Opinion

(i)Accounting Treatment of Base Stock; and (ii) Valuation of Inventory Booked by the Customers.

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 is engaged in manufacturing of contract material made of silver and silver alloy for low voltage electrical switchgear industry. Silver is a basic raw-material and silver content in parts/components generally varies from 70% to 100%.
2. The querist has stated that two processes are involved for the manufacturing:
   (i) *Melting:* Silver is melted with copper or nickel or cadmium, casted in the form of billet or plate. In case of billet, it is hot extruded in required shape, strip or wire and components are punched/headed. In case of plate, first all 6 sides machined, thereafter hot rolled, annealed and cold rolled in required thickness and thereafter components are punched.
   (ii) *Powder Metallurgy:* Silver powder is made by atomisation, chemical reduction or by cementation. Subsequently, powder is mixed with the tungsten, nickel, cadmium oxide or tin oxide in required ratio as per the requirement. The billet is pressed, sintered, extruded in the form of strip or wire and subsequently, components are punched or formed as per requirement.
3. There are 20 to 30 operations to make components of silver or silver alloy right from melting to finished product and at every stage, silver scrap is generated which goes into recycling. In the whole process of manufacturing, out of average 4 kg silver, the company gets 1 kg finished product and balance 3 kg silver goes back into refining. According to the querist, on an average, the company has 7500 kg of silver in stock. Out of this, 3500 kg silver always remains on the shop floor; it is fixed stock remaining on the shop floor at all the time and cannot be reduced; it remains as a permanent inventory.
4. The querist has stated that silver price is fluctuating and hence, few customers of the company book silver in advance, which is the principal raw material for the finished goods at an agreed price and whenever the product is ready, the company bills such customer based on the silver price booked by them *plus* other material and manufacturing costs.
5. Accounting policy for inventory valuation of the company is as under:
   "Consumable tools, raw material, packing material, work in progress, finished goods and stores & spares have been valued at lower of cost and net realisable value. Cost of finished goods and work-in-progress has been ascertained at estimated cost. Cost of raw material has been ascertained on weighted average cost basis. Cost of other inventories has been ascertained on First-In-First-Out method (FIFO). Silver booked by customers for their process work has been valued at the rates at which the same is booked by them. Scrap is valued at Net Realisable Value."
6. The querist has further stated that at present, the company is valuing at cost or net realisable value (NRV) whichever is lower. Further, in case of silver booked by customer, the company is valuing inventory at booked price of silver by customer. At present, the company has identified four stages of production and estimated related cost at each stage for the purpose of valuation is as under:
   Stage (i) – ₹100/-
   Stage (ii) – ₹400/-
   Stage (iii) – ₹900/-
   Stage (iv) – ₹1200/-
7. The querist has separately clarified that the company gets an order from customer, for example, silver quantity 220 kgs for supply

of electric contacts over a period of time and customer fixes the silver price prevailing on the same day on London Metal Exchange (LME) basis, for example, say at ₹41,000 per kg, and pay money in a day or two for that much of quantity of silver; in this example, 220 kgs * ₹41,000 = ₹90.20 lacs. The company buys silver within a day or two depending upon the availability of silver in the market and the company has to buy a lot, may be 300 kg or may be 500 kg, on that day's LME price basis, for example, say at ₹40,000 per kg or at ₹42,000 per kg. Thus, the company's purchase price may vary because of fluctuation in market but for all purposes, the customer's price is fixed and the company supplies the electric contacts to the customer over a period of time at the same price.

8. As the principal raw material of the company is silver, hence at various stages, silver is being consumed and the valuation is done based on the cost of silver or net realisable value (NRV) whichever is lower plus the related cost attached to that stage for cases where silver is not booked in advance. In case, where silver is booked in advance, valuation is done at booked price of silver plus the related cost attached to that stage.
9. According to the querist, there is a wide fluctuation in the silver price which impacts the valuation heavily. The management is of the view that due to fluctuation of silver price, ranging between ₹5,000/- per kg to ₹10,000/- per kg, the business performance is never reflected properly and is heavily influenced by this fluctuation in silver price. Further, it affects the balance sheet every quarter sometimes positive and sometimes negative and it is not a true reflection of our business. The shareholder of the company considers the company as a commodity company whereas in reality, the company is precious engineering company engaged in manufacturing of high technology critical components for Original Equipment Manufacturers (OEMs).

B. Query

10. In view of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
    (i) Whether silver booked by the customer for their process work can be valued at the rate at which the same is booked by them.
    (ii) Whether the company should value raw material, i.e., base stock of 3500 kg of silver at cost which will remain unchanged instead of present valuation of lower of cost and net realisable value.

    or

    Whether 3500 kg of silver which normally remains in cycle of production can be considered as part of plant and machinery and capitalised instead of present valuation of lower of cost and net realisable value.

