

Valuation of inventories where final product is expected to be sold at above cost

A Facts of the Case

1. The main business of a power sector company is transmission of power in general and generation of power in shared projects.

2. According to the querist, Accounting Standard (AS) 2, 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India, states that inventories should be valued at cost or net realisable value, whichever is lower. In the view of the querist, the net realisable value is required to be based on the most reliable price the inventories are expected to realise, or based on general selling price.

3. The querist has stated that the power sector deals in inventories of exclusively typical nature and procures goods as per its specific requirements and specifications. The goods procured are mostly technical in nature and most of these are not readily available for sale in the market. Electricity equipments/goods are generally manufactured as per given and specific technical specifications. Considering this fact, in the view of the querist, it is not possible to obtain general selling price for these products. Moreover, according to the querist, electricity sector being a bulk consumer, the prices are also affected by the volume of purchases made from time to time. Thus, it may not be possible to have data of prevailing/replacement prices.

4. The querist has also stated that the company is breaking even and will continue to do so for some more years as per the Financial Restructuring Plan (FRP) approved by the State Government. In other words, cost is being fully recovered.

B. Query

5. In the circumstances narrated above,

Expert Advisory Committee

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

the querist has sought the opinion of the Expert Advisory Committee as to whether the power sector companies can get the benefit of paragraph 24 of AS 2, which provides that inventories which are used in the production of finished products that are sold at or above cost, can be valued at cost. For example, in the case of the company, the stores/spares used for transmitting/generating power can be valued at cost, provided the cost incurred in transmission/generation of power is fully recovered. Therefore, whether it would be in the fitness of things that the inventories in the power sector companies are valued at cost.

C. Points considered by the Committee

6. The Committee notes the definition of the term 'inventories' as contained in paragraph 3 and paragraph 4 of AS 2, which are reproduced below:

"Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

"4. Inventories encompass goods pur-

chased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets."

7. The Committee also notes paragraph 24 of AS 2, which states as follows:

"24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value."

8. The Committee notes from the above that if the finished products or the services being rendered are expected to be sold at or above their cost, then the inventories which are used in the production of finished products or

rendering of services should be valued at cost. The Committee further notes from paragraph 4 of the Facts of the Case that the cost of the product being produced by the company, viz., electricity, and cost of the service being rendered, viz., transmission of the electricity, are being fully recovered. Thus, under the facts and circumstances of this query, the Committee is of the view that the inventory items falling within the definition of the term 'inventories' as per AS 2 should be valued at cost. The Committee notes that paragraph 24 of AS 2 is contained within the sub-heading 'Net Realisable Value' and the application of the principle enunciated by the said paragraph does not imply that the basic principle of valuation of inventories has undergone a change. The principle contained in paragraph 24 of AS 2 is in-built in the broader principle of valuation of inventories at the lower of cost and net realisable value. Thus, as a matter of policy, the inventories should continue to be valued at lower of cost and net realisable value and should be so stated in the statement of significant accounting policies.

D. Opinion

9. On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 5 above that the stores/spares used for transmitting/generating power, should be valued at cost, since in the facts and circumstances of the query, the company expects to sell the power at a price which would enable it to recover all cost. However, the accounting policy should state that the inventories are valued at the lower of cost and net realisable value.

Notes:

1. *The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.*
2. *The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty four volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.*