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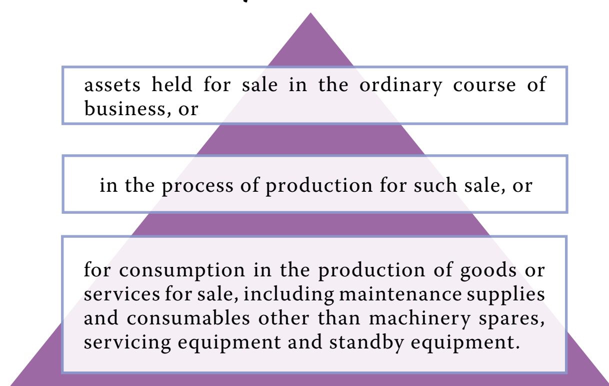
CA FOUNDATION - PAPER 1 - PRINCIPLES AND PRACTICE OF ACCOUNTING

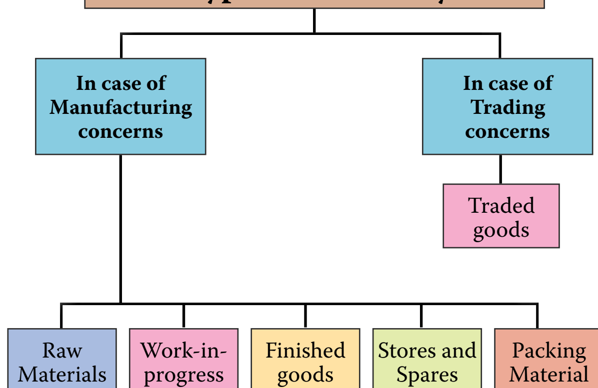
The objective of Paper 1 "Principles and Practice of Accounting" at Foundation level is to develop an understanding of the basic concepts and Principles of Accounting and apply the same in preparing financial statements. It has always been the endeavour of Board of Studies to provide quality academic inputs to the students. Considering this objective, it has been decided to bring forth a crisp and concise capsule on the topic of Inventory Valuation covered in the syllabus of this paper. The concepts involved in this chapter have been gathered and presented through pictorial presentations in this capsule which will help the students in grasping the intricate practical aspects for quick revision of this chapter. Under no circumstances, such revision can substitute the detailed study of the material provided by the Board of Studies. Students are advised to refer Chapter 4 of the Study Material for comprehensive study.

CHAPTER 4: INVENTORIES

Introduction

The chapter "Inventories" will help you to understand the term "Inventory" and the techniques of valuing the inventories. It will also enable you to comprehend the methods of inventory valuation for record keeping and intricacies related to book-keeping.





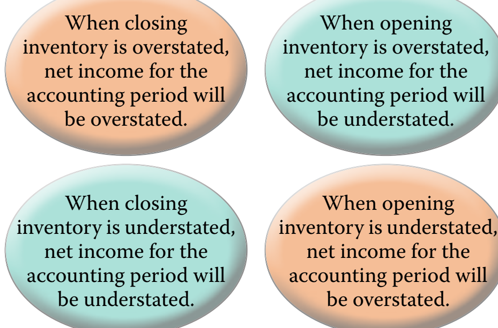
Inventory Valuation

Inventory is generally the most significant component of the current assets held by a trading or manufacturing enterprise. Both excess of inventory and its shortage affects the production activity, and the profitability of the enterprise whether it is a manufacturing or a trading business.

The significance of inventory valuation arises due to various reasons as explained in the following points:

(i) Determination of Income

The valuation of inventory is necessary for determining the true income earned by a business entity during a particular period. To determine gross profit, cost of goods sold is matched with revenue of the accounting period.
The effect of over or understatement of inventory may be explained as:



(ii) Ascertainment of Financial Position

Inventories are classified as **current assets**. The value of inventory on the date of balance sheet is required to determine the financial position of the business. If inventory is not properly valued, the balance sheet will not disclose the truthful financial position of the business.

