SBS AND COMPANY LLP
CHARTERED ACCOUNTANTS

ICDS II – Valuation of Inventory

General Points on ICDS:

- ICDS was made applicable from FY 2016-17 (i.e. A.Y 2017-18) as per Notification S.O.892(E) dated 31.03.2015
- However, It is not for the purpose of maintenance of books of accounts.

Applicability:

- To those Assesses who are maintaining Books of Accounts under Mercantile system.
- Having Income under head Profits and Gains of Business or Profession and Income from Other Sources.

In the following cases ICDS is not applicable,

- To those Assesses who are maintaining Books of Accounts under Cash system (or)
- Individual or HUF who are not required to get their Books of Accounts audited u/s 44AB of the Act.

In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and the ICDS, the provisions of the Act shall prevail to that extent.

Non-Compliance

Non-Compliance with ICDS can be ground for an assessing officer to complete the Assessment under "Best Judgment Assessment" under Section 144.

Scope of ICDS-II:

This Income Computation and Disclosure Standard shall not be applied for valuation of inventories, in following cases:

- Work-in-progress arising under 'construction contract' including directly related service contract which is dealt with by the ICDS-III (Construction contracts).
- Work-in-progress which is dealt with by other ICDS.
- Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the ICDS-VIII (Securities).
- Inventories of livestock, agriculture and forest products, mineral oils, ores and gases to the extent that they are measured at **Net Realisable Value**.
- Machinery spares, which can be used only in connection with a tangible fixed asset and their use is expected to be irregular, shall be dealt with ICDS-V (Tangible Asset).

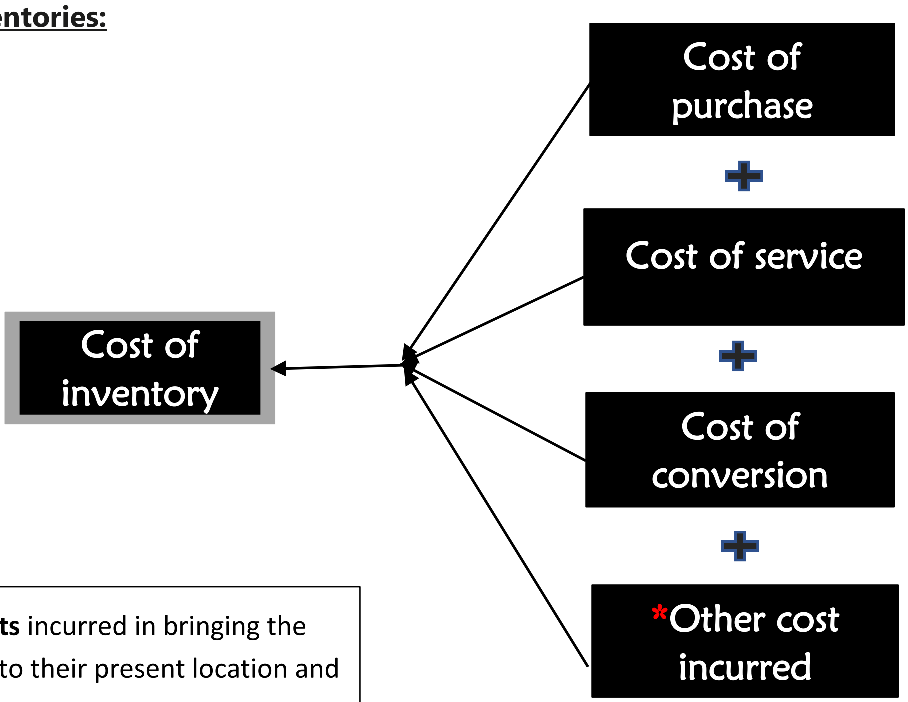
Definitions:

1. Inventories are assets:
   a. held for sale in the ordinary course of business;
   b. in the process of production for such sale;
   c. in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Measurement of Inventory:

- "Inventories shall be valued at cost, or net realisable value, whichever is lower".

Cost of Inventories:



***Other Costs** incurred in bringing the inventories to their present location and condition.

➢ Costs of Purchase:

- The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase.

Method	Description
Inclusive Method	Inclusive Method means a method for calculating the Income under Profit or Gain from Business or Profession by including duties and taxes (i.e. including recoverable)
Exclusive Method	Exclusive Method means a method for calculating the Income under Profit or Gain from Business or Profession by excluding duties and taxes (which are recoverable in nature).

Accordingly, if an exclusive method is followed for the purpose of valuation of inventory as per Accounting Standards, the tax payer would be required to prepare the memorandum account to demonstrate that vis a vis inclusive method, it is tax neutral. For a detailed understanding refer below Example.

Format for calculation of cost of purchases:

Particulars	Amount
Purchase price	xx
Add: Duties and Taxes (no exclusion of CENVAT)	xx
Add: Freight inward and other expenses directly attributable to acquisition	xx
Less: Trade discounts, rebates and similar items	xx
Cost of purchase	**xx**

Example:

M/S Varuchitwaja Associates has purchased 4 items of Rs.3,00,000/-(Exclusive of GST @ 5%) During the year. GST on purchase @ 5%. 3 are sold @ Rs.4,20,000/- per item. GST on sales @ 5%.