C. Points considered by the Committee

11. The Committee notes that the basic issues raised in the query relate to valuation of silver (main raw material of the finished product) booked by the customers; and accounting treatment of base stock of 3500 kg of silver as inventory or a part of plant and machinery and its valuation. The Committee has, therefore, examined only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, valuation of other items of inventory and propriety of accounting policy in respect thereof, such as, scrap, consumable tools, packing material, etc., correctness of determination of costs of processing/conversion at various stages, accounting for the forward contracts for advance booking of the silver by the customers, etc. The Committee presumes from the Facts of the Case that the stock of silver booked by the customers is not held by the company on behalf of its customers.
12. For the sake of convenience, at first, the Committee deals with the second issue relating to the treatment of base stock as inventory or a part of plant and machinery. In this regard, the Committee notes the definition of the term 'inventories' as given in Accounting Standard (AS) 2, 'Valuation of Inventories', and the definition of the term 'property, plant and equipment' as given in Accounting Standard (AS)

10 (Revised), 'Property, Plant and Equipment', notified by the Ministry of Corporate Affairs vide Notification dated 30th March, 2016, which are reproduced below:

AS 2

"3.1 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."

AS 10 (Revised)

"Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months."

13. From the above, the Committee notes that the classification of an asset as a 'property, plant and equipment' or inventory depends on its intended primary use for an entity. If an asset is essentially held for using it for the purpose of producing or providing goods or services rather than for sale in the normal course of business, it is classified as 'property, plant and equipment'. However, if it is held for sale in the ordinary course of business, or if it is used in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services, the asset should be classified as inventory. The Committee notes from the Facts of the Case that although the base stock of silver of 3500 kg may be essential at all times for uninterrupted production, however, the stock is intended to be used in the process of production for sale of finished goods. Moreover, although the quantity of silver stock may be fixed or constant at all times, the composition of such stock would keep on changing as there would be inflow of new silver stock purchased and outflow of silver issued for further processing. Further, the fixed quantity of stock is not maintained due to any technological requirement of any plant and machinery; rather seems to be due to administrative convenience so that the inventory of silver is always available for use in production process. Accordingly, the Committee is of the view that the base stock of silver is an inventory as per AS 2 and cannot be considered and recognised as a 'property, plant and equipment'. Therefore, the same should be valued at cost or net realisable value, whichever is lower, as per the requirements of paragraphs 5 and 24 of AS 2 (reproduced in paragraph 14 below).

14. With regard to the valuation of inventory of silver booked by the customers in advance, the Committee notes that silver is a basic raw material in the extant case. Further, the Committee notes the following paragraphs of AS 2:

"3.2 Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale."

"5. Inventories should be valued at the lower of cost and net realisable value."

"22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices…

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."

From the above-reproduced paragraph 24 of AS 2, the Committee notes that the materials held for use in the production process should normally be valued at cost unless (i) there has been a decline in the price of materials, and (ii) it is estimated that the cost of the finished product will exceed its net realisable value. If these two conditions are fulfilled, then the materials held should be valued at net realisable value.

15. The Committee notes that in the extant case, valuation of the silver booked by the customers in advance is done at booked price of silver plus the related cost attached to that stage. From this, it appears that such stock of silver is being valued at a value which is different from the cost as the prices at which the silver is booked by the customer would generally be different from the prices at which the same is purchased by the company. Thus, the Committee is of the view that the aforementioned principle of valuation of materials held for use in the production process, as discussed in paragraph 14 above is not being followed by the company and accordingly, the same is not appropriate and in accordance with the requirements of AS 2. In this regard, the Committee wishes to point out that the value at which the stock of silver is booked by the customer would be relevant only for determination of net realisable value of the silver or its finished product. Further, the net realisable value would be considered for the purposes of valuation of the inventory only when there has been a decline in the price of silver, and it is estimated that the cost of the finished product will exceed its net realisable value, as discussed in paragraph 14 above.

D. Opinion

16. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:
    (i) No, the silver booked by the customer for their process work should not be valued at the rate at which the same is booked by them, as discussed in paragraphs 14 and 15 above.
    (ii) The base stock of silver is an inventory as per AS 2 and cannot be considered and recognised as a 'property, plant and equipment' and therefore, the same should be valued at cost or net realisable value, whichever is lower, as per the requirements of paragraphs 5 and 24 of AS 2, as discussed in paragraph 13 above.

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 December 20, 2016. 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 five volumes. A CD of Compendium of Opinions containing thirty five 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