(iii) Liquidity Analysis

Inventory is classified as a current asset, it is one of the components of net working capital which reveals the liquidity position of the business. Current ratio which studies the relationship between current assets and current liabilities is significantly affected by the value of inventory.

(iv) Statutory Compliance

Schedule III to the Companies Act, 2013 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements.

As per the requirements of the Accounting Standards, 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.

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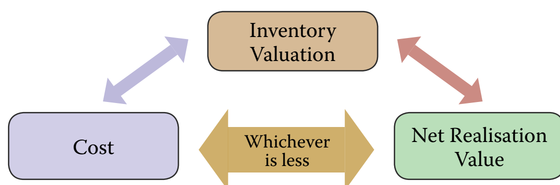
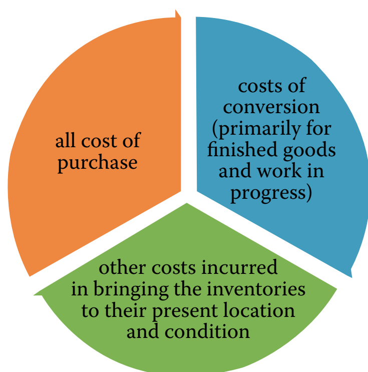
Basis of Inventory Valuation



The above principle is governed by 'Principle of Conservative Accounting' under which any expenses or losses from transactions entered or event occurred are to be recognized immediately, however, any gains or profits are recognized until it becomes due or are actually realized.

Cost

As per Accounting Standards, Cost of inventories should comprise



Cost of purchase	includes any amount paid to the seller reduced by any discounts/rebates given by the seller. Similarly, any duties paid to the supplier will be part of cost of the inventory unless the enterprises can recover these taxes duties from the authorities.
Costs of conversion	inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable overheads.
Other Costs	may include administrative overheads incurred to bring the inventory into present location and condition or any cost specifically incurred on inventory of a specified customer. Interest and other borrowing costs are generally not included in the cost of inventory.

Exclusions from cost of inventories

- abnormal amounts of wasted materials, labour or other production overheads;
- storage costs, unless those costs are necessary in the production process prior to further production stage;
- administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- selling and distribution costs.

Net Realisable Value

This 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.

In case of raw materials	replacement cost is generally considered as net realisable value.
In case of work in progress	Net realisable value mean expenses and overheads required to be incurred to convert work in progress into finished goods and making it ready for sale as reduced from selling price.
In case of finished goods and traded goods	Net realisable value means selling price reduced by selling and distribution expenses.

Inventory Record System

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'. The periodic system is less expensive to use than the perpetual method. But the useful information obtained from perpetual system is more than cost incurred on it.

Periodic Inventory System

Periodic inventory system is a method of ascertaining inventory by taking an actual physical count (or measure or weight) of all the inventory items on hand at a particular date on which inventory is valued.

The cost of goods sold is determined as shown below:

opening inventory (Known) + Purchases (known) – closing inventory (physically counted) = Cost of goods sold.

- Physical inventory taking is required more than once a year for preparation of quarterly or half yearly financial statements thereby making this system more expensive.
- Physical count of goods requires closure of normal operations of business.
- As cost of goods sold is taken as residual figure, it is not possible to identify loss of goods due to pilferage, damage or even fraud.
- Inventory control is not possible under this system.
- Books of accounts does not reflect inventory in hand and its value therefore, it is difficult to plan operations e.g. how much or when to order/manufacture.

This system is used by small enterprises where it is easy to control physical inventory. This system is not considered suitable for medium or larger enterprises which generally use Perpetual Inventory system.

