Determination of normal capacity for the purpose of allocation of fixed overheads to cost of inventories and inclusion of various costs in the valuation of inventories.

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

A. Facts of the Case

1. A public sector undertaking was established in the year 1976 under the administrative control of the Ministry of Steel, to develop the mine and plant facilities to produce 7.5 million tonnes of concentrate per year. The mines and plant facilities were commissioned in the year 1980 and the first shipment of concentrate was made in October, 1981. A pelletisation plant with a capacity of 3 million tonnes per year was commissioned in the year 1987 for production of high quality blast furnace and direct reduction grade pellets for export. However, in view of the Hon'ble Supreme Court verdict, the mine of the company was closed w.e.f. 31-12-2005. After the closure of the mine, the company's activities are restricted to production of pellets on bought out ore from outside source.

2. Existing method of valuation of closing stock of finished goods:
   (a) Accounting policy of the company on valuation of closing stock of finished goods is reproduced as follows:
   "Stock of finished goods namely, pellets and pig iron (including stock with the consignment agents) is valued at lower of cost and net realisable value. Cost comprises expenditure incurred in the normal course of business in bringing such inventories to their location and includes wherever applicable, appropriate overheads based on normal level of activity. However, when the actual production is abnormally lower as compared to normal level, the expenditure of fixed nature is reduced in proportion to the shortfall."
   (b) Based on the accounting policy of the company, closing stock of finished goods is valued after considering the following:
   (i) Fixed cost is allocated based on actual production of the financial year 2010-11 adjusted to the average production of the last five years.
   As per the querist, the company relied on paragraph 9 of Accounting Standard (AS) 2, 'Valuation of Inventories' in support of the above action, which, inter alia, states that, "The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance."
   The querist has stated that since 01-01-2006, the mining activities of the company were stopped and hence, the production facilities of the pellet plant are wholly dependent on iron ore bought from external sources. It is, therefore, felt that under the circumstances, the average production during past 5 years considered as normal capacity for allocation of fixed overheads, is in accordance with AS 2.
   (ii) Expenses such as general expenses,

welfare expenses, interest, advertisement and publicity, opportunity costs of loans and other income (interest recovered from employees on their loans), etc. are considered for valuation.

The querist has provided the details of above expenses as follows:

a. General expenses: Expenses like printing and stationary, books and periodicals, conveyance, training, legal, consultancy, courier, freight and other office expenses are classified under general expenses. As per the querist, the purpose of these expenses is day-to-day operations of plant and these are directly and indirectly related to production of finished goods.

b. Tender notice advertisement expenses: Advertisement expenses for tender notification are incurred for publishing notices in newspaper for hiring various services and procurement of material, stores and spares for production of finished goods.

c. Other income (interest recovered from employees on their loans): Loans and advances are given to employees of the production unit as per the policy of the company for acquiring house, purchase of vehicle (car/two wheeler) and computers/laptops. Interest recovered from employees on the outstanding balance of respective loan amount are shown as 'other income' in the books. As per the querist, employees are main resources of the company for running the plant to produce goods. Advances given for acquiring assets as stated above are for betterment of employees to get best results. Normal opportunity cost of such advances is, therefore, considered for valuation of closing stock of finished goods.

As per the querist, the company relied on paragraph 11 of AS 2 in support of the above action, which is reproduced as follows:

> "11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of the inventories."

3. The querist has further stated that all the expenses and other income related to the pellet plant unit only have been considered for the valuation of inventories (i.e., pellet). Such costs and other income are accumulated separately and are entirely connected to and arising from the production activity of the unit. In view of this, according to the querist, the valuation of finished goods is as per AS 2.

4. Comptroller and Auditor General (C&AG) during the review of accounts for the year 2010-11 expressed that management should reassess the 'normal capacity' after taking into account the budgeted production plan targets and should value the stock in accordance with AS 2 from the year 2011-12 onwards. Further, management should exclude the cost, viz., general expenses, welfare expenses, tender, advertisement & publicity, etc. and other income in respect of particular unit which do not contribute to bringing the inventories to their present location for the purpose of valuation of inventories. The querist has stated that in view of C&AG's observation, the opinion of the Expert Advisory Committee is being sought.

B. Query

5. Based on the above background, the querist has sought the opinion of the Expert Advisory Committee regarding valuation of closing stock of finished goods as to:

   (a) Whether the average production for the last five years is to be reckoned as normal production or the budgeted production for the year under review is to be taken as normal production for the purpose of valuation of inventory.

   (b) Whether the expenditure on staff welfare, i.e., expenditure on township maintenance, health centre, etc. which are being maintained exclusively for the employees of that unit, general expenses, tender notice advertisement expenses and other income (interest recovered from employees on their loans) are to be considered for the purpose of valuation of inventory.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to the basis to be used for determining the normal capacity of production for the purpose of allocation of fixed overheads to cost of inventories and also to determine the propriety of inclusion of various costs, viz., staff welfare expenses, general expenses, tender notice advertisement expenses, opportunity costs of loans and advances given to employees of production unit in the cost of inventories. Accordingly, the Committee has examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, accounting policy followed for valuation of inventories in general, allocation of fixed production overheads in case of idle capacity of plant, accounting for impairment of plant facilities, if any, etc. At the outset, the Committee notes that while giving the details of 'other income', the querist has indicated that the opportunity cost of loans and advances has been included in the cost of the inventories. Accordingly, while expressing its opinion, the Committee has dealt with both, interest income recovered from employees on the loans and advances given as well as opportunity cost of such loans and advances.

