

Determination of cost of inventories of imported raw materials

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

A. Facts of the Case

1 A private limited company is engaged in the manufacture of polymerization initiators. The company uses various imported materials as well as domestically purchased materials in the manufacture of the initiators. The company makes several types of polymerization initiators and it sells these products in the domestic market as well as overseas market. Certain raw materials are used in the manufacture of more than one product and the company cannot physically identify duty-free stocks and duty-paid stocks. Also, during the manufacture of the products, it cannot be identified whether a product is meant for export or for domestic sale.

2 The querist has informed that in the case of exports, the company gets the benefit of Advance Import License, which entitles it to import raw materials free of duty. Further, it has been informed by the querist that it is not necessary that the Advance License for import of raw materials has to be made before the end-product is exported. The only requirement is that the company should apply to Director General Foreign Trade (DGFT), for Advance License, before the date of export and after the license is obtained, it would import raw materials free of duty against the Advance License. The company can produce the goods meant for export using the raw materials purchased earlier on full payment of duty and can replenish the same with duty-free imported materials. Hence, the basic raw material can be imported by paying full duty or without payment of duty using Advance License.

3 The querist has further stated that whenever the duty-free materials are imported, cost thereof is determined based on their landed cost, without duty. When the same material is imported with duty, its cost is at a higher value as it includes the import duty. Therefore, under the weighted average costing method, the weighted average unit cost of the raw material is obviously lower than the cost of the duty-paid raw material and higher than the cost of the duty-free material. For instance, if the company imports Rs. 100 worth of raw material, the landed cost will work out to Rs. 150.80 (25% Customs duty + 16% CVD and 4% SAD) on full payment of duty and Rs. 100 only on duty-free imports resulting in a difference of Rs. 50.80 for every Rs. 100 worth of imports made.

4 The querist has informed that for the finished products costing system, the company uses the weighted average cost of raw material and, as a result, the finished products, whether exported or sold in India, carry the same average cost. Consequently, as per the querist, the costing of the domestic sales is under-priced and that for the export sales is over-priced leading to wrong information and sometimes wrong pricing decisions.

5 The querist has informed that the company wants to change the costing system to the following, to reflect costing of the finished goods for domestic sales and for export sales which is correct according to the company:

- (i) Open, at the time of import, a 'Duty to be earned account'.
- (ii) Account for all the imports including the duty applicable.
- (iii) The corresponding credit for the duty applicable but not incurred would be made to 'Duty to be earned account'.
- (iv) When exports are actually made, the duty concession earned is quantified and transferred

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 23 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.

from 'Duty to be earned account' to 'Duty concession earned account', which would reduce the cost of goods exported.

- (v) If Advance Licence is not redeemed by exports, any duty liability would be paid by debiting 'Duty to be earned account'.
- (vi) At the end of the accounting period, the stock of imported materials would be reduced by the relevant credit lying in the 'Duty to be earned account' to fall in line with AS 2.

6 As informed by the querist, the advantages of the method stated in paragraph 5 are:

- (a) Obligation incurred on duty-free imports is recognised in the books.
- (b) Cost of domestic sales and export sales gets realistically accounted for.

7 The querist has also informed that the company will maintain separate stock records for domestic purchases and imported purchases of raw materials. The company does not plan to maintain separate stock accounts for raw materials imported duty free and imported by paying customs duty. There will be only one raw material stock account for imported raw materials. The company maintains separate General Ledger Accounts for recording domestic sales and export sales separately.

B. Query

8 On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the accounting treatment suggested in paragraph 5 above is acceptable.

C. Points considered by the Committee

9 The Committee notes that the basic issue raised in the query relates to whether accounting treatment suggested by the querist in respect of determination of cost of inventories, is proper or not. The Committee has, therefore, not considered recognition of advance licence entitlement benefit in the books of account as this issue has not been raised by the querist. The Committee has also not touched upon any other issue arising from the facts of the case such as determination of net realisable value for valuation of inventories, etc.

10 The Committee notes paragraph 7 of Accounting

Standard (AS) 2, 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India, which states, inter alia, as follows:

“7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.”

