

ACCOUNTING STANDARD (AS) 2

VALUATION OF INVENTORIES

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Agenda

By end of this session...

- Objectives, Scope and Key Definitions
- Measurement of inventories, Cost formulae and exclusions from cost
- Net realisable value
- Disclosure requirements
- Case studies

Objective

- Determination of value at which inventories are carried in the FS;
- Ascertainment of cost of inventories;
- Write down to net realisable value, where necessary

Scope

Applied in accounting for inventories other than:

- work in progress (WIP) arising under construction contracts (AS 7);
- WIP arising in the ordinary course of business of service providers;
- shares, debentures and other financial instruments held as stock-in-trade; and
- 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

Definitions

Inventories are assets;

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services

Note: Machinery spares are accounted as Fixed Assets in accordance with AS 10

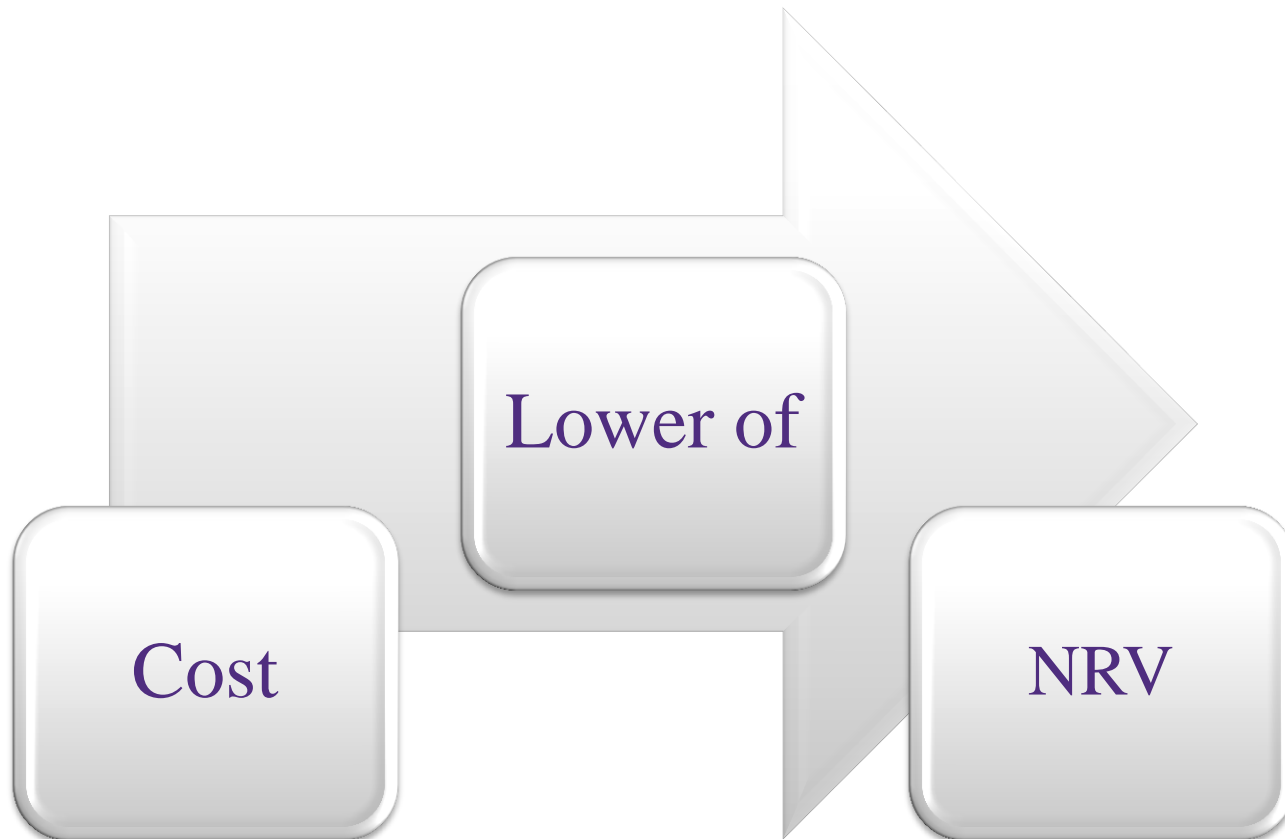
Definitions (Contd.)

