• Overstated
• understated

CH-4 Inventories

• Inventory can be defined as asset held:-
(a) for sale in ordinary course of business
(b) in the production for such sale
(c) for consumption in the production of goods or services for sale (including stores + spares, consumables etc)

Inventory

manufacturing Entities
- raw materials
- work in progress
- finished goods
- stores and spares
- packing material

Trading entities
↓
Stock in trade (traded goods)

(AS-2)

• Significance of Inventory valuation :-
(a) Correct determination of income (Closing Stock affects gross profit & NP)
(b) Correct financial position (Balance sheet) related
(c) It helps in liquidity analysis (current ratio)
(d) Statutory compliances - Schedule III of Companies Act, 2013 (disclosure in financial statements)

(Overstated)
★ Over valuation of closing stock will lead to overstatement of income & assets.

Closing Inventory	⇒ Direct relation ⇒ Income & Assets
Opening Inventory	⇒ Inverse relation ⇒ Income & Assets

* Concept of Cost of goods sold (COGS)

→ (i) COGS ⇒ Opening Stock (+) net purchase (+) direct expenses (−) closing stock

* Net purchase = purchase (−) purchase return
* Direct expense = manufacturing exp., factory exp. – carriage inwards, wages, freight, octroi etc.

(ii) COGS ⇒ Net sales (−) Gross profit
(iii) COGS ⇒ Net sales (−) Gross Loss

* Adjusted purchase = opening stock (+) net purchase (−) closing stock
* Cost of goods available for sale = opening stock (+) net purchase

* Concept of over valuation and undervaluation of Inventory

(i) Over valuation of closing stock ⇒ Profit ↑, COGS ↓
(ii) Over valuation of opening stock ⇒ Profit ↓, COGS ↑
(iii) Under valuation of closing stock ⇒ Profit ↓, COGS ↑
(iv) Under valuation of opening stock ⇒ Profit ↑, COGS ↓

* Basis of Inventory Valuation (AS-2) (due to Conservatism)

→ Inventory valued at cost or NRV whichever is $\boxed{\text{lowest}}$

• Cost = cost of purchase (+) cost of conversion (+) cost (other)

- cost of purchase ⇓ expense incurred on acquisition of goods including taxes
- cost of conversion ⇓ includes direct labour or direct expenses
- cost (other) ⇓ includes cost incurred in bringing the inventory to their present location.

• NRV = Net Realisable Value
= expected selling price (−) expected cost of completion

~~Average~~ Adjusted selling price method (Retail inventory method)

* Inventory Valuation Techniques

- Inventory is not interchangable
  - Specific identification method
- Inventory is interchangable
  - Historical cost method
    - FIFO (AS-2)
    - LIFO
    - Average price
    - Weighted Average price (AS-2)
  - Non-historical cost methods
    - ↳ Adjusted selling price method

1.) FIFO, LIFO, Average price, Weighted Average Price method

eg. 1 January → 2 boxes purchased for ₹ 10 each
3 January → 3 Boxes purchased for ₹ 12 each
5 January → 4 boxes purchased for ₹ 14 each
9 January → 1 box purchased for ₹ 11 each
10 January → Sold 3 boxes for ₹ 500 each

- FIFO ⇒ closing stock = 12+12 + 56 + 11 ⇒ ₹ 91
- LIFO ⇒ Closing stock = 28 + 36 + 20 ⇒ ₹ 84
- Average price method = Avg. selling price × inventory left

$$= \frac{10+12+14+11}{4} \times 7$$

$$= 11.7 \times 7 \Rightarrow ₹\ 82.25 \text{ (closing stock)}$$

- Weighted Average price method ⇒ weighted avg. price × inventory left

$$= \frac{(10\times2)+(12\times3)+(14\times4)+(11\times1)}{10} \times 7$$

$$= 12.3 \times 7$$

$$= ₹\ 86.1 \text{ (closing stock)}$$

(2) Adjusted Selling Price method (Retail Inventory method)

Sales	xxx
(+) Closing stock at selling price	xxx
Selling price at goods available for sale	A
(−) Opening stock	(xx)
(−) purchases	(xx)
Gross margin	B

Now, Gross margin (%) = $\frac{B}{A} \times 100$

Finally, closing stock at selling price xxx

(−) Gross margin (%) (xx)

$\boxed{\text{closing stock at cost} \quad xxx}$

* Inventory Record Systems (4 marks theory)

Periodic Inventory System	Perpetual Inventory System
(a) This system is based on physical verification.	(a) This system is based on book records.
(b) In this system COGS is residual value.	(b) In this system, closing stock is residual value.
(c) Goods lost is assumed to be part of COGS.	(c) Goods lost is assumed to be part of closing stock.
(d) It is simple and less expensive.	(d) It is costlier method.
(e) This system require closure of business for physical verification. (stock taking)	(e) This system does not affect operations of business.

