

SREERAM COACHING POINT

AS – 2

VALUATION OF INVENTORIES

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Meaning of the term - Inventory

Inventories are Assets

- **Held for Sale → Finished Goods**
- **In the process of production → WIP**
- **In the form of materials or supplies to be consumed in the production →
Raw material, Consumables and Loose Tools**

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Valuation of Inventory

Cost or NRV

whichever is lower

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What is cost?

Includes:

- Cost of purchase
- Conversion cost
- Other cost

Excludes:

- Abnormal loss
- Storage cost
- Administration OH
- Selling and distribution cost
- Interest and borrowing cost

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What is cost of purchase?

Includes:

- Purchase price
- Duties and taxes
- Freight inward
- Other expenditure directly attributable to acquisition

Excludes:

- Duties and taxes recoverable Example: CENVAT
- Trade discount
- Rebate
- Duty drawback etc.

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What is conversion cost?

Includes:

- **Direct labour**
- **Direct expenses**
- **Overhead [both variable and fixed]**

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Treatment of Overheads

Variable OHs

- Based on Actual Use of Production Facilities

Fixed OHs

- $\text{OH absorption rate} = \frac{\text{Total OHs}}{\text{Normal Capacity}}$
- If actual capacity > normal capacity, reduce the absorption rate
- If actual capacity < normal capacity, unabsorbed overhead is transferred to P & L

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NRV

- Estimated Selling Price
- Less: Estimated Cost of completion
- Less: Estimated Costs to make sale

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Cost Vs. NRV comparison

- Usually on “**Item-by-Item**” basis
- However, in some circumstances, it may be appropriate to group similar or related items
- Example: Factory clearance sale

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Treatment of Joint Product/By product

- In case of Joint product/By product, if cost of conversion is separately identifiable, then such costs will be included in the part of inventories
- If the cost of conversion is not separately identifiable, allocate such cost on rational basis
Example: Sale Value at the time of separate identity/split off point

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Treatment of Joint Product/By product

- Most by-products as well as scrap or waste materials, by their nature, are immaterial
- If this be the case, they are often measured at NRV and this value is deducted from the cost of the main product
- As a result, the carrying amount of the main product is not materially different from its cost

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Methods of Inventory valuation

Inventories are purchased / produced for specific project

- Specific identification method

Inventories are not purchased / produced for specific project

- FIFO or
- Weighted Average

Methods of Inventory valuation

- Standard Cost method
- Retail method [Selling Price – GP ratio]

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NRV – Points to be noted

- NRV should be assessed at each Balance Sheet date
- While assessing NRV, the following should be considered
 - Events occurring after B/S date to the extent that such events conform the conditions existing at B/S date
 - The purpose for which the inventory is held Example: NRV of quantity held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the NRV of the excess inventory is based on general selling prices

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Replacement Cost

If replacement cost of raw material had fallen

- If finished product in which raw material (or other supplies) are used is expected to be sold at cost or above cost →
- Raw material is valued at cost

- If finished product in which raw material (or other supplies) are used is expected to be sold below cost →
- Replacement cost of the materials may be the best available measure of their NRV

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Treatment of Machinery Spares

- If the machinery spares are not specific to a particular item of fixed asset →
- It should be treated as Inventory. As and when such machinery spares issued for consumption, it should be charged to P&L