Net realisable value:

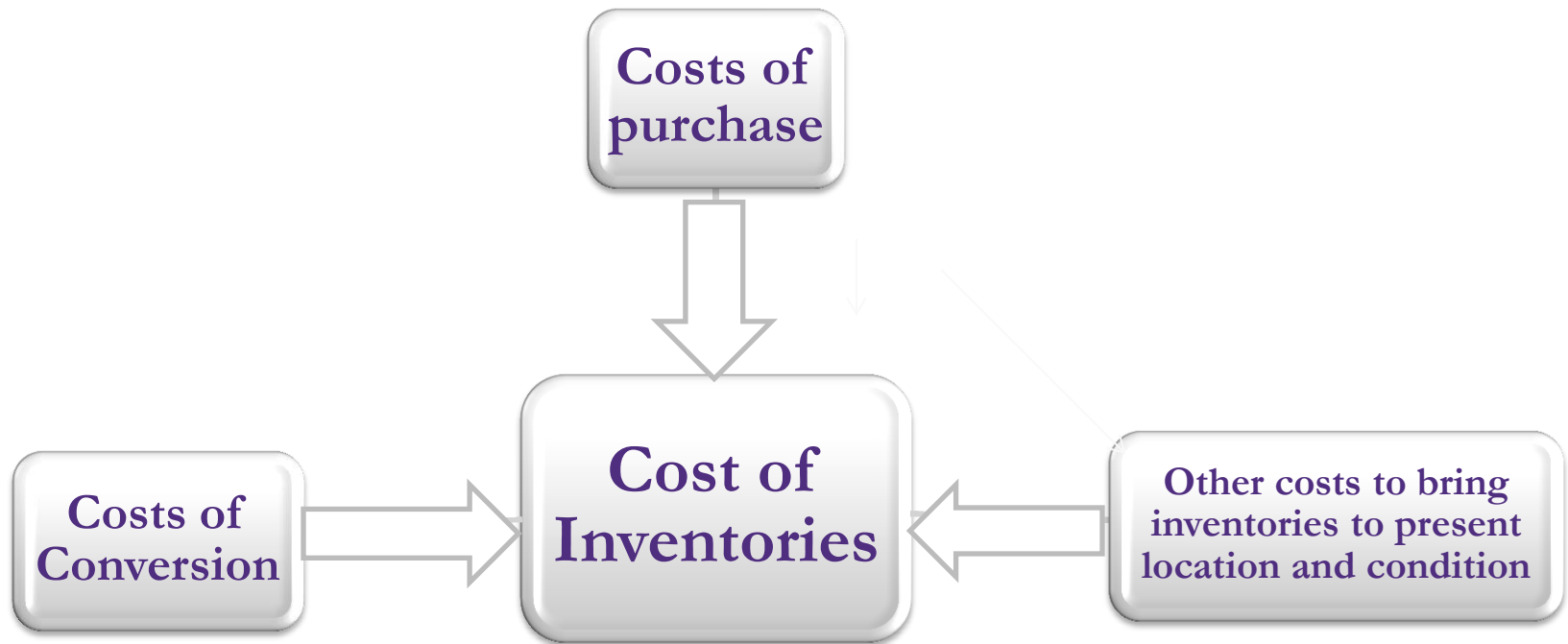
- is the estimated selling price in the ordinary course of business
- less the estimated costs of completion and the estimated costs necessary to make the sale

Measurement of inventories

Inventories should be valued at the:



Cost of inventories



Costs of Purchase

Costs of purchase include:

- duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities)
- freight inwards 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

Costs of Conversion and other costs

Costs of conversion include:

- costs directly related to the production of finished goods (direct labour)
- systematic allocation of fixed (based on normal capacity) and variable production overheads that are incurred in converting materials into finished goods

Other costs included:

- only to the extent they are incurred in bringing the inventories to their present location and condition

Costs of Inventory – Some key pointers

- No adjustment to overheads allocated, if production lower than normal capacity
- Overheads allocated adjusted if production higher than normal capacity to avoid valuing inventory above cost
- In case of joint production, costs of conversion allocated on a rational basis, for example on relative sales value
- In case of by products, waste materials, etc., cost of main product adjusted by net realizable value of these products
- Interest and other borrowing costs are generally excluded

Exclusions from the cost of inventories

- ✓ 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.

