Accounting Standard (AS) 2

Valuation of Inventories

Objective

This Standard deals with the determination of the value at which inventories are carried in the financial statements until the related revenues from their sale are recognised, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

This Standard should be applied in accounting for inventories other than:

(a) work in progress arising under construction contracts, i.e cost of part construction (see Accounting Standard (AS) 7, Construction Contracts);

(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

Definitions

The following terms are used in this Standard with the meanings specified:

1. Inventories are assets:

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

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

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services (RM). Eg raw materials, maintenance supplies, stores and spares, consumables other than machinery spares, servicing equipment and standby equipment meeting the definition of PPE and loose tools awaiting use in the production process.

2. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion (further expenditure) and the estimated costs necessary to make the sale such as commission or brokerage paid for disposal of goods.

- Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale.
- Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Measurement of Inventories

Inventories should be valued at the lower of historical cost and net realisable value.

Cost of Inventories:

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

1.Costs 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), freight inwards (transport, handling) 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.

2.Costs of Conversion

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour.

They also include fixed and variable production overheads that are incurred in converting materials into finished goods.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation, rent and maintenance of factory buildings and the cost of factory management and administration.

Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials.

3.Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the 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:

(a) abnormal amounts of wasted materials, labour, or other production costs; (normal wastage will be considered)

(b) storage costs, (because they do not generate any extra economic benefits for the co.) ,unless those costs are necessary in the production process prior to a further production stage; (In case of wine, it has to be stored as a part of the production process)

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

Cost Formulas

AS-2 permits the use of specific identification method to ascertain the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects, otherwise it requires the use of FIFO (First in first out) or weighted average cost method for valuation of inventory.

Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced.

The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.

Under the weighted average cost formula, the 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 average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

(*NOTE: The formula used should reflect the fairest possible approximation to the actual cost incurred in bringing the items of inventory to their present location and condition*.)

Techniques for the Measurement of Cost

Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

The retail inventory method is often used in the retail business for measuring inventories of large numbers, (comprising of many similar items), the individual costs of which are not readily ascertainable and for which it is impracticable to use other costing methods.

The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. All the inventories are valued at selling price (MRP), which is then adjusted for the normal gross profit ratio and selling expenses to reach at its cost. (MRP - Gross Profit = Cost of ending inventory)

Lower of Cost or Market (LCM)

According to conservatism concept, inventory should be reported in the balance sheet at lower of its cost or its market value (NRV).

Net Realisable Value

The cost of inventories may not be recoverable when the sale proceeds or value of inventory falls below the cost:

- if those inventories are damaged,
- if they have become wholly or partially obsolete, or
- if their selling prices have declined.

- if the estimated costs of completion or the estimated costs necessary to make the sale have increased.

In such a case, the practice should be of writing down inventories below cost to net realisable value. (Because this is consistent with the view that assets should not be carried in excess of the amount expected to be realised from their sale or use)

Inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line.

Disclosure

The financial statements should disclose:

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

(b) 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.