7. The Committee notes paragraph 9 of AS 2, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules'), which is reproduced as below:

> "9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production *expected to be achieved* on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities." (Emphasis supplied by the Committee).

From the above, the Committee is of the view that the normal capacity is the production *expected to be achieved* on an average *over a number of periods under normal circumstances*, taking into account the loss of capacity resulting from planned maintenance. In other words, it is the normal level of production that will be achieved over a number of periods after considering the planned maintenance and other normal wastages in the utilisation of the facilities. Thus, the normal capacity should also take into account the normal idle capacity. However, the idle capacity due to abnormal reasons, such as, short supply of raw material, etc. should not be considered for determining normal capacity. The Committee is of the view that normal capacity may be determined at the average of production of last 5 years *provided* it approximates the production expected to be achieved in the future periods also. However, if there are significant changes in circumstances, then such an estimation would not be appropriate. In such a situation, budgeted production should also be considered for determining normal capacity. Thus, an enterprise should consider under the facts and circumstances of its case as to what can be considered as the normal capacity of production keeping in view various factors.

8. With regard to propriety of inclusion of various items in the determination of cost of inventories, the Committee notes paragraphs 6, 7, 11 and 13 of AS 2, notified under the Rules, which provide as follows:

"Cost of Inventories

6. 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.

Costs of Purchase

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. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

"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:

(a) abnormal amounts of wasted materials, labour, or other production costs;
(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;
(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
(d) selling and distribution costs."

9. From the above, the Committee notes that the cost of inventory includes cost of purchase (which comprises purchase price as well as other expenditure directly attributable to the acquisition), and such other costs that are incurred in bringing the inventories to their present location and condition. The Committee is of the view that the test for determining whether or not the cost of carrying out a particular activity should be included in the cost of inventories is whether that particular activity contributes to bringing the inventory to their present location and condition or not. Also, the Committee notes that administrative overheads which do not contribute to bringing the inventories to their present location and condition are not included in the cost of inventories and are expensed when incurred. The Committee is of the view that overheads that are incurred to administer the factory in relation to production activities are factory or production overheads which contribute to bringing the inventories to their present location and condition and not administrative overheads. Accordingly, the Committee is of the view that such costs should be included in the cost of inventories.

10. In order to determine the propriety of inclusion of various costs, viz., staff welfare expenses, general expenses, tender notice advertisement expenses, opportunity costs on loans and advances given to employees in the cost of inventories and interest income arising therefrom, the Committee discusses each of these elements as follows:
    (a) *Staff welfare expenses and general expenses:* The Committee is of the view that staff welfare expenses on township maintenance and health centres are of the nature of employees' compensation costs. Accordingly, to the extent these are used by the employees of factory/production unit who render their services in relation to production activities, these should be considered for inclusion in the cost of inventories. Further, general expenses, if these are of the nature of factory or production overheads, as discussed in paragraph 9 above, these should be considered for inclusion in the cost of inventories.
    (b) *Tender notice advertisement expenses:* The Committee is of the view that these expenses are incurred for exploring the possible suppliers of materials and services and accordingly, cannot be considered as the cost of purchase of inventories or other costs that are directly attributable to the acquisition. In the view of the Committee, cost of inventories include cost 'of' purchase and not costs incurred prior to purchase and, accordingly, such expenses should not be included in the cost of inventories.
    (c) *Opportunity Costs of loans and advances given to employees:* The Committee is of the view that opportunity costs are imputed costs, which are not used as a basis for measuring the cost and, therefore, these cannot be included in the cost of inventories. As regards interest income recovered from the employees, the Committee is of the view that these are part of 'other income' and, therefore, should not be adjusted in the cost of inventories.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 5 above:
    (i) The normal capacity may be determined at the average of production of last 5 years *provided* it approximates the production expected to be achieved in the future periods also. However, if there are significant changes in circumstances, then such an estimation would not be appropriate. In such a situation, budgeted production should also be considered for determining normal capacity, as discussed in paragraph 7 above.
    (ii) The staff welfare expenditure, i.e., expenditure on township maintenance and health centre, to the extent these are used by the employees of factory/production unit who render their services in relation to production activities, should be considered for inclusion in the cost of inventories. General expenses may be considered for the purpose of valuation of inventory only if these are incurred in bringing the inventories to their present location and condition, as discussed in paragraphs 9 and 10 above. Tender notice advertisement expenses cannot be included in the cost of inventories, as discussed in paragraph 10(b) above. As regards interest income recovered from the employees, the Committee is of the view that these are part of 'other income' and, therefore, should not be adjusted in the cost of inventories.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on 26.04.2012. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty volumes. A CD of Compendium of Opinions containing thirty volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.org.

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