* Periodic Inventory System:

$$\boxed{\underset{\text{(known)}}{\text{Opening Stock}} \ (+) \ \underset{\text{(known)}}{\text{purchases}} \ (-) \ \underset{\text{(physically counted)}}{\text{Closing Stock}} = \underset{\text{(residual value)}}{\text{COGS}}}$$

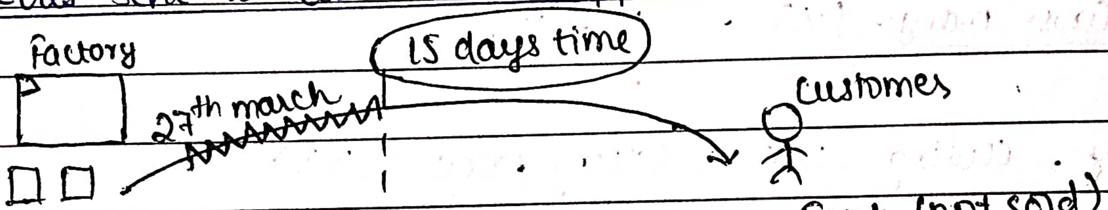
* Perpetual Inventory System

$$\boxed{\underset{\text{(known)}}{\text{Opening Stock}} \ (+) \ \underset{\text{(known)}}{\text{Purchases}} - \underset{\text{(known)}}{\text{COGS}} = \underset{\text{(residual value)}}{\text{Closing Stock}}}$$

Special Concepts

(i) Goods Sent to customer on approval basis

eg.



Cost = 100/- each

(+) Profit = 20/- each

S.P = 120/- each

31st march (year end) (pending for approval)

physical count = 73 boxes

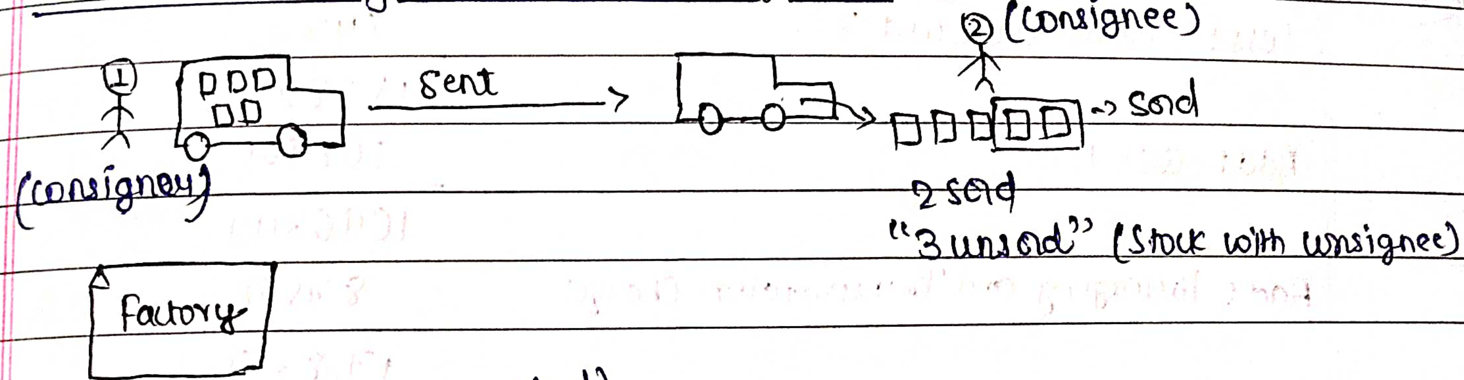
CA

□□ → 100/- each

(Stock with customer)

Closing Stock = 7300 + 200 ⇒ ₹7500/-

(ii) Goods remaining unsold with Consignee



~~73 boxes (physically counted)~~

Closing Stock = 7300 + 300 = ₹7600

• Closing Stock = Opening Stock (+) net purchase (+) direct expense (−) COGS

• Opening Stock = Closing Stock + COGS (−) net purchase (−) direct expenses

* Profit = 25% on cost = 20% on sales

* Profit = 33.33% on cost = 25% on sales