

Inclusion of transportation cost in the cost of inventories lying in the field godowns

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.

A. Facts of the Case

1. A public sector company, registered under the Companies Act, 1956, is under the administrative control of the Ministry of Chemicals & Fertilisers with 97% of its share capital being held by the Government of India. The company's turnover during the year 2001-2002 was Rs. 1200 crore.
2. The company has three manufacturing divisions located at two different places in Kochi. The finished products are fertilisers and caprolactam (an industrial raw material). The company also has facilities to produce intermediate products required by it such as ammonia, sulphuric acid, phosphoric acid, anone, hyam sulphate, etc. The products are marketed by the marketing division of the company. Besides these, the company has an engineering and design division and an engineering works division also.
3. The company produces two grades of nitrogenous fertilisers, viz., urea and ammonium sulphate and a complex fertiliser, viz., ammonium phosphate 20:20. These fertilisers are marketed in the four southern states of the country. The marketing in each of these states is under the control of an Area Office. Under each Area Office there are a few Regional Offices, each of which operates a few Agro Service Centres. The authorised dealers are supplied the fertilisers from these Agro Service Centres who, in turn, sell the same to the actual consumers/farmers.

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 21 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.

4. Fertilisers packed in 50 kg. HDPE bags are transported from the factory gate to the field godowns of various Agro Service Centres either by rail or by lorry at the cost of the company. There is no storage facility at the production site. The entire production of fertilisers is sold through the marketing outlets, viz., Agro Service Centres spread over the entire south India and nothing is sold directly at the factory gate. The selling price is the same for all the marketing territories regardless of the impact of transportation cost.

5. According to the querist, for the purpose of arriving at the value of closing stock with the Agro Service Centres, the company has been including the primary freight incurred for the movement of the product from the plant to the field godowns. However, the secondary freight incurred between the field godown and dealers' godown has not been included in the valuation of inventory as the same is considered to be a selling expense. The querist has held that this treatment is in line with Accounting Standard (AS) 2, 'Valuation of Inventories' (paragraph 6), which requires that "***The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition***". As per the querist, according to AS 2, the cost of inventory comprises not merely costs of production but also other costs, incurred even after production, for bringing the same to their present location and condition.

6. The querist has stated that the statutory auditors have objected to the inclusion of the cost of transportation of the products to the field godowns from where the sales are effected, in the cost of inventories. The auditors have qualified the accounts stating that the valuation of stock of fertilisers is not in accordance with AS 2 because of inclusion of freight in the cost of inventories.

7. The querist has forwarded the following comments of statutory auditors and the company's reply to the same:

Auditors' comment

"The valuation of closing stock of fertilisers is not in accordance with Accounting Standard 2, issued by the Institute of Chartered Accountants of India, because of inclusion of freight in the cost of inventories. (Profit overstated by Rs. 574.40 lakh)".

Company's reply

"The comment is with reference to valuation of stock of Factamfos 20:20 at field warehouses. The Accounting Standard 2 has become mandatory with effect from 1-4-1999 and the company has not deviated from the practice. We are consistently following AS 2 with regard to valuation of inventories. As per paragraph 6 of Accounting Standard 2, "the cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition". Factamfos 20:20 is sold through company's Agro Service Centres located at many places in all the southern states of Kerala, Tamilnadu, Karnataka and Andhra Pradesh. The company is not selling the product at factory gate. The freight incurred for movement of the product is the cost to be recognised for comparison of the net realisation at that stage. For the purpose of comparison of cost/net realisation at the point of field warehouses, the comparison of cost including freight with net realisation alone will give the correct picture. We also understand that some other fertiliser companies are also following the same method. This practice has been followed by the company consistently and is part of the company's Accounting Policy Statement.

In view of the above, the profit is not overstated as commented by the auditors".

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the issue as to whether inclusion of freight in arriving at the cost of inventories held in field godowns of Agro Service Centres is in order.

C. Points considered by the Committee

9. The Committee notes paragraph 6 of AS 2 reproduced in paragraph 5 above. The Committee notes that

the said paragraph specifically provides that other costs incurred in bringing the inventories to their present 'location' should form part of the cost of the inventories.

- 10 In this context, the Committee also notes paragraph 13 of AS 2 which provides as below:

"13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

.....

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d)selling and distribution costs."

11. The Committee is of the view that the term 'distribution costs' referred to in paragraph 13(d) of AS 2 reproduced above read with paragraph 6 of AS 2, should be construed as distribution costs which are incurred by the seller in making the goods available to the buyer from the point of sale. In other words, distribution costs comprising the expression 'selling and distribution costs' would include only those costs which are incurred for moving the goods from the premises of the seller, whether from the factory or from the godown of the seller, to the premises of the buyer. Thus, the costs incurred in moving the goods from the factory to the seller's godown before sale, should be construed as the costs incurred in bringing the inventories to their present location within the meaning of paragraph 6 of AS 2 and, therefore, should be included as part of the cost of inventories lying in the said godowns. The Committee notes from the facts of the case that the company in question stores its products in the field godowns of the Agro Service Centres from where the sale is made. Accordingly, the transportation cost of goods from factory to the field godowns should form part of the cost of inventories.

D. Opinion

- 12 On the basis of the above, the Committee is of the opinion that freight incurred for transportation of goods from factory to the field godowns of Agro Service Centres should be included in the cost for the purpose of valuation of inventories held in field godowns of Agro Service Centres. ■