts' should be classified as debtors, although separate disclosure is prescribed. Counsel's opinion obtained by the ASC confirms that 'amounts recoverable on contracts' should be classified under 'Debtors' and cannot be classified under 'Stocks'.
- 7 In determining the amounts at which long-term contracts should be included in the financial statements, contracting activity should be reviewed on an individual contract by contract basis. The following example illustrates the process of applying the principles set out in the standard to long-term contracts.

STOCKS AND LONG-TERM CONTRACTS

	<i>Project Number</i>					Balance Sheet Total	Profit & Loss Account
	1	2	3	4	5		
Recorded as turnover – being value of work done	145	520	380	200	55		1,300
Cumulative payments on account	(100)	(600)	(400)	(150)	(80)		
Classified as amounts recoverable on contracts	45			50		95DR	
Balance (excess) of payments on account		(80)	(20)		(25)		
Applied as an offset against long-term contract balances – see below		60	20		15		
Residue classified as payments on account		(20)	–		(10)	(30)CR	
Total costs incurred	110	510	450	250	100		
Transferred to cost of sales	(110)	(450)	(350)	(250)	(55)		(1,215)
	–	60	100	–	45		
Provision/accrual for foreseeable losses charged to cost of sales				(40)	(30)		(70)
		60	100		15		
Classified as provision/accrual for losses				(40)		(40)CR	
Balance (excess) of payments on account applied as offset against long-term contract balances		(60)	(20)		(15)		
Classified as long-term contract balances		–	80		–	80DR	
Gross profit or loss on long-term contracts	35	70	30	(90)	(30)		15

STATEMENT OF STANDARD ACCOUNTING PRACTICE

PROJECT 1

Profit and Loss Account – cumulative

Included in turnover	145
Included in cost of sales	(110)
	<hr/>
Gross profit	<u>35</u>

Balance Sheet

The amount to be included in debtors under 'amounts recoverable on contracts' is calculated as follows:

Cumulative turnover	145
LESS: Cumulative payments on account	(100)
	<hr/>
Included in debtors	<u>45</u>

In this case, all the costs incurred to date relate to the contract activity recorded as turnover and are transferred to cost of sales, leaving a zero balance in stocks.

NB If the outcome of the contract could not be assessed with reasonable certainty, no profit would be recognised. If no loss is expected, it may be appropriate to show as turnover a proportion of the total contract value using a zero estimate of profit.

STOCKS AND LONG-TERM CONTRACTS

PROJECT 2

Profit and Loss Account – cumulative

Included in turnover	520
Included in cost of sales	(450)
	<hr/>
Gross profit	70
	<hr/> <hr/>

Balance sheet

As cumulative payments on account are greater than turnover there is a credit balance, calculated as follows:

Cumulative turnover	520
LESS: Cumulative payments on account	(600)
	<hr/>
Excess payments on account	(80)
	<hr/> <hr/>

This credit balance should firstly be offset against any debit balance on this contract included in stocks and then any residual amount should be classified under creditors as a payment received on account as follows:

Total cost incurred to date	510
LESS: Cumulative amounts recorded as cost of sales	(450)
	<hr/>
	60
LESS: Excess payments on account (above)	(80)
	<hr/>
Included in creditors	(20)
	<hr/> <hr/>

Amount to be included in stocks is zero and the credit balance of 20 is classified as a payment received on account and included in creditors.

The balance sheet note on stocks should disclose separately the net cost of 60 and the applicable payments on account of 60.

STATEMENT OF STANDARD ACCOUNTING PRACTICE

PROJECT 3

Profit and Loss Account – cumulative

Included in turnover	380
Included in cost of sales	(350)
	<hr/>
Gross profit	30
	<hr/> <hr/>

Balance Sheet

As with Project 2, cumulative payments on account are greater than turnover and there is a credit balance calculated as follows:

Cumulative turnover	380
LESS: Cumulative payments on account	(400)
	<hr/>
Excess payments on account	(20)
	<hr/> <hr/>

This credit balance should firstly be offset against any debit balance on this contract included in stocks and the residual amount, if any, should be classified under creditors as a payment received on account.

The amount to be included in stocks under long-term contract balances is calculated as follows:

Total costs incurred to date	450
LESS: Cumulative amounts recorded as cost of sales	(350)
	<hr/>
	100
LESS: Excess payments on account (above)	(20)
	<hr/>
Included in long-term contract balances	80
	<hr/> <hr/>

The balance sheet note on stocks should disclose separately the net cost of 100 and the applicable payments on account of 20.

STOCKS AND LONG-TERM CONTRACTS

PROJECT 4

Profit and Loss Account – cumulative

Included in turnover	200
Included in cost of sales	<u>(290)</u>
Gross loss	<u><u>(90)</u></u>

Balance Sheet

The amount to be included in debtors under 'amounts recoverable on contracts' is calculated as follows:

Cumulative turnover	200
LESS: Cumulative payments on account	<u>(150)</u>
Included in debtors	<u><u>50</u></u>

The amount to be included as a provision/accrual for foreseeable losses is calculated as follows:

Total costs incurred to date	250
LESS: Transferred to cost of sales	(250)
Foreseeable losses on contract as a whole	<u>(40)</u>
	<u><u>(290)</u></u>
Classified as provision/accrual for foreseeable losses	<u><u>(40)</u></u>

Note that the credit balance of 40 is not offset against the debit balance of 50 included in debtors.

STATEMENT OF STANDARD ACCOUNTING PRACTICE

PROJECT 5

Profit and Loss Account – cumulative

Included in turnover	55
Included in cost of sales	(85)
	<hr/>
Gross loss	(30)
	<hr/> <hr/>

Balance Sheet

As cumulative payments on account are greater than turnover there is a credit balance, calculated as follows:

Cumulative turnover	55
LESS: Cumulative payments on account	(80)
	<hr/>
Excess payments on account	(25)
	<hr/> <hr/>

The credit balance should firstly be deducted from long-term contract balances (after having deducted foreseeable losses) and the residual balance included in creditors under payments received on account as follows:

Total costs incurred to date	100
LESS: Transferred to cost of sales	(55)
Foreseeable losses on contract as a whole	(30)
	<hr/>
	(85)
	<hr/>
	15
LESS: Excess payments on account (above)	(25)
	<hr/>
Included in creditors	(10)
	<hr/> <hr/>

The balance sheet note on stocks should disclose separately the net cost of 15 and the applicable payments on account of 15.

