INVENTORY

1. Definition : it means

- the assets in the form of materialor supplies to be consumed in production
- the assets in the process of production
- the assets held for sale in the ordinary course of business

2. Cost of inventory :

Cost of purchase	xxx	
Less: trade discount		(xxx)
Add: taxes	xxx	
Add: cost of transportation		xxx
		xxx
Add: cost of conversion	xxx	
(in case of manufacturing unit)		

3. Need For Inventory valuation

(i) To determine True performance (P/L)
(ii) To determine True position (B/S)

4. Exclusion from cost of Inventory

a) Abnormal loss
b) Storage cost
c) Administrative overhead
d) Selling and distribution cost

5. System of inventory valuation :

- Periodic inventory system :- this is the method where inventory (closing stock) is determined by actual physical count

  Hense**COGS** is calculated as residual figure (which include lost goods also)

  COGS = OPENING STOCK+PURCHASE-CLOSING STOCK
- Perpetual inventory system :- this is the method where inventory is determined after each receipt and issue (As per books of accounts)

  Hence closing inventory is calculated as residual figure (which includes lost goods also)

  CLOSING STOCK = OPENING STOCK+PURCHASE-COGS

6. Methods of Inventory valuation :

1) Specific identification method
2) Historical cost method
3) Non Historical cost method

1) Specific identification method :

- As per AS-2, this method should be used for inventory which are not interchangeable
- It means when the goods are bought/manufacture for specific purpose/customers

  All the concerned cost charged to those project or customers

2) Historical cost method :

a) FIFO METHOD
b) LIFO METHOD

c) AVERAGE PRICE METHOD
d) WEIGHTED AVERAGE PRICE METHOD
e) BASE STOCK METHOD

a) FIFO METHOD :

- This method is based on assumption that the inventory which are receive first are issued first
- The cost of material issue (COGS) represents the cost of earlier purchase
- The cost of closing stock represents the cost of latest (last) purchase

Result (implication)

i. Inflationary condition (rising price)
   - **COGS :** lower, since it represents the old stock (lower cost) have been sold
   - **CLOSING STOCK :** higher, since it represents the latest stock (higher cost) remained unsold
   - **HIGHER INCOME :** since old cost (lower) matched with current revenue (selling price)

   Gross profit = sale price(current) –cogs (lower)

ii. Deflationary condition (falling price) :- opposite of rising price

iii. Widely accepted by income tax authorities, since income is higher so tax will be higher

b) LIFO METHOD :

- This method is based on assumption that, the goods which are received latest issue first
- The cost of material issue (cogs) represents the cost of latest purchase
- The cost of closing inventory represent the cost of earlier purchase

Result (implication)

i. Inflationary condition (rising price)
   - **COGS :** higher, since it represents the latest stock (higher cost)
   - **CLOSING STOCK :** lower, since it represents theearlier purchase (lower cost)
   - **GROSS PROFIT :** lower, since latest cost (higher) match with current revenue

ii. Deflationary condition :- opposite of rising price

c) WEIGHTED AVERAGE METHOD :

- This method is based on assumption that, each issue of goods consist a due proportion of earlier lots
- It use the weighted averages price for issuing, until new stock purchased

$$\textbf{WEIGHTED AVERAGE PRICE} = \frac{\textbf{TOTAL COST OF MATERIAL IN STOCK}}{\textbf{TOTAL QUANTITY IN STOCK}}$$

- Very useful method , when quantity of material purchased in each lot is not uniform
- This method average out the effect of price fluctuation.

d) SIMPLE AVERAGE PRICE METHOD :

- This is very simple approach of valuation
- In this method, all the different price are added together then divided by "number of prices"

$$\textbf{SIMPLE AVERAGE RATE (SAR)} = \frac{\textbf{SUM OFDIFFERENT PRICE}}{\textbf{NUMBER OF PRICES}}$$

- **CLOSING STOCK = CLOSING STOCK UNIT** X **SAR**

e) BASE STOCK METHOD :

- This method is based on assumption that, a minimum quantity of inventory (base stock) must be held all the times
- Inventory upto this stock is stated at cost at which base stock was acquired any excess inventory are dealt with on some other bases.
- Note: As per AS 2 only FIFO AND WAM ALLOWED.

3) NON HISTORICAL COST METHOD :

1. ADJUSTED SELLING PRICE METHOD
2. STANDARD COST METHOD
3. LATEST PUCHASE PRICE METHOD

1) ADJUSTED SELLING PRICE METHOD (RETAIL INVENTORY METOD)

- Mainly used in retail business
- The cost of inventory is determined by reducing the estimate % of gross margin from sale value of inventory

COST OF INVENTORY = SALE VALUE(LESS) GROSS PROFIT

2) STANDARD COST METHOD :

- In this method, a predetermined (standard) cost is set and used as basis for "pricing the material issued".

Some other points:

(i) If closing stock is overstated, the COGS will decrease but profit will increase
(ii) If closing stock is understated, the COGS will increase but profit decrease
(iii) Cost of goods lying with other, like sent of Approval/consignment, etc, will form part of closing stock.