Exclusive Method: (as per AS/Ind AS)

P&L a/c for the Financial Year 20XX – 20XX

Particulars	Qty	Rate	Amount	Particulars	Qty	Rate	Amount
To Purchases	4	3,00,000	12,00,000	By Sales	3	4,20,000	12,60,000
				By Closing stock	1	3,00,000	3,00,000
To Profit a/c			3,60,000				
			15,60,000				**15,60,000**

Inclusive Method: (As per ICDS)

P&L a/c for the Financial Year 20XX – 20XX

Particulars	Qty	Rate	Amount	Particulars	Qty	Rate	Amount
To Purchases	4	3,15,000	12,60,000	By Sales	3	4,41,000	13,23,000
				By Closing stock	1	3,15,000	3,15,000
To GST Paid on sales			*63,000	By Input Tax utilised on COGS			*45,000
To Profit a/c			3,60,000				
			16,83,000				**16,83,000**

*Total Output Tax = 4,20,000 *3* 5% = 63,000
ITC of GST on COGS = 3,00,000 *3* 5% = 45,000

Instead of Revising whole Profit and Loss statement, we can prepare a simple memorandum account having particulars of Impact on Profit (i.e. Increase / Decrease).

Increase / Decrease in Profit as per ICDS (memorandum account):

S. No	Particulars	Increase in Profit	Decrease in Profit
1	Increase in Cost of Purchases	-	60,000
2	Increase in Sales	63,000	-
3	Increase in Value of Inventory	15,000	-
4	Tax paid on Sales	-	63,000
5	Input Tax utilised on COGS	45,000	-
	Total	**1,23,000**	**1,23,000**

➢ **Costs of Services:**

- The costs of services shall consist of labour and other costs of personnel directly engaged in providing the service *including* supervisory personnel and attributable overheads.

➢ **Costs of conversion:**

- The costs of conversion of inventories shall include costs directly related to the units of production and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.
  - ⇒ Fixed production overheads shall be those indirect costs of production that remain relatively constant regardless of the volume of production.
  - ⇒ Variable production overheads shall be those indirect costs of production that vary directly or nearly directly, with the volume of production.

Other Costs:

- Other costs shall be included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

- Interest and other borrowing costs shall not be included in the costs of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the Income Computation and Disclosure Standard on borrowing costs i.e ICDS-IX.

Exclusions from the cost of Inventories:

In determining the cost of inventories in accordance with above, the following costs shall be excluded and recognised as expenses of the period in which they are incurred, namely:-

- Abnormal amounts of wasted materials, labour, or other production costs;
- Storage costs, unless those costs are necessary in the production process prior to a further production stage.
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition. For eg: office rent, staff salaries, travelling expenses etc,.
- Selling costs. For eg: Sales commission, Packing charges ets,.

Formulas for cost of inventories –

Cost Formulae is used for allocation of cost to the units.

Specific identification of cost:

'Specific identification of cost' means specific costs are attributed to identified items of inventory

- that are not ordinarily interchangeable; and
- goods or services produced and segregated for specific projects

shall be assigned by specific identification of their individual costs.

"Judgement is required to decide whether the items of inventory are ordinarily interchangeable or not".

Eg: For Inventory of Arts and Sculptures, Medical pharmacy etc Specific identification of cost method is used.

Example:2

Date	Units purchased	Units sold	Balance
April 01	1000 units @ Rs.2		1000 units
April 12	3000 units @ Rs. 2.2		4000 units
April 17		2000 units	2000 units
April 30	1000 units @ 2.4		3000 units

The 3,000 units in the inventory on April 30 is composed of 500 units from purchases made on April 01, 1,500 units from purchases made on April 12 and 1,000 units from purchases made on April 30.

Cost of Inventory under Specific identification method will be:

Date	Units	Cost per unit	Total cost
April 01	500	Rs. 2.00	1,000
April 12	1500	Rs. 2.20	3,300
April 30	1000	Rs. 2.40	2,400
Total	**3000**		**6,700**

Cost of Inventory = 6,700

Cost of inventories, other than the inventory dealt with in above para, shall be assigned by using the First-in First-out (FIFO), or weighted average cost formula.

First-in First-out Formula:

- The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.

Example:3

Date	Units purchased	Units sold	Balance
April 01	1000 units @ Rs.2		1000 units
April 12	3000 units @ Rs. 2.2		4000 units
April 17		2000 units	2000 units
April 30	1000 units @ 2.4		3000 units

Cost of Inventory under FIFO method will be:

Date	Units	Cost per unit	Total cost
April 12	2000	Rs. 2.20	4,400
April 30	1000	Rs. 2.40	2,400
Total	**3000**		**6,800**

Cost of Inventory = 6,800

Weighted Average Cost Formula:

- Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average shall be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances.

Example:4

Date	Units purchased	Units sold	Balance
April 01	1000 units @ Rs.2		1000 