Cost formulas

The cost formulas specified by the standard are as follows:

- Specific identification method,
- First in first out (FIFO) and
- Weighted average method

Cost formulas (contd.):

For items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects:

- Specific identification/attribution of individual costs to inventory
- Not applicable when there are large number of items, ordinarily interchangeable.

Cost formulas (contd.):

- **FIFO** - assumes items which were purchased/produced first are consumed / sold first
- **Weighted average cost** - cost of each item is determined from the weighted average of the cost of **similar** items at the **beginning of a period** and the cost of similar items **purchased or produced during the period**

The choice of formula should be with a view to providing the **fairest possible approximation** of the cost incurred in bringing the items to its present location and condition

Other techniques for measurement of cost

Standard cost:

- takes into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilization
- regularly reviewed and revised in the light of current conditions

Other techniques for measurement of cost

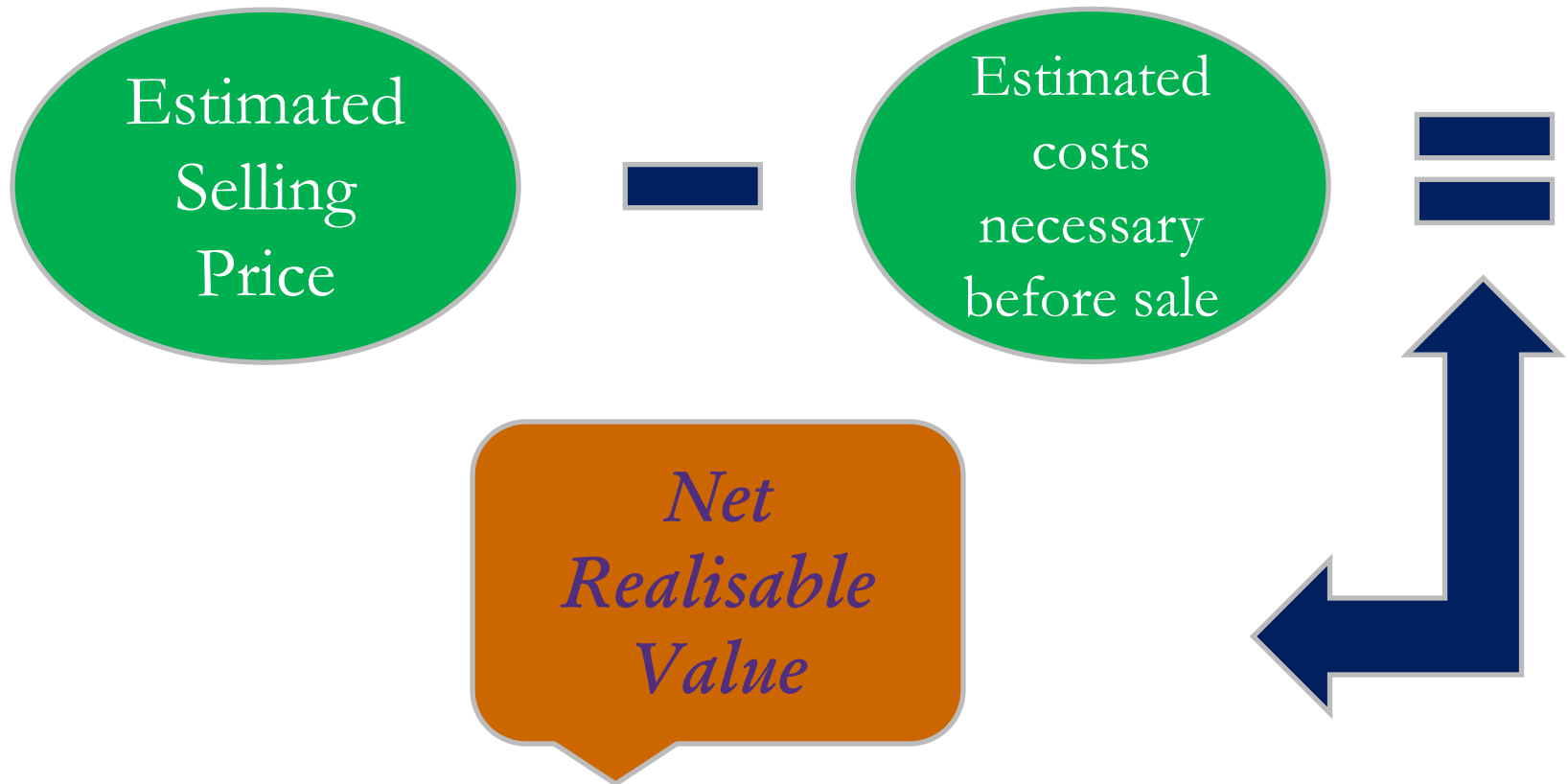
Retail method:

- used for measuring inventories of **large numbers** of rapidly **changing items** that have **similar margins**, where other costing methods cannot be used.
- determined by **reducing the appropriate percentage of gross margin from the sales value**

Net realizable value

- inventories are written down to net realizable value **on an item-by-item basis except** where it is appropriate to group **similar or related items**. An assessment of net realizable value is made **as at each balance sheet date**
- materials and other supplies held for use in production will not be recorded below cost if the finished goods are expected to be sold above cost
- if the cost of the finished good **is expected** to exceed NRV, the materials are written down to NRV
- Events subsequent to B/s date considered for determining NRV

Net realisable value (contd.) :



Disclosure requirements

The financial statements should disclose:

- the accounting policies adopted in measuring inventories, including the cost formula used; and
- the total carrying amount of inventories and its classification appropriate to the enterprise
- common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares and loose tools

Case studies:

- Goods in transit - goods in transit must be included in stock if it legally belongs to the Company
- Goods sent on approval basis - goods sent on approval basis must be included in stock if the customer has not yet approved the same
- Goods sent on consignment basis - sometimes goods are sent on consignment basis to an agent, who sells the goods for a commission. In such cases even though the goods may be lying with the agent but legally they belong to the Company. Hence they should be included in the stock

Case studies (contd.)

Inclusion of transportation cost from factory to stockyards as a part of the cost of inventories lying in stockyards?

Whether the freight incurred for transfer of materials from plant to different marketing locations of the Company and the handling expenditure towards unloading of the material, stacking and segregating at the stockyard before sale are to be considered as selling and distribution costs or to be included in the valuation of inventories

Case studies (contd.)

Opinion

The freight incurred for transfer of materials from plant to different marketing locations of the Company and handling expenditure towards unloading and stacking of the material at the stockyards before sale is effected should be included in the cost for the purpose of valuation of inventories.

Expenditure incurred on segregation of inventories at the stockyards should be included in cost if such expenditure is incurred for changing the location of the inventories prior to effecting the sale

Case studies (contd.)

Whether divisional headquarter expenses should form part of cost of inventories ?

- A Company is engaged in refining, transportation and sale of petroleum products
- The Company has various function-based divisions such as refineries, pipelines, marketing, etc. In respect of refineries, the Company has a headquarter at Delhi to coordinate and control the operations of various refineries. The refineries' headquarter functions are basically in the nature of production planning, working out crude oil requirements, monitoring of performance of the refineries on day-to-day basis, etc. The headquarter also acts as a coordinator for crude procurement, monthly production plans, monthly dispatch plans, etc., with other divisions such as pipelines, marketing, etc.
- Whether the expenses of the refineries' headquarter should be included for determination of the cost of inventory of finished products

Case studies (contd.) :

Opinion

The expenditure incurred at the refineries' headquarter should be included in the cost of inventories to the extent that such expenditure relates directly and clearly to bringing the inventories to their present location and condition. However, the general administrative overheads incurred at the refineries' headquarter should not be included in the cost of inventories as they cannot be considered as relating to bringing the inventories to their present location and condition. Such overheads should be expensed in the year of incurrence.

Case studies (contd.)

ABC Trading Company purchases motorbikes from several countries and sells them to European countries. During the current year, this company has incurred following expenses:

1. Trade discounts on purchase
2. Handling costs relating to imports
3. Salaries of accounting department
4. Sales commission paid to sales agents
5. After sales warranty costs
6. Import duties/freight expense/Insurance on purchases
7. Costs of purchases (based on supplier's invoices)
8. Brokerage commission paid to indenting agents

ABC Trading Company seeks your advice on which costs are allowed by AS 2 for inclusion in the cost of inventories

Case studies (contd.)

Solution:

- Items 1, 2, 6, 7 and 8 are allowed by AS 2 to be included for the calculation of cost of inventories.
- Salaries of accounts department, sales commission, and after sale warranty costs are not considered to be related to the cost of inventory therefore they are not allowed by AS 2 to be included in cost of inventories

Thank you

