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FACULTY OF COMMERCE AND MANAGEMENT

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LECTURE-25

INVENTORY VALUATION:

Reasons for too much emphasis on Inventory Valuation:

The following three seem to be the important reasons for too much emphasis on inventory valuation:

(i) Inventory constitutes the major bulk of current assets and it represents the major current assets investment. As such, its valuation should be made in such a way so that the profit or income is determined accurately and the Balance Sheet can exhibit a true and fair position at a particular date,

(ii) Since the inventory has a direct impact on profit, proper determination of the latter depends on the proper valuation of the former. In other words, if closing inventory is undervalued, profit will be understated or vice-versa. Besides, if the ending inventory is overvalued and is shown in the Balance Sheet, the same amounts to a case of 'window-dressing' which will exhibit a wrong picture about the liquidity position of a firm.

Therefore, inventory should always be valued properly so that the short term liquidity must not suffer, i.e., creditors must not be misleded. If inventory is valued properly. Balance Sheet will exhibit a true and fair view of the financial position of a firm.

(iii) The next one involves the fluctuation in commodity prices. It again seems to be a greater appreciation of the effects of these changes on the individual firm and the business community as a whole.

In the words of Paul, Garner, S.:

"It became common knowledge that the income of some enterprises for specific years was tremendously influenced by the accounting procedure adopted for handling the fluctuations in the market value of the inventory consumed in operations or sold. Many firms began to indicate in their published statements the income (or loss) before and after the 'inventory adjustment', as they called it. These adjustments were quickly impressed on the mind of the public with the result that increasing attention was devoted to the matter not only by accountants, but also by the students of finance, banking credit, taxation and others".

Cost Elements:

The presentation of inventory in the annual financial statement on the basis of historical cost system of valuation is widely accepted although there are some other methods which are used for

certain special cases. Historical cost of inventories is the sum total of cost of purchases including costs of conversion and certain other costs which are incurred in order to be a finished product:

Cost of Purchase:

It includes purchase price together with import duties, other purchase taxes, transport and handling costs and any other costs which are directly attributable to prime cost after deducting rebate and discounts etc.

Cost of Conversion:

It includes cost of purchases plus the production overhead (both fixed and variable overhead) which are incurred during production. But certain other costs are to be excluded from the cost of conversion, e.g., waste-material of exceptional amounts, cost of idle plant etc.

Production Overhead:

It relates to the costs of production other than the cost of direct materials and direct labours, e.g., indirect materials, indirect labours, factory expenses etc.

Other Expenses:

It includes costs which are necessary for the inventories in order to be a finished/marketable product, e.g., expenditures which are incurred in designing product for specific customers etc. The conventional method of valuation of inventories, of course, which is universally applicable at present is historical cost price or the market price value' whichever is lower '.

The term 'market price/ value' is used to designate the 'replacement price/value' and 'net realizable value'.

As such, at present inventories are valued at the lowest of:

(i) Historical cost,

(ii) Net realisable value and

(iii) Replacement price/ value.

If this method is used as a method of valuation of inventories. Profit and Loss Account will automatically be adjusted when historical cost will be more than the net realisable or replacement value.

However, market value is to be determined on the following two bases:

1. 'Net Realisable Value' Basis, and

2. 'Replacement Value' Basis.

1. Net Realisable Value Basis:

Under this concept, 'market prices value' is considered as the 'net realisable value' which is equal to the estimated selling price in the ordinary course of business minus the cost of completion. This method of valuation of inventories particularly followed where the inventories are damaged or partially obsolete.

In this case, inventories are to be valued below the historical cost since the selling price of the same items will be reduced.

As a result, historical cost for the items will not be realised and the difference will, however, be adjusted in Profit and Loss Account by writing down the inventories to the net realisable value. That is why, value of inventories must not be shown at a higher figure than its expected realisable value in future.

It should be remembered that the estimated realisable value must not be determined on the basis of temporary fluctuation of prices but on the basis of most reliable evidence.

2. Replacement Value Basis:

Under this concept, the market value is considered to be the current replacement cost which is equal to the current cost of acquisition either by purchases or by production together with the incidental and acquisition cost. This basis usually applies more appropriately to materials or purchased merchandise since calculation of replacement cost of work-in-progress or finished goods will not be an easy task.

Current cost of each element of total cost of inventory will be determined. However, current cost of raw materials and labour should be determined (with tolerable precision) by incorporating current rate of wages and materials to be multiplied by actual quantity of material or labour related to finished or semi-finished product.

It may be noted that there is a difference between replacement value and realisable value. The former represents a sacrificial value whereas the latter represents a beneficial value. At the same time, historical cost represents a sacrificial value and realised value is a beneficial value.

Sometimes, market value on reproduction basis should be determined on the basis of market price of raw materials, labour and overheads.

However, the AICPA has approved certain limits for inventory valuation which have been stated by the Committee on Accounting Procedure, Bulletin 29, as under:

‘As used in the phrase ‘lower of cost or market the term ‘market’ means current replacement cost (by purchase or by production, as the case may be) except that:

(i) Market should not exceed the net realisable value (i.e. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal), and

(ii) Market should not be less than net realisable value reduced by an allowance for an approximately normal profit margin’

From the above, exception (ii) states not to reduce value until there is a clear apparent loss. The AICPA prefers to use ‘market value’ only to the ‘replacement or reproduction value’ and ‘net realisable value’ is treated as a separate item.

But, the Institute of Chartered Accountants of England and Wales prefers to use, lower of cost and net realisable value, ‘at the lowest of cost, net realisable value and replacement including reproduction price’ or ‘at cost less provision to reduce the net realisable value’.

Therefore, after considering the recommendations of both the Institutes, valuation should be made on the basis of the lowest of the three (stated above), with one exception imposed by AICPA. That is, if market price is found to be so lower than the net realisable value less normal profit, the latter should be considered.