

As-2 Valuation Of Inventory

Introduction

The accounting treatment for inventories is prescribed in AS 2 (Revised) 'Valuation of Inventories', which provides guidance for determining the value at which inventories, are carried in the financial statements *until related revenues are recognised. It also provides guidance on the cost formulas that are used to assign costs to inventories and any write-down thereof to net realisable value.*

Inventories

AS 2 (Revised) defines inventories as assets held:

- ❖ for sale in the ordinary course of business, or
- ❖ in the process of production for such sale, or
- ❖ for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment meeting the definition of Property, plant and equipment.

Following are excluded from the scope of AS 2 (Revised):

- Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10 (Revised), Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) (Revised) 10, Property, Plant and Equipment.
- Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site should however be covered by AS-2 (Revised).
- Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.
- Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 (Revised) as well. The current Indian practice is however to value them at lower of cost and fair value.
- Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

Measurement of Inventories

Inventories should be valued at *lower of cost and net realisable value*. Net realisable 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. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.

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Cost of Inventory

Costs of inventories comprise all *costs of purchase, costs of conversion and other costs* incurred in bringing the inventories to their present location and condition.

Cost of Purchase

The costs of purchase consist of the purchase price including *duties and taxes* other than those subsequently recoverable by the enterprise from the taxing authorities, and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Cost of Conversion

The costs of conversion include costs *directly related to production, e.g. direct labour*. They also include overheads, both fixed and variable that are incurred in converting raw material to finished goods.

Joint or By Products

In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example, value of by products, scraps and wastes are usually not material. These are therefore valued at net realisable value. The cost of main product is then valued as joint cost minus net realisable value of by-products, scraps or wastes.

Other Costs

- These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost.
- Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory. Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine.
- The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.
- Exchange differences are not taken in inventory costs.

Exclusions from Cost of Inventories

In determining the cost of inventories, 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 the production process requires such storage;
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- Selling and distribution costs.

Cost Formula

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible. In all other cases, the cost of inventory should be determined by the *First-In First-Out (FIFO), or Weighted Average cost formula*. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Other techniques of cost measurement

- Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of

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material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.

- In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. *By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.*

Example

A trader purchased certain articles for ₹ 85,000. He sold some of articles for ₹ 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was ₹ 15,000. Cost of closing inventory is shown below:

Particulars	₹
Sale value of opening stock and purchase (₹ 85,000 + ₹ 15,000) x 1.25	1,25,000
Sales	(1,05,000)
Sale value of unsold stock	20,000
Less: Gross Margin (₹ 20,000 / 1.25) x 0.25	(4,000)
Cost of inventory	16,000

Estimates of Net Realisable Value

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. *These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.*

Comparison of Cost & Net Realisable Value

The comparison between cost and net realisable value should be made on item-by- item basis. In some cases nevertheless, it may be appropriate to group similar or related items.

Example

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation.

Net realisable 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. AS 2 (Revised) also provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

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NRV of materials held for use or disposal

Materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

Review of net realisable value at each balance sheet date.

An assessment is made of net realisable value as at each balance sheet date.

Disclosures

The financial statements should disclose:

- The accounting policies adopted in measuring inventories, including the cost formula used; and
- The total carrying amount of inventories together with a classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are:

- raw materials and components,
- work in progress,
- finished goods,
- Stock-in-trade (in respect of goods acquired for trading),
- stores and spares,
- loose tools, and
- Others (specify nature).

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