RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: MBA III SEM..

SUBJECT: WORKING CAPITAL MANAGEMENT

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LECTURE: 26

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LECTURE-26

Methods of Valuation of Inventory – Based of Historical Cost:

Valuation of inventory is made on a conservative basis i.e., expected profits are not to be considered whereas possible losses are to be provided for. As such, it is valued at the lowest of (i) historical cost; (ii) net realisable value and (iii) replacement price/value. The term 'cost' usually refers to designate the historical cost, i.e., outlay of cash or its equivalent in the acquisition of a particular item of inventory.

In other words, it is the sum total of the price paid along with all expenditures and charges directly or indirectly incurred in bringing inventory to its existing condition and' location. Therefore, in case of materials and supplies, the price paid including freight and carriage represents their cost and sometimes a part of the storage expenditure is also included.

In case of work-in-progress, however, cost represents the sum total of direct material cost, direct wages and direct expenses including manufacturing and factory overhead.

The elements making up cost of finished goods or stock-in-trade are incurred in bringing:

(i) The purchase price of goods, stores, and in case of processed stock, materials used in manufacture,

(ii) All direct expenditures (e.g. direct wages, cost of tools, design etc.) incurred in bringing stock-in-trade to its existing condition and location; and

(iii) Indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

As the production and sales cycle is a continuous and repetitive process, cost which are incurred during as accounting period at different times in order to bring an article to its existing condition and location, varies due to certain factors, viz., the seasonal effects, the efficiency of the workers, the attitude of management etc.

This variation, no doubt, creates the difficulty of identification of cost of inventories for the purpose of their valuation. Of course, the said difficulties may be overcome by certain arbitrary assumptions and, as such, different bases are generally adopted.

Some of them are enumerated below:

(a) First-in-First-out:

Under this method, materials which are received first are also issued first. In other words, the pricing of the issue of the first lot is done at the cost at which that lot was acquired. As such, the closing inventories are valued at latest purchase price and thus it will represent current condition as far as possible.

That is, closing inventories are always out of the latest lots acquired or purchased or manufactured. The same leads to represent replacement price. This method is particularly applicable where prices do not fluctuate very frequently and the materials are not fast moving.

Illustration:

In a factory, stores are issued and accounted for on FIFO method. If the stock of a particular material on 1st Jan. 1992 is 1,000 units valued at Rs. 5 per unit and the particulars of purchases and issues during the month of Jan. 1992 are as follows, prepare a statement showing how the value of issues should be arrived at:

Solution:

Store Ledger Account
FIFO Method

Folio No -
Name of Material –
Maximum level –
Specification –
Minimum level –
Code No –
Bill No –
Re-ordinaring level –
Unite of Measurement —
Location –

	Receipts				Issues				Balance			
Date	G.R. No.	Quantity	Rate	Amount	S.R. No	Quantity	Rate	Amount	Quality	Rate	Amount	Rem-arks
1992				Rs.				Rs.			Rs.	
Jan. 1.									1,000	5	5,000	
3.		200	5,5	1,100					1,000	5	5,000	
									200	5.5	1,100	
9.						1,000	5	5,000	,200	5.5	1,100	
15.		1,400	6	8,400					200	5.5	1,100	
									1,400	6	8,400	
17.						200	5.5	1,100				
						800	6	4,800	600	6	3,600	
21.		800	6.5	5,200					600	6	3,600	
									800	6.5	5,200	
23.						600	6	3,600				
						400	6.5	2,600	400	6.5	2,600	