

Treatment of Disputed Elements of Cost in Valuation of Inventory of Raw Material

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 company (hereinafter referred to as 'A Refinery Ltd.' or 'A Ltd. '), a Government of India undertaking, is engaged in refining of crude oil having a refining capacity of 3 MMTPA. A Ltd. is jointly-owned by other public sector undertakings and a State Government (SG). It is engaged in production of petroleum products, i.e., high speed diesel, motor spirit, aviation turbine fuel, superior kerosene oil, liquefied petroleum gas, naphtha, sulphur, raw petroleum coke and calcined petroleum coke. The refinery is the fourth refinery in the State.
2. A Ltd. has stated that it shares transportation cost on crude with X Refinery and Petrochemicals Limited (hereinafter referred to as 'X Refinery Ltd.' or 'X Ltd. ') and certain elements of this transportation cost are disputed. The company has accounted for these disputed elements as a part of its raw material cost and considers the same also for closing inventory valuation. There is a difference of opinion on the present accounting treatment as to whether such disputed elements should be considered for inventory valuation or not.
3. There are four refineries located in the North East (NE) having an overall refining capacity of 7 MMTPA as detailed below:

Refinery	Company	Refinery Capacity
B Refinery	Z Ltd.	0.65 MMT per annum
C Refinery	Z Ltd.	1.00 MMT per annum
X Refinery	Z Ltd.	2.35 MMT per annum
A Refinery	A Refinery Ltd.	3.00 MMT per annum

Against crude oil refining capacity of 7 MMTPA, crude oil availability in the State is only around 4.50 MMTPA which is delivered to the four NE Refineries from the crude oil fields owned by Z Ltd./D Ltd. in the State. In view of low availability of State crude at 4.50 MMTPA, the overall refining capacity of the North East is not fully utilised and, therefore, with a view of optimising the refining capacity in the North East, the Ministry of Petroleum & Natural Gas (hereinafter referred to as MOP&NG or 'the Ministry') allocated 1.5 MMTPA of Ravva PSC crude effective from 1st

April, 2003 to X Refinery Ltd. MOP&NG vide letter reference no. P-20029/67/02 – PP dated 18th February, 2003 stated that consequent upon the allocation of 1.5 MMTPA of Ravva PSC crude oil to X Refinery Ltd., the total crude oil availability for the North East refineries for the financial year 2003-04 would go up by 1.5 MMTPA over and above the State crude oil quantity. This additional 1.5 MMTPA Ravva crude along with the State crude would be re-apportioned among the four North East refineries in proportion to their installed capacities and in case of X Refinery Ltd., quantity re-apportioned above would comprise 1.5 MMTPA of Ravva crude oil and the balance quantity would be made up by the State crude oil. It was also decided that the additional transportation cost of Ravva crude over the State crude would be shared by all the North East refineries in the proportion in which crude availability to the North East refineries is individually augmented on account of the enhanced reallocation.

4. Thus, crude oil transported in two sectors is as follows:
 - a) Haldia to Barauni through pipeline owned by Z Ltd.
 - b) Barauni to X Refinery through pipeline owned by another company, E Limited.

As per MOP&NG instructions, the additional transportation cost of Ravva crude over the State crude would be shared by all the North East refineries in the proportion in which crude availability to the North East refineries is individually augmented. This additional transportation cost is to be shared by the 4 NE Refineries, as transportation cost of Ravva crude is higher than the transportation cost of the State crude which is available locally and X Refinery Ltd. is foregoing its share of the State crude to the other 3 NE Refineries as it processes both Ravva crude (1.50 MTPA) and balance State crude.

5. The querist has further stated that X Refinery Ltd. is debiting the additional transportation cost incurred for Ravva crude to the other three NE Refineries on a year-to-year basis from the financial year 2003-

04 on the quantity of augmented crude received by each refinery. Transportation cost consists of elements like service tax, entry tax, terminalling charges, marine insurance, agency fee, etc. As the MOP&NG instructions did not indicate the elements of additional transportation cost, the same was discussed with X Refinery Ltd. and certain elements were agreed to between the two main parties i.e., X Refinery Ltd. and A Refinery Ltd. Although A Refinery Ltd. is not agreeable to some of the elements of this additional transportation cost debited by X Refinery Ltd., provisions are being made in the books of account based on the debits raised by X Refinery Ltd.; however, payments have been released only for the agreed items. The elements of additional transportation cost agreed and not agreed to by A Refinery Ltd. are as under:

6. Elements of additional transportation cost agreed to by A Refinery Ltd. for which payments are regularly made to X Refinery Ltd.:
 - (a) Ocean freight, bunker charges, insurance up to port and other import-related costs,
 - (b) Pipeline freight for movement from port to X Refinery Ltd.,
 - (c) Pipeline consumption and ocean loss,
 - (d) Entry tax payable on the additional transportation cost on entry of Ravva crude into the State.
 7. However, some elements of additional transportation cost debited by X Refinery Ltd. have not been agreed to by A Refinery Ltd. and the same are currently under dispute as detailed below:
 - (a) The State Freight Savings adjustment—All the four NE refineries have to pay crude oil pipeline transportation cost to Z Ltd./D Ltd. on the State crude oil received at each refinery. As the other three NE refineries are receiving higher quantity of the State crude through this exercise, they have already incurred the State crude transportation cost and this cost should be reduced from the additional transportation cost of Ravva augmented crude to be borne by each refinery. The calculation methodology of this State freight savings is under dispute.
 - (b) Entry Tax element—Further, on account of the difference in opinion of the State freight savings, A Refinery Ltd. is also settling the entry tax on a lower net transportation cost.
 - (c) Other issues—Disputes are also towards
- quantity of loss on elements such as ocean loss, pipeline loss incurred on Ravva crude transportation.
8. The differential on account of the above differences, i.e., difference in opinion on the State Freight Savings cost and the entry tax on the same, and high element of ocean and transportation loss on Ravva crude movement through ship and pipeline, is accounted for as a liability in A Refinery Ltd.'s books of account and debited to raw material cost, i.e., part of the crude cost, though no payment is being made to X Refinery Ltd. for these differentials. Further, as these items are being accounted for as a part of the raw material cost, the same are also considered for the purpose of closing inventory valuation. Though the amount is disputed, negotiations are going on against the disputed elements.
 9. A Refinery Ltd. is considering all the elements as part of inventory cost in line with paragraph 6 of Accounting Standard (AS) 2, 'Valuation of Inventories', which states, ***"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."***
 10. A Refinery Ltd. has included the disputed amount of Ravva crude transportation cost as a part of crude oil cost and the closing inventory valuation of crude oil and provision for the same has been made in the books of account following a conservative approach. The querist has separately clarified that the disputed amount has been provided for as a liability and disclosed in its balance sheet under 'sundry creditors' and not as a provision.
 11. A Refinery Ltd.'s auditors, during the audit for the financial year 2011-12, have raised an objection for inclusion of disputed amount of Ravva crude transportation cost in crude inventory valuation. In the opinion of the auditors, as per AS 2, no abnormal (disputed) amount should be considered for valuation of closing stock. Thus, inclusion of disputed amount of liability has resulted in inflation of closing stock with corresponding overstatement of profit.
 12. A Refinery Ltd. is of the view that amount that is disputed by it is not an abnormal item but a difference in calculating the net amount (rate) payable on account of Ravva crude transportation. Again, as per paragraph 13 of AS 2, following

costs are to be excluded:

- “(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.”

(Emphasis supplied by the querist.)

As disputed amounts are not abnormal items and the disputes are purely commercial in nature, A Refinery Ltd. has been considering the same as part of inventory cost.

B. Query

13. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee as to whether the procedure followed by A Refinery Ltd. for valuation of inventory with inclusion of disputed items of additional transportation cost for which no agreement has yet been reached between two parties as a part of cost of crude oil is correct or not.

C. Points considered by the Committee

14. The Committee notes that the basic issue raised in the query relates to the inclusion of additional transportation cost which is under dispute in the aggregate cost of inventory. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the facts of the case, such as, appropriateness of inclusion of various components of the additional transportation costs in the cost of inventories, appropriateness of creation of liability/provision in respect of transportation cost which is under dispute, etc. Further, the opinion expressed hereinafter is purely on the accounting issue raised in the query and not on the legal issues involved.
15. The Committee notes from the facts of the case that A Ltd. has recognised transportation cost which is under dispute in the cost of inventories and, therefore, the Committee has presumed from the facts of the case that these are the costs necessary for bringing the inventories to their present location and condition. Accordingly, the issue that arises is that only because these are ‘disputed’, whether these should be considered as ‘abnormal’ and excluded from the cost of inventories, as contemplated under paragraph 13 of AS 2, as follows:

“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;
- ...”

(Emphasis supplied by the Committee.)

The Committee is of the view from the above that costs that are excluded from the cost of inventories are abnormal wasted materials, labour or other production costs, etc. The Committee is of the view that just because a cost is under dispute does not make it wasted materials, labour, or other production cost and, therefore, it cannot be considered as an abnormal cost.

D. Opinion

16. On the basis of the above, and subject to the presumptions stated in paragraph 15 above, the Committee is of the view that the procedure followed by ‘A’ Refinery Ltd. for valuation of inventory with inclusion of additional transportation cost which is under dispute as a part of cost of crude oil is correct.

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 May 21-22, 2013. 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.in