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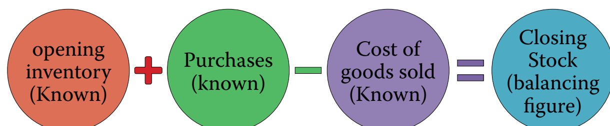
Perpetual inventory system

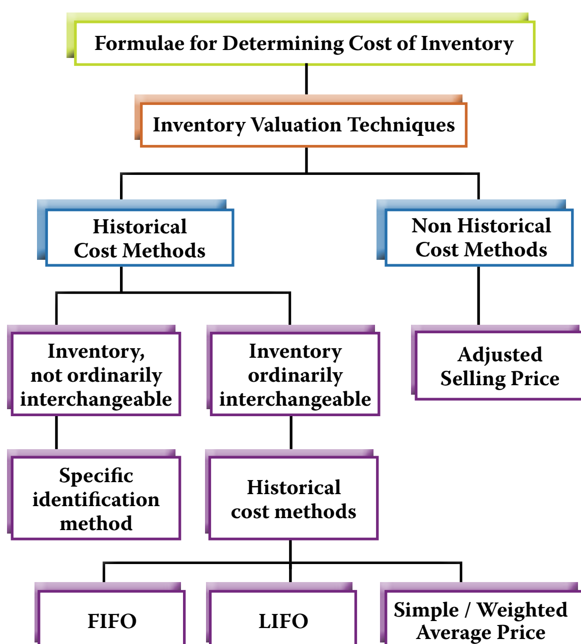
Perpetual inventory system is a system of **recording inventory balances after each receipt and issue**. In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined and inventory of goods is taken as residual figure with the help of inventory ledger in which flow of goods is recorded on continuous basis.

Closing inventory is determined as follows:



Sl. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.
4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
5.	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
6.	This system is simple and less expensive.	It is costlier method.
7.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.

Methods to Determine cost of Inventory



Historical Cost Methods

The different techniques for valuation of inventory have been discussed below:

(i) Specific Identification Method

- It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in inventories are left. The historical costs of such specific purpose inventories may be determined on the basis of their specific purchase price or production cost.
- This method is generally used to ascertain the cost of inventories of items that are not ordinarily interchangeable and their value is high like expensive medical equipments.

(ii) FIFO (First in first out) Method

- This method is based on the assumption that cost should be charged to revenue in the order in which they are incurred, that is, it is assumed that the issue of goods is usually from the earliest lot on hand. The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first and consequently items remaining in the inventory at the end of the period are those most recently purchased or produced.
- Thus, the closing inventory is valued at the price paid for latest consignments.

(iii) LIFO (Last in first out) Method

- The LIFO formula assigns to cost of goods sold, the cost of goods that have been purchased last though the actual issues may be made out of the earliest lot on hand to prevent unnecessary deterioration in value. Under this basis, goods issued are valued at the price paid for the latest lot of goods on hand which means inventory of goods in hand is valued at price paid for the earlier lot of goods.
- The price paid for the earliest consignments is used for valuing closing inventory.

(iv) Simple Average Price Method

- In Simple Average Price method, all the different prices are added together and then divided by the number of prices.
- The closing inventory is then valued according to the price ascertained.

(v) Weighted Average Price Method

- Under Weighted Average Price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit. Thus
- Weighted average price per unit = $\dfrac{\text{Total cost of goods available for sale during that period}}{\text{Total number of units available for sale during that period}}$
- Closing inventory = No. of units in inventory × Weighted average price per unit
- Cost of goods sold = No. of units sold × Weighted average price per unit.

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Non Historical Cost Methods

(i) Adjusted selling price method

This method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The cost of the inventory is determined by reducing from the sales value of the inventory an appropriate percentage of gross margin. The percentage used takes into consideration inventory which has been marked below its original selling price. An average percentage for each retail department is often used.

(ii) Standard cost method

This method is used when there is frequent change in the price per unit of the goods and goods are purchased frequently by the business e.g. crude oil. Based on the experience a standard cost is determined on the basis of frequent changes in prices and inventory is valued on that price per unit.

Inventory Taking

Normally all operations are suspended for one or two days during the financial year and physical inventory is taken for everything in the godown or the store periodically. For the year-end inventory valuation, physical inventory taking is done during the last week of the financial year or during the first week of next financial year. If inventory taking is finished on 26th March, whereas accounting year ends on 31st March purchases and sales between 26th and 31st March are then separately adjusted. Later, a value is put on each item. The principle of cost or Net realizable value, whichever is lower, is applied either for the inventory as a whole or item by item.

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