Chapter 5
Inventories

1. Inventories – Basics – AS 2

1.1 Inventories – Definition

Inventories are Assets –

Nature of Inventory	Description
1. Held for sale in the ordinary course of business, or	**Finished Goods** – including trading merchandise, software, land or other property held for resale.
2. In the process of production for such sale, or	**Work in Progress.**
3. In the form of materials or supplies to be consumed in the production process or in the rendering of services.	**Raw Materials** – including Maintenance Supplies, Consumables & Loose Tools used in production process.

Note: Inventory does **not** include Machinery Spares – (a) which can be used only in connection with an item of Fixed Asset, and (b) whose use is expected to be irregular. Such Machinery Spares are generally accounted for as Fixed Assets.

Scope: At Foundation Level, the scope of discussion is limited to valuation of – (a) **Raw Materials** of **Manufacturing Entities**, and (b) **Finished Goods** of **Trading Entities.**

1.2 Significance of Inventory Valuation

Inventory Valuation is important / significant due to the following reasons –

Purpose	Explanation
1. To ascertain the **true income earned** by the entity during the accounting period.	See separate Note below this Table.
2. To determine the **true financial position** of the entity as on the Balance Sheet date.	Inventory is classified as "Current Assets". Balance Sheet will disclose the correct financial position, only if Inventory is properly valued.
3. To analyse the **liquidity** of the enterprise. (**Note:** Liquidity = Ability to meet short–term commitments)	Liquidity is analysed in terms of **Net Working Capital** (Current Assets Less Current Liabilities), and **Current Ratio** (Current Assets divided by Current Liabilities). Inventory forms an important part of Current Assets.
4. To ensure **compliance with disclosure requirements** under Accounting Standard – 2, and applicable Statutes like Companies Act.	• As per AS–2, 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.

Purpose	Explanation
	• As per Companies Act, details of quantities of each class of goods along with the method of valuation of Raw Material, WIP and Finished Goods should be disclosed in the Financial Statements.

Note: **Effect of wrong valuation of inventory on Profits and Balance Sheet position**

Situation	Effect on Profit	Effect on Balance Sheet	Effect on Liquidity
Closing Inventory is overstated	Overstated	Higher Current Assets	High
Closing Inventory is understated	Understated	Lower Current Assets	Low
Opening Inventory is overstated	Understated	–	–
Opening Inventory is understated	Overstated	–	–

1.3 Measurement or Valuation of Inventory

Principle: Inventories should be valued at – (a) Cost, or (b) Net Realisable Value, **whichever is lower.**

1.4 Components of Cost

Meaning of Cost: The Cost of Inventories shall comprise **all** –

Costs of **Purchase** + Costs of **Conversion** + **Other Costs** incurred in bringing the inventories to their present location and condition.

1. Cost of Purchase is determined as under –

	Particulars		Amount
	Purchase Price including duties and taxes (excluding tax refunds / credits)		XXXX
Add:	Freight Inwards	XXX	
	Other Expenditure directly attributable to the purchase (See Note)	XXX	XXXX
Less:	Trade Discounts, Rebates, Duty Drawbacks and other similar items		(XXX)
	Costs of Purchase		XXXX

Note: Examples of expenditure directly attributable for purchases are – (a) Cost of Containers, (b) Transit Insurance, (c) Buying Commission where purchase of raw material is possible only through buying agents.

2. Costs of Conversion includes –

Type of Cost	Costs directly related to the units of production.	Variable Production Overheads	Fixed Production Overheads
Description / Example	e.g. Direct Labour, i.e. cost of workers who are directly associated in production process.	Indirect Costs which vary directly or nearly directly, with the volume of output, e.g. Indirect Materials, Indirect Labour.	Indirect Costs which remain relatively constant regardless of the level of output, e.g. Factory Rent, Salary, etc.

3. Other Costs are included in the cost of inventories only to the extent they are incurred in bringing the inventories to their present location and condition.

Items includible as "Other Costs"	Items excludible from "Other Costs"
• Costs of designing products for specific customers. • Non–Production Overheads incurred for bringing inventories to their present location.	• Interest and other Borrowing Costs. • Overheads incurred after inventories are brought to their present location and condition.

1.5 Exclusions from Cost

The following costs are **excluded** in determining the Cost of Inventories –

Nature of Costs	Explanation / Exception
1. Abnormal Costs of wasted materials, labour or other production costs.	**Reason:** Inefficiency does not make a product more valuable by means of higher cost, hence excluded.

Nature of Costs	Explanation / Exception
2. Storage Costs.	**Exception:** They are includible when Storage Costs are necessary in the production process, prior to a further production stage.
3. Administrative Overheads which do not contribute to bringing the inventories to their present location and condition.	**Exception:** They are includible when such costs contribute to bringing the inventories to their present location and condition.
4. Selling and Distribution Costs.	**Reason:** These are incurred after bringing the inventories to their present location and condition and hence excluded.

1.6 Net Realisable Value (NRV)

	Particulars		Amount
	Estimated Selling Price in the ordinary course of business		XXXX
Less:	Estimated Cost of Completion	XXX	
	Estimated Costs necessary to make the sale	XXX	(XXX)
	Net Realisable Value (NRV)		**XXXX**

Example: Material X can be re–sold in the market at ₹ 50 per unit. Presently, 500 units are in stock and ₹ 750 will be incurred to put them in saleable condition. The NRV will be ₹ 24,250 (₹ 50 × 500 – ₹ 750).

Basis of Valuation of Inventories: Inventories are usually written down to Net Realisable Value on an item–by–item basis. They **should not** be valued at Net Realisable Value on –

1. **Wholistic basis,** i.e. all items of inventory taken together, and
2. **Classification basis,** e.g. all Finished Goods, or all inventories in a particular business segment.

Exceptions: In special circumstances, it may be appropriate to group similar or related items, viz.

1. Inventory items relating to the same product line that have similar purposes or end uses,
2. Produced and marketed in the same geographical area, and
3. Cannot be practicably evaluated separately from other items in the product line.

Illustration 1:

Sumukha Ltd deals in 3 products A, B & C, which are neither similar nor interchangeable. At the end of a financial year, the Historical Cost and NRV of items of Closing Stock are given below. Determine the value of Closing Stock.

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in ₹ Lakhs)
A	40	28
B	32	32
C	16	24

Inventories are to be valued at the lower of cost and Net Realisable Value (NRV). Inventories are usually written down to NRV on **an item–by–item basis.** The Value of Closing Stocks is determined as under –

Stock Item	Historical Cost	NRV	Valuation = Least of Cost or NRV
A	₹ 40 Lakhs	₹ 28 Lakhs	₹ 28 Lakhs
B	₹ 32 Lakhs	₹ 32 Lakhs	₹ 32 Lakhs
C	₹ 16 Lakhs	₹ 24 Lakhs	₹ 16 Lakhs
Total			**₹ 76 Lakhs**