11 The Committee notes from the above that the cost of purchase of inventories should comprise all costs including custom duties incurred, if any, with a view to provide the fairest possible approximation to the costs incurred in bringing the item to its present location and condition. Therefore, the Committee is of the view that inventories should be recorded at the actual purchase cost at which they are procured including duty incurred, if any.

12 The Committee further notes paragraphs 14 and 16 of AS 2 which provide as under:

“14. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.”

“16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.”

13 The Committee notes from the above that AS 2 prescribes only three formulae for determination of costs of inventories, namely, specific identification, first-in first-out (FIFO) and weighed average cost formula. The Committee notes from the facts of the case that specific identification formula cannot be applied in the present case since items of inventories are interchangeable and no separate records are maintained for raw materials

imported free of duty and those by paying customs duty. The Committee also notes that the proposed accounting treatment as suggested by the querist in paragraph 5 above is not commensurate with costing formulae, as prescribed by AS 2. Therefore, the Committee is of the view that the company should follow either FIFO or weighted average cost formula for determining the cost of inventories which reflects the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

14 The Committee while addressing the problem

raised in paragraph 5 above is of the view that separate management accounts can be maintained for management information and decision making such as for pricing, if considered necessary.

D. Opinion

15 On the basis of the above, the Committee is of the opinion on the issue raised in paragraph 8 above that the accounting treatment suggested by the querist in paragraph 5 above is not acceptable and, accordingly, the imported raw materials should be recorded at the cost at which they are procured as explained in paragraph 13 above. ■

FOR THE KIND ATTENTION OF MEMBERS IN PART-TIME PRACTICE

The Council at its 241st meeting decided that effective from 1.04.2005, any member in part-time practice (namely, holding certificate of practice and is also engaging himself in any other business and/or occupation) is not entitled to perform attest function, and that the resolution passed under Regulation 190A, which is currently in force and appears as Appendix 10 to the Chartered Accountants Regulations 1988 (Appendix No. 9 in 2002 Edition), be reviewed by the Executive Committee, in the light of the above decision

The Council at its 242nd meeting noted the recommendations made to it by the Executive Committee in this regard and accordingly passed the following resolution as a part of and in continuation of the existing resolution under Regulation 190A which appears as Appendix no. 9 to the C.A. Regulations, 1988 (2002 edition)

IT IS FURTHER RESOLVED that the general and specific permission granted by the Council is subject to the condition that –

- i) any member engaged in any other business or occupation, in terms of general or specific permission granted as per Appendix No. (9) shall not be entitled to perform any attest function except in the following cases.
 - a. Authorship of books and articles
 - b. Holding of Life Assurance Agency Licence for the limited purpose of getting renewal commission.
 - c. Attending classes and appearing for any examination.
 - d. Holding of public elective offices such as M.P., MLA & MLC.
 - e. Honorary office-bearership of charitable, educational or other non-commercial organizations.
 - f. Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.
 - g. Part-time tutorship under the Coaching Organisation of the Institute.
 - h. Valuation of papers, acting as paper-setter, head-examiner or a moderator for an examination.
 - i. Editorship of professional journals – (not in employment)
 - j. Acting as surveyor and Loss Assessor under the Insurance Act, 1938 (not in employment).
 - k. Acting as Recovery consultant in the Banking Sector (not in employment)
 - l. Any coaching assignment organized by the Institute, its Regional Councils and Branches of Regional Councils.
 - m. Engagement as Lecturer in an University, affiliated college, educational institution, coaching organization, private tutorship, provided the direct teaching hours devoted to such activities taken together do not exceed 25 hours a week.
 - n. Engagement in any other business or occupation permitted by the Executive Committee from time to time.
- ii) A member who is not entitled to perform attest function shall not be entitled to train articled clerks.
- iii) The decision (of the Council) taken at its 223rd meeting held in February, 2002 prescribing the criteria for individual cases of articleship shall continue to be in operation, mutatis mutandi.”

The Council in this connection also clarified that the Attest function for the purpose of this Resolution would cover services pertaining to audit, review, certification, agreed upon procedures, and compilation, as defined in the Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services published in the July, 2001 issue of the Institute’s Journal.