
Study of Accounting Standard AS 2 – Valuation of Inventories

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Introduction

Inventory management is required at different locations within a facility or within multiple locations of a supply network to protect the regular and planned course of production against the random disturbance or uncertainties of running out of materials or goods.

Objectives:-

- 1) To Study Meaning & Definition of Inventories.
- 2) To study Accounting standard 2 Valuation of Inventories.

Research Methodology:-Secondary data collection method.

Accounting standards AS 2 – Valuation of Inventories:-

This accounting standard is applicable to all companies irrespective of their level (Level I, II and III). This standard prescribes the accounting treatment for inventories and sets the guidelines to determine the value at which the inventories are carried in the financial statements.It explains the different methods of accounting the inventory or closing stock which has a huge impact on the business revenue and the assets.following points are considered

- Valuation of Inventories
- Accounting disclosure
- Comparison with ICDS
- Comparison with Ind AS
- Case Studies

Valuation of Inventories:-

This Standard should be applied in accounting for all inventories except the following :

- (a) work in progress in the construction business, including directly related service contracts
- (b) work in progress of service business (consulting, banking etc)
- (c) shares, debentures and other financial instruments held as stock in trade
- (d) Inventories like livestock, agricultural and forest products, mineral oils etc These inventories are valued at net realizable value

Definition

Inventory includes the following:

- A. Held for sale in the normal course of business i.e finished goods
- B. Goods which are in the production process i.e work in progress
- C. Raw materials which are consumed during production process or rendering of services (including consumable stores item)

II. Net Realisable Value (NRV):

“Net realizable 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”

Valuation of Inventories

Inventories should be valued at lower of cost and net realizable value. Following are the steps for valuation of inventories:

- A. Determine the cost of inventories
- B. Determine the net realizable value of inventories
- C. On Comparison between the cost and net realizable value, the lower of the two is considered as the value of inventory. A comparison can be made the item by item or by the group of items.

Let's discuss the important items of Inventory valuation in detail:

A. Cost of Inventories:-

The cost of inventories includes the following

- i) Purchase cost
 - ii) Conversion cost
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iii) Other costs which are incurred in bringing the inventories to their present location and condition.

B. Cost of Purchase:-

While determining the purchase cost, the following should be considered:

- i) Purchase cost of the inventory includes duties and taxes (except those which are subsequently recoverable from the taxing authorities)
- ii) Freight inwards
- iii) Other expenditure which is directly attributable to the purchase
- iv) Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase

C. Cost of Conversion:-

Cost of conversion includes all cost incurred during the production process to complete the raw materials into finished goods. Cost of conversion also includes a systematic allocation of fixed and variable overheads incurred by the enterprise during the production process.

Following are the categories of conversion cost:

I. Direct Cost

All the cost directly related to the unit of production such as direct labor

II. Fixed Overhead Cost

Fixed overheads are those indirect costs which are incurred by the enterprise irrespective of production volume. These are the cost that remains relatively constant regardless of the volume of production, such as depreciation, building maintenance cost, administration cost etc.

The allocation of fixed production overheads is based on the normal capacity of the production facilities. In case of low production or idle plant allocation of these fixed overheads are not increased consequently.

III. Variable Overhead Cost

Variable overheads are those indirect costs of production that vary directly with the volume of production. These are the cost that will be incurred based on the actual production volume such as packing materials and indirect labor.

D. Other Cost:-

All the other cost which are incurred in bringing the inventories to the current location and condition. For (eg) design cost which is incurred for the specific customer order. If there are by-products during the production of main products, their cost has to be separately identified. If they are not separately identifiable, then allocation can be made on the relative sale value of the main product and the by-product. Some of the cost which should not be included are:

- a. Cost of any abnormal waste materials cost
- b. Selling and distribution cost unless those costs are necessary for the production process
- c. A normal loss which occurs during the production process is apportioned over the remaining no of units and abnormal loss is treated as an expense

Accounting Disclosure:-

The following should be disclosed in the financial statements:

Accounting policy adopted in inventory measurement Cost formula used Classification of the of inventory such as finished goods, raw material & WIP and stores and spares etc Carrying amount of inventories carried at fair value less sale cost Amount of inventories recognized as expense during the period Amount of any write-down of inventories recognized as an expense and its subsequent reversal if any.

Conclusion

Scope of AS 2 does not deal with the inventory treatment related to Service Providers. AS 2 requires lesser disclosure in the financial statements. Cost of Inventories does not include “selling and distribution costs” under AS 2 and it is expensed in the period in which they are incurred. AS 2 requires the inventories value of goods which cannot be segregated for specific projects should be assigned using FIFO or WAC.

Reference

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