Accounting Standards – 2 Valuation Of Inventories

OBJECTIVE

valuation of inventories

• Formulate the method of computation of cost of inventories/stock.

• Determining the value of closing stock at which it is to be shown in balance sheet till it is not sold and recognized as revenue.

Applications

• This Standard should be applied in accounting for inventories other than:

(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);

(b) work in progress arising in the ordinary course of business of service providers;

(c) shares, debentures and other financial instruments held as sk in trade; and

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

DEFINITION

Inventories are assets:

• Held for the sale in the ordinary course of business (Finished Goods).

• In the process of production of such sale (Raw material and working progress).

• In the form of materials and supplies to be consumed in the production process or in the rendering of services (Stores, Spares, Raw material).

• Inventories do not include machinery.

Measure Of Inventories

Inventories should be valued at the lower of cost and net resale value

MAJOR POINTS FOR VALUATION OF INVENTORIES

• Determination of cost of Inventories

• Determination of net realizable value of inventories

• Comparison between the cost and net realizable value

Determination of Cost of Inventories

Cost of Inventories Includes:

– Cost of Purchase

– Cost of Conversion

– Other Costs (incurred in bringing the inventories to their present location and condition)

Cost Of Purchase

Cost of Purchase Price includes :

• Duty and Purchase Price

• Taxes

• Freight Inward

• Other Expenditure directly attributable to the acquisition.

Less :

• Duties and taxes recoverable by enterprises from taxing authorities

• Trade discount

• Duty Drawback

• Rebate

Cost Of Conversion

• It Consists of the cost directly related to the units(Direct Labor, Direct Material, Direct Expenses)

Add:

• Systematic allocation of fixed and variable production overheads that are incurred in converting material into finished goods.

Other Costs

Cost incurred in bringing the inventories to their present location and condition

• Excise duty contributes directly to bringing the inventories to its present location and condition

• Excise duties is direct costs, which should be included in the valuation of inventories

Determination of net realizable value of Inventories.

• Net realizable value means estimated selling price in ordinary course of business less estimated costs of completion and estimated costs necessary to make the sale

• If the finished product is sold at cost or above cost, then the estimated realizable value of raw material and supplies is considered more than its cost

• If the finished product is sold below cost, then the estimated realizable value of raw material or supplies is equal to replacement price of raw material or supplies

Methods of computing Inventories

• First-in, First-out (FIFO)

• Last-in, First-out (LIFO)

• Weighted-average cost (WAC)

First-in, First-out (FIFO)

• This method assumes that the first unit acquired are the first unit sold

• The costs of ending inventories is that of the most recent purchases

• A major criticism of FIFO: Improper matching of cost with revenues since the cost of goods sold is computed on the bases of old price that are possibly unrealistic

Last-in, First-out(LIFO)

• This method assumes that the last unit acquired are the first unit sold

• The cost of the units in the ending inventory is that of the earliest purchases

• The chief advantage of LIFO is that balance sheet value of inventories may be outdated and unrealistic

Weighted average Cost (WAC)

• This method assumes that the goods available for the sale are homogeneous

• The average cost is computed by dividing the cost of goods available for sale by the number of the units available by sale

• The major criticism of WAC is that it assigns no more importance to current prices than to past prices paid several months ago

Disclosure in financial statements

• Accounting policy adopted in measuringinventories

• Cost formula used

• Classification of inventories like Finished Goods,WIP, Raw Materials, Spare Parts.

Accounting Standard (AS) - 19 Lease

Objective

ʌʌ The objective of this standard is to prescribe accounting treatment for Leases & disclosures in relation to Financial and Operating leases.

Scope

ʌʌ This standard applies to all leases except:-

a) Lease rights to explore for or use of natural resources, such as oil, gas and other mineral rights,

b) Leases of motion pictures and

c) Lease agreement to use land.

Definitions

ʌʌ **Lease**:- Agreement between two parties where one party obtains right to use asset against consideration or series of consideration for an agreed period of time.

Lease term: The non cancellable period for which the lessee has agreed to take on lease the asset together with any further period for which the lessee has to continue the lease of the asset.

