E-Learning Module-2:

Accounting standard (AS) 2: Valuation of Inventories

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Course Summary:

This course attempts to discuss about accounting for inventories as per Accounting Standard (AS)-2: Valuation of Inventories. This course is mainly designed for the undergraduate students of commerce.

Course Content:

1. Objectives of AS-2.
2. Meaning of Inventories and Net Realisable Value.
3. Measurement of Inventories.
4. Cost Formula Used.
5. Disclosure.

Objectives of AS-2:

Objective of this accounting standard is to prescribe guidance on the determination of value at which inventories are carried in the financial statements as on balance sheet date. It also provides guidance on the cost formulas to be used to ascertain cost of inventories and any write down thereof to net realizable value. This standard is mandatory in nature for all entities for accounting periods commencing on or after 1st April, 2017.

This standard does not apply to –

1. Work in progress of construction contracts including directly related service contracts. (*These are dealt with by* ***Accounting standard (AS) 7: Construction Contracts****.)*
2. Work in Progress arising in the ordinary course of business of service providers.(In this case **AS 9: Revenue Recognition** is applied)
3. Shares, debenture and other financial instruments held as stock in trade. (**AS 13:Accounting for Investments** is applied)
4. Inventories of Livestock, agricultural and forest products, mineral oil, ores and gases. All these items are values at <u>net realizable value</u>. We do not have any accounting standard for these items.

Meaning:

Inventories:

Inventories are assets-

i) held for sale in the ordinary course of business; (**Finished Goods).**

ii) in the process of production for producing finished goods for such sale; (**Work-in-progress);** or

iii) In the form of **raw material or supplies** to be consumed in the production process or rendering of services. (***Raw materials or supplies)***

It is to be noted that the above classes of inventories are found to exist in case of manufacturing concern and in case of trading concern inventory includes only **unsold stock of goods purchased for resale**.

Net realizable Value (NRV):

Net realizable value is the estimated selling price in the ordinary course of business *minus* any estimated selling expenses necessary to make the sale.

Measurement of Inventories:

Valuation of Finished Goods:

Let us start with the measurement of the value of **finished goods**. Finished goods should be valued at **lower of cost and net realizable value**. In accounting, we always follow the conservatism principle. According to this principle all possible losses should be considered but any expected increase in revenue should not be recognized until it is actually realized. The net realizable value of stock is calculated on an item by item basis.

Example 1:

There are three items of inventories, X, Y and Z, which are neither similar nor interchangeable. On the balance sheet date the historical cost and net realizable value of these items are:

Items	Historical Cost (Rs.)	Net Realizable Value (Rs.)
X	50,000	48,000
Y	25,000	28,000
Z	10,000	10,000

Calculate the value of closing stock on the balance sheet date.

Solution:

The value of Closing Stock is determined as follow by comparing each dissimilar item separately:

Items	Historical Cost (Rs.) A	Net Realizable Value (Rs.) B	Closing Stock (Rs.) Lower of A and B
X	50,000	48,000	48,000
Y	25,000	28,000	25,000
Z	10,000	10,000	10,000
Total	**85,000**	**86,000**	**83,000**

Here, **Cost** includes **Cost of purchase**, **cost of conversion** and **any other cost** necessary to bring inventory to its present location and condition.

Example 2

A trading concern bought goods at the cost of Rs.60,000 in January, 2018. Till the end of the accounting year as on 31st March, 2018, 80% of the goods were sold. The company wants to value its closing stock at Rs.12,000. The expected sales value of the closing stock is Rs.12500 with expected selling expenses Rs.1000. What would be the correct value of closing stock to be disclosed as on 31.03.2018.

Solution:

As we know, as per para 5 of the Accounting Standard 2 'Valuation of Inventories', the inventories should be valued at lower of cost and net realizable value.

In the above case, the cost of inventories is **Rs.12,000** (Rs.60,000 x20%) and the net realizable value of the inventories is Rs. 12,500-Rs.1,000 =**Rs.11,500**. Therefore, the stock should be valued at lower value at **Rs.11,500**.

Cost of Purchase includes purchase price of materials *plus* any non recoverable duties and taxes and also expenditure directly attributable to such purchase *minus* discounts, rebates and similar items.

The cost of conversion includes direct labour and systematically allocated fixed and variable production overhead. It is to be noted that fixed production overheads should be allocated based on standard unit of production without considering any abnormal situations/conditions when actual production is low. However, in case of actual production is abnormally high, fixed production overhead is allocated based actual unit of production so that

inventories are not valued above cost. The variable production overhead is allocated based on actual production facilities.

There are some expenses which are also to be included in cost, such as, **designing cost** or **any other cost** necessary to bring inventory to its present location and condition.

Valuation of material and work in progress:

The **raw material** and **work in progress** are normally valued at **cost** even if there has been a decline in price of materials. However, there are some situations when raw material and work in progress are valued below cost at net replacement cost. When the finished products in which raw material and work in progress will be incorporated are expected to be sold in the market at below cost, the raw material and work in progress are written down to net replacement cost. In other word, when cost of finished goods are expected to exceed net realizable value of finished goods, the raw material and work in progress are valued at below cost at net replacement cost. In all other situations they are valued at actual costs.

Cost Formula:

In case of inventories specifically identifiable and those which are not ordinarily interchangeable should be valued at identified individual cost. In all other cases inventories should be assigned by following FIFO formula. However, weighted average formula is also used when items of inventories are produced or purchased at same cost or price during different time within the financial year.

Disclosure:

The financial statement should disclose-

1. The accounting policies adopted and the cost formula used;
2. Classification of inventories appropriate to the enterprise along with total carrying amount.

The common classifications used are-

a. Raw materials and components
b. Work-in-progress
c. Finished goods
d. Stock-in-trade (in case of trading concern)
e. Stores and spares
f. Loose tools
g. Others, if any.

Example 3

Compute the value of closing stock as per AS-2 from the following information-

Sales	Rs.4,00,000
Opening stock	1000 units @ Rs.11 per unit.
Purchase during the year:	
2500 units @ Rs.10.50 per unit	
1000 units @ Rs.12 per unit.	
Closing inventory 1500 units.	

Solution:

As per para 16 of the Accounting Standard 2 "Valuation of Inventories", the items of inventories which are not ordinarily interchangeable should be assigned by following first-in, first-out (FIFO) or weighted average cost formula. As the items were purchased at different prices at different time, FIFO method should be used.

Valuation of inventories:

Sales = (opening stock+purchase)-closing stock

= (1000+2500+1000)-1500=3000 units

As FIFO method is followed the closing stock of 1500 units comprises 500 units @ Rs.10.50 per unit and 1000 units @ Rs.12.00 per unit.

The cost of closing stock:

500 units @ Rs.10.50	Rs 5,250.00
1000 units @ Rs.12.00	Rs. 12,000.00
	……………………
	Rs. 17,250.00
	……………………