

ACCOUNTING STANDARD – 2: VALUATION OF INVENTORIES

- ❖ *This AS is mandatory to be followed. As per para 26 of this AS, accounting policy of valuation including cost formula & value of stock are to be disclosed in financial statements.*

Exclusions from AS-2

- WIP in construction contracts & directly related service contracts (refer AS-7).
- WIP arising in the business of service providers.
- Shares, debentures & other financial instruments held as stock-in-trade (refer AS-13).
- Producer's inventories like livestock, agricultural & forest product, mineral oil/gases.

Inventory means (Para 3)

- Asset held for sale in ordinary course of business.
- Asset in process of production (Work-in-progress).
- Asset in form of raw material held for consumption.

Valuation of finished goods & WIP

Value = Lower of cost price OR net realizable value (NRV)

1. This valuation technique is not for raw material. Lower will be taken on item by item basis. Following is an example-

ITEM	COST(₹)	NRV(₹)	LOWER(₹)
A	20	14	14
B	16	16	16
C	08	12	08
D	16	25	16
E	12	08	08
Total	72	75	62

In the above table lower of cost and NRV for each item is taken. Therefore, value of stock is ₹62.

2. Cost price will be either-

- Identified using standard cost (**1st preference**)
- Identified using retail price method (**2nd preference**)
- Calculated (**3rd preference**)

Example – HUL has stock of shampoo of 100 pkts. Standard cost as per cost accountant is ₹50 per pkt. What is the cost as per AS-2?

Solution – Since standard cost is given, which is also our 1st preference, we will take the same for the purpose of inventory valuation.

Value of stock = $50 \times 100 = ₹5,000$

NRV is not given

∴ Value of inventory is ₹5,000.

Example – HUL has stock of shampoo of 100 pkts. Its retail price is ₹90 per pkt. Gross profit is 25% of sales. Find the cost as per AS-2?

Solution – Since standard cost is not given, we will take retail price, which is our 2nd preference. Therefore, stock would be valued as follows:

PARTICULARS		₹
Retail price		90.00
Less: Gross profit @ 25%		22.50
COST PRICE PER PKT.		67.50
Total cost (67.50x100)	(A)	6,750.00
NRV (90x100)	(B)	9,000.00
Lower of (A) & (B)		6,750.00

3. Calculation of cost price – lot based (3rd preference)

PARTICULAR		₹	₹
Direct material cost [#]			xxx
Add- <u>Cost of conversion</u> :			
Direct labor		xxx	
Variable production overheads		xxx	
Fixed production overheads		xxx	xxx
Other cost			xxx
Total cost of production	(A)		xxx
Number of units	(B)		xxx
Cost per unit	(A÷B)		xxx

Example – HUL manufactures LUX soap in the month of March. It produced 1,00,000 units of soap.

Direct material of chemical consumed ₹6 00,000

Direct labor used in soap division ₹2,00,000

Indirect material (variable production o/h) ₹1,00,000

Fixed production overheads ₹2,50,000

Transport cost ₹50,000

Assume normal production 1,20,000 units of soap. Calculate cost per unit as per AS-2?

Solution – Valuation of stock as per AS – 2 for March lot

PARTICULAR	₹	₹
Direct material cost		6,00,000
Add- Cost of conversion:		
Direct labor	2,00,000	
Variable production overheads	1,00,000	
Fixed production overheads*	2,08,333	5,08,333
Transport cost (other cost)		50,000
Total cost of production (A)		11,58,333
Number of units (B)		1,00,000
Cost per unit (A÷B)		11.58

Value of stock = $11.58 \times 1,00,000 = ₹11,58,000$

NRV is not given, therefore, cost is ₹11,58,000

*Fixed production overhead will be taken in actual cost on recovery basis i.e. overhead

recovered = $\frac{\text{fixed production overhead}}{\text{normal production}} \times \text{units produced} = \frac{2,50,000}{1,20,000} \times 1,00,000 = 2,08,333$

Important note – If actual production is higher than normal production, then take actual production as denominator.

#Calculation of direct material cost (3rd preference)

PARTICULARS	₹
Purchase price	xxx
Add- Taxes on purchase	xxx
Other commission on purchase	xxx
Freight	xxx
Less- Trade discount	xxx
COST OF DIRECT MATERIAL	xxx

4. Following costs are not included in valuation of inventories-

- Abnormal loss of wasted material, labor, or other production costs due to abnormal reasons like fire, theft etc.
- Storage cost, unless necessary in the production process
- Borrowing cost e.g. interest etc.
- Office administration cost
- Selling & distribution expenses

5. Cost formula

- If stock in hand is unique, not similar to each other, then use specific identification method. For e.g. concept car (unique car) of Honda.
- If stock in hand is similar, then use general identification method (lot based value). We can use FIFO method or weighted average method for stock valuation.

Net realizable value (NRV)

NRV = Expected selling price – expected selling expense – expected cost of completion

Expected means management estimate. Such estimates can be made due to contract received. It may be general price also.

Example – Stock on 31st March were 100 units, out of which 60 units were sold for ₹ 5,000. Contract of 20 units in future to be sold @ ₹ 4,000 per unit. Expected to be sold 20 units @ ₹ 4,800 per unit.

Solution – Calculation of NRV

(a) $60 \times 5,000 = 3,00,000$

(b) $20 \times 4,000 = 80,000$

(c) $20 \times 4,800 = 96,000$

$\therefore \text{NRV } (a+b+c) = ₹ 4,76,000$

Valuation of raw material stock (Para 24)

- Raw material stock will be valued at cost only, if the finished products in which they (i.e. raw material stock) will be incorporated are expected to be sold at or above cost price (i.e. at profit).
- Raw material stock will be valued at lower of cost price or replacement price (i.e. current price & not NRV), if the finished products in which they will be incorporated are expected to be sold below cost price (i.e. at loss).