ʌʌ **Minimum Lease Payment**: The amount which is required to pay by lessee over the lease term including any guaranteed residual value, but excluding any contingent rent or expense which are reimbursed by lessor

Fair Value: The amount for which an asset can be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

ʌʌ **Contingent rent**: A portion of lease payment which is based on a factor such as percentage of sales etc.

CLASSIFICATION OF LEASES

• A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

• An operating lease is a lease other than a finance lease

• Classification depends on substance of the transaction rather than the form of the contract

• Basic criteria providing guidance in determining whether these risks and rewards have been transferred

EXAMPLES OF FINANCE LEASES

- Ownership transferred by end of lease term.
- Lease contains bargain purchase option.
- Lease term for major part of asset's economic life.
- Present value of minimum lease payments amounts to at least substantial all of asset's fair value.
- Leased asset of specialised nature that only lessee can use without major modifications being made

ACCOUNTING FOR FINANCE LEASES LESSEE'S BOOKS

¬ At inception of a finance lease, lessee should recognise lease as an asset and a liability on the basis of fair value or present value of minimum lease payments .

• Liability for a leased asset should be presented separately in balance sheet as a current liability or a long-term liability as case may be.

• Lease payments should be apportioned between finance charge and reduction of outstanding liability on a basis which produces a constant periodic rate of interest on remaining balance of liability for each period.

• A finance lease gives rise to depreciation expense for asset (on the basis of lessee's depreciation policy for owned assets) as well as a finance expense for each accounting period.

• If there is no reasonable certainty that lessee will obtain ownership by end of lease term, asset should be fully depreciated over lease term or its useful life whichever is shorter.

ACCOUNTING FOR FINANCE LEASES-LESSOR`S BOOKS

- Lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to net investment in the lease.
- (MLP+ unguranteed residual value-unearned finance income).
- Recognition of finance income should reflect a constant periodic rate of return on net investment of lessor outstanding in respect of finance lease.
- Manufacturer or dealer lessor should recognise transaction of sale in profit and loss in accordance with policy followed by enterprise for outright sales. In case of artificially low rate of interest, compute sale price based on commercial rates of intrest initial direct costs to be expensed.

ACCOUNTING FOR OPERATING LEASES LESSEE'S BOOKS

Lease payments (excluding costs for services such as insurance & maintenance) under operating lease should be recognised as an expense in profit and loss on a straight line basis over lease term unless anothersystematic basis is more representative of time pattern of user's benefit.

ACCOUNTING FOR OPERATING LEASES LESSOR'S BOOKS

• Lease income from operating leases should be recognised in profit and loss on a straight line basis over lease term unless another systematic basis more representative of time pattern in which benefit derived from use of leased asset diminished.

• Leased asset to be disclosed under fixed assets.

• Depreciation of leased assets should be on a basis consistent with normal depreciation policy of lessor for similar assets.

SALE AND LEASEBACK TRANSACTIONS RESULTNG IN FINANCE LEASES-SELLER –LESSEE'S BOOKS

• Excess or deficiency of sale proceeds over carrying amount should be deferred or amortised over lease term, in proportion to depreciation of leased asset.

SALE AND LEASEBACK TRANSACTIONS RESULTNG IN OPERATING LEASES

• If transaction established at fair value, any profit or loss should be recognised immediately.

• If sale price is below fair value, any profit or loss should be recognised immediately except that if loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to lease payments over the period for which asset is expected to be used.

• If sale price is above fair value, the excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

• If fair value at time of a sale and leaseback is less than carrying amount of asset, a loss equal to amount of difference between carrying amount and fair value should be recognised immediately.

Disclosure in case of Finance Lease

1. Assets acquired on Lease should be shown separately

2. For each leased assets, show net carrying amount at the balance sheet date

3. Provide reconciliation between Minimum Lease Payment at balance sheet date and their present value

4. **Disclose total of minimum lease payment at balance sheet date and their present value for:**

a)Not later than one year

b) Later than one year but not later than five year

c) Later than five years

5. Future minimum sublease payment expected to receive at balance sheet date

6. General description of lessee significant leasing arrangements

Disclosure in case of Operating Lease

1. **Future lease payment for the following period**

a) Not later than one year

b) Later than one year but not later than five years

c) Later than five years

2. Total Expected future lease payment

3. Lease payment recognized in the statement of Profit and Loss for the period

4. General Description of Lessee significant leasing arrangements