

AS 2: VALUATION OF INVENTORIES

HOW IS INVENTORIES DEFINED?

AS 2 Defines 'Inventory' as assets:

- a. Held for sale in the ordinary course of business;
- b. in the process of production for such sale;
- c. in the form of materials or supplies to be consumed in the production process or the rendering of service.

ITEMS COVERED UNDER THE TERM INVENTORIES

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ITEMS EXCLUDED FROM THE SCOPE OF AS 2

AS 2 does not apply to:

- a. Machinery spare parts which can be used only in connection with an fixed asset and whose use is expected to be irregular (Covered in AS 10);
- b. Work in progress arising under construction contracts (Covered in AS 7);
- c. Work in progress in case of service providers (Incomplete Assignments of a consultants, Merchant Banker)
- d. Investments held as stock-in-trade (Shares or Debentures)

VALUATION OF STOCK

- Valuation of Stock means finding out the proper value at which the closing stock is to be bought in the books of accounts.
- Stocks must be properly valued (**Neither Overvalued nor Undervalued**).
- Overvaluation leads to Higher profits and larger current assets.
- Undervaluation of stock results in lower profits and small current assets.

RULES FOR VALUATION OF STOCK

- Normally Stock is valued at cost.
 - Stock can also be valued at Net Realisable Value (NRV).
 - Thus, it is always valued at Cost or NRV which ever is lower.

(NRV means the estimated selling price in the ordinary course of business less the estimated costs of completion of work-in-progress and estimated costs of making the sale.)

RULES FOR VALUATION OF STOCK

Why Stock are not valued at NRV, if it is more than the cost:

- Accounts will show higher profits, these profits are only expected profits and not actual realized profits.

Why Stock are valued at NRV, if it is less than the cost:

- If goods are sold at cost, then goods are likely to be sold at loss. Hence, following the cost of conservatism, goods are sold at NRV if it is lower than cost.

WHICH GOODS ARE VALUED AT COST EVEN IF NRV IS LESS

AS 2 lays down that materials and other supplies held for use in the production of inventories are not valued at NRV if the finished goods in which they will be used are expected to be sold at or above cost.

STEPS INVOLVED IN VALUATION OF INVENTORY

1. Measurement of cost.
2. Measurement of NRV
3. Comparison between cost and NRV-

METHOD OF VALUATION OF INVENTORY

1. First In First Out (FIFO)
2. Last In Last Out (LIFO)
3. Weighted Average Method (WAM)

FIRST IN FIRST OUT (FIFO)

- First In, First Out (FIFO) is an accounting method in which assets purchased or acquired first are disposed of first.
- FIFO assumes that the remaining inventory consists of items purchased last.
- For instance, if a business sold 100 units of an item, and 75 units were originally purchased by the company at \$10.00 and 25 units were purchased at \$15.00, it cannot assign the \$10.00 cost price to every unit sold. Only 75 units can be. The remaining 25 items must be assigned to the higher price, the \$15.00.
- Lastly, the product needs to have been sold to be used in the equation. You cannot apply unsold inventory to the cost of goods calculation.

FIRST IN FIRST OUT (FIFO)

ADVANTAGES:

- The method is easy to understand, universally accepted and trusted.
- FIFO follows the natural flow of inventory. This makes bookkeeping easier with less chance of mistakes.
- Less waste.
- Higher profit.

DISADVANTAGE:

- The FIFO method can result in higher income tax for a business to pay, because the gap between costs and profit is wider (than with LIFO).
- A company also needs to be careful with the FIFO method in that it is not overstating profit.

WEIGHTED AVERAGE METHOD

In the weighted average cost method, the cost of goods available for sale is divided by the number of units available for sale and is commonly used when inventory items are so melded or identical to each other that it is impossible to assign specific costs to single units.

WEIGHTED AVERAGE METHOD

Formula for Weighted Average Cost

$$\frac{\text{Cost of units already in hand} + \text{Cost of newly purchased units}}{\text{Units already in hand} + \text{Newly purchased units}}$$

OR

$$\text{Weighted average unit cost} = \frac{\text{Total cost of item}}{\text{Total units of item}}$$

EXAMPLE

P Ltd. Purchased 2,000 units of raw material at list price of Rs. 100 per unit. The excise duty amounted to Rs. 50,000 (Out of which Rs. 20,000 was refundable). The Central Sales tax amounted to Rs. 30,000. The seller gave a rebate of Rs. 10,000 on the list price. The company send Rs. 10,000 on transportation and Rs. 5,000 for loading and unloading. Ascertain the cost of purchase.

SR NO.	ITEMS	AMOUNT
1.	Purchase price (2,000 X 100)	2,00,000
2.	Add: Duties & Taxes (50,000 + 30,000)	80,000
3.	Add: Transportation / Loading, etc. charges (10,000 + 5,000)	15,000
4.	Less: Refundable Taxes	(20,000)
5.	Less: Trade Discounts, Rebates, Duty Drawbacks	<u>(10,000)</u>
	COST OF PURCHASE	<u>2,65,000</u>

EXAMPLE

Small Mart has closing stock of several retail items having a MRP of Rs. 20,000. The average rate of gross profit on cost is 25%. Calculate the cost of closing stock using the retail method.

SR NO.	ITEMS	AMOUNT
1.	Closing Stock at Sale Value	20,000
2.	Less: Gross Profit (20,000 X 0.25 / 1.25)	<u>(4,000)</u>
3.	Closing Stock at cost	<u>16,000</u>