AS – 2 Accounting for inventories

1.0 Objective:

- A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognized.
- This Statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realizable value.

2.0 Scope: This Statement should be applied in accounting for inventories other than:

a) work in progress arising under construction contracts - AS 7;

b) work in progress arising in the ordinary course of business of service providers;

c) shares, debentures and other financial instruments held as stock-in-trade; and

d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realizable value in accordance with well established practices in those industries.

3.0 Definitions:

Inventories: are assets:

a) held for sale in the ordinary course of business;

b) in the process of production for such sale; or

c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net Realizable Value: is 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.

4.0 Valuation of inVentories: Inventories are to be valued at cost or nrv whichever is lower.

4.10 Cost of inventories: It includes

a) cost of purchase

b) cost of conversion

c) other costs which are necessary to bring the inventory into the present condition and situation.

a) Cost of purChase: It includes

a) Purchase price

b) Duties and taxes

c) Fright inwards

d) Other expenditure directly attributable to the acquisition.

Less:

- Duties and taxes recoverable by the enterprise from taxing authorities
- Trade discounts
- Rebates
- Duty drawbacks
- Other similar items

B) Cost of conversions: It consists of costs directly related to the units of production, such as direct labour plus systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

Fixed Production overheads are allocated based on Normal capacity.

Variable overheads are allocated based on actual capacity only.

Joint products: when cost of conversion of each product is not separately identifiable allocate the total cost of conversion based on certain rational and consistent basis i.e. relative sale value of product.

By products: If by products, scrap or waste materials are not of significant value , their net realizable value should be deducted from the total conversion cost and the balance conversion cost needs to be distributed among the other main products.

C) Other cOsts: Any other costs which are incurred to bring the inventories to the present condition and situation i.e. overheads other than production overheads or The cost of designing products for specific customers.

Exclusions from thE cost of invEntoriEs:

In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- abnormal amounts of wasted materials, labour, or other production costs;
- storage costs, unless those costs are necessary in the production process prior to a further production stage;
- administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- selling and distribution costs.

4.20 MeasureMent of inventories:

- ❖ **Specific identification price:** The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

- ❖ **FIFO or Weighted Average Cost:** where the specific identification method is not applicable the cost of inventories can be valued at FIFO or Weighted Average Cost.

- **When it impracticable to calculate the cost, the following are the permissible alternatives for valuation of inventories**

    - Standard cost method
    - Retail price method

4.30 nrv of inventories:

- It means the estimated selling price in the ordinary course of business less estimated cost of completion and sale.
- it must be estimated based on the most reliable evidence at the time of valuation.
- While estimation of NRV one should consider the purpose of estimation.
- Estimation of NRV should be made at each balance sheet date.

4.40 valuations of inventories

a) **Raw material:** Raw materials are to be valued at cost only.
Exception: if the finished goods in which the raw material is used is likely to be sold below the cost, then the raw material should be valued at NRV.

b) **Finished goods/ work in progress:** Always valued at COST or NRV whichever is lower. But while vaulting we need to follow individual inventory wise comparison rather than global comparison of inventories.

Note: if we write down the inventories to net realizable value by considering the COST or NRV (when NRV is low) later if NRV is more than the cost of inventories, we can write back the inventories to the extent to the extent value of earlier reduction in cost.

5.0 Disclosure

The financial statements should disclose

a) The accounting policies in measuring inventories, including the cost formula used; and

b) The total carrying amount of inventories and its classification appropriate to the enterprise.

Quick revision

OBJECTIVE

- To formulate the method of computation of cost of inventories
- To determine the value of closing inventory

VALUATION OF INVETORY

On item by item basis, in few cases may be done on group bases

Lower of

Cost
Means

Cost of purchase + Cost of conversion

Purchase price
+freight, duties & Taxes
+ other Expenditure Directly Attributable to Acquisition

Direct labour
+ allocated variable production overheads
+ allocated fixed production Overheads (based on normal capacity)

Net realizable value

Estimated Selling price in the ordinary Course of business

Minus

Estimated cost of completion

Minus

Estimated cost necessary to make the sale

COST FORMULAS

- FIFO
- Weighted average Cost Method
- Standard cost method
- **LIFO not allowed**

SPECIAL CONSIDERATIONS

- Joint costs to be allocated on rational & consistent basis.
- In case of by products, deduct the NRV of by products from the cost of main products
- NRV to be estimated by considering
  - Most reliable evidence available
  - Price fluctuations
  - Relevant post balance sheet events
  - Purpose for which inventory is held
- Material and other supplies for use in production of inventories
  - o Do not write down below cost if ultimate product expected to be sold at or above cost

Disclosure

- Accounting policies adopted for valuation
- Cost formula used
- Carrying amount of inventories appropriate classification of inventories

Practical questions

1) Raw materials inventory of a company includes certain material purchased at Rs. 100 per kg. The price of the material is on decline and replacement cost of the inventory at the year end is Rs. 75 per kg. It is possible to convert the material into finished product at conversion cost of Rs. 125.

   Find out the value of inventory, if selling price is (i) Rs. 175 and (ii) Rs. 235.

   Solution:

   As per para 24 of AS 2 “Valuation of Inventories”, materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

   (i) When selling price of the finished product is Rs.175, the raw material should be valued at Rs.75 per kg because the selling price of the finished product is less than Rs.225 (i.e. 100 + 125) per kg.

   (ii) When selling price of the finished product is Rs.235, the raw material should be valued at Rs.100 per kg because the selling price of the finished product is not less than Rs.225 (i.e. 100 + 125) per kg.

2) Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2005. Till March, 2006, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2006.

   Answer:

   As per Para 5 of AS 2 “Valuation of Inventories”, the inventories are to be valued at lower of cost and net realizable value. In this case, the cost of inventory is Rs.10 lakhs. The net realizable value is 11, 00,000 90% = Rs.9, 90,000. So, the stock should be valued at Rs.9,90,000.