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Valuation of Inventory

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Introduction

An accounting standard is a common set of principles, rules, standards and procedures that explain the basis of financial accounting policies and practices. Accounting standards increase the transparency of financial disclosures in all countries. Accounting standard 2 is for valuation of inventory .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 kinds of methods of accounting the inventory or closing stock which has a huge impact on the business revenue and the assets. The standard requires inventories to be measured at the lower of cost and net realisable value (NRV) and outlines acceptable methods of determining cost.

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

I. Definition of the Inventory includes the following:

A. Held for sale in the normal course of business i.e finished goods

B. Goods which are in the under progress 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 Realizable Value (NRV):

"Net realizable value is the estimated selling price in the ordinary course of business less the predetermined costs of completion and the estimated costs importance to make the sale"

Valuation of inventories:

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

1. Determine the cost of inventories
2. Determine the net realizable value of inventories
3. Comparison between the net realizable value and cost, 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.

Important items of Inventory valuation:

A. Cost of Inventories

The cost of inventories includes the following

a) Purchase cost

b) Conversion cost

c) Other costs which are expended in bringing the inventories to their present condition and location

B. Cost of Purchase

When determining the purchase cost, the following should be taken into considered:

i) Purchase cost of the inventory includes duties and taxes ii) Freight inwards

iii) Other expenditure which is directly related 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 includes a systematic distribution of fixed and variable overheads expended by the enterprise during the production process.

Following are the categories of conversion cost:

I. Direct Cost

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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 same regardless of the volume of production.

The allocation of fixed production overheads is based on the normal capacity of the production. In case of low production or idle plant distribution of these fixed overheads are not 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 design cost which is expended for the specific customer order.

If there are by products while the production of main products, their cost has to be separately calculated.

Some of the cost which should not be included are:

a. Cost of any abnormal waste materials cost

b. Selling and distribution cost unless that costs are necessary for the production.

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

III. Methods of Inventory Valuation:

A. First-in, First-out (FIFO)

B. Last-in, First Out (LIFO)

C. Simple Average

D. Weighted Average

First-in, First out (FIFO)

The FIFO method follows the principle that materials received first are issued first. After the first lot or batch of material purchased is exhausted, the next lot is taken up for supply. It does not suggest, however, that the some lot will be used from storage. Some times all materials are tagged with their arrival date and issued in date order especially with stocks that deteriorate. The inventory is price at the latest cost.

Last-in, First Out (LIFO)

The last in, first out (LIFO) method is used to place an accounting value on inventory. The Last in First out method operates under the assumption that the last item of inventory purchased is the firstly issued. Picture a store shelf where a clerk includes material from the front, and customers also take their selections from the store; the remaining materials of inventory that are stored further from the front of the store house are rarely taken for issue, and so remain on the stock – that is a Last in first out method.

The trouble with the LIFO scenario is that it is rarely encountered in practice. If a company were to use the process flow embodied by LIFO, a significant part of its inventory would be very old, and likely obsolete. Nonetheless, a company does not actually have to experience the LIFO process flow in order to use the method to calculate its inventory valuation.

Effects of LIFO:

The reason why companies use LIFO is the assumption that the cost of inventory increases over time, which is a reasonable assumption in times of inflating prices. If you were to use LIFO in such a situation, the cost of the most recently acquired inventory will always be higher than the cost of earlier purchases, so your ending inventory balance will be valued at earlier costs, while the most recent costs appear in the cost of goods sold. By shifting high-cost inventory into the cost of goods sold, a company can reduce its reported level of profitability, and thereby defer its recognition of income taxes. Since income tax deferral is the only justification for LIFO in most situations, it is banned under international financial reporting standards

Weighted Average Method

The weighted average method is an inventory costing method that use for average costs to each unit of inventory when it is issued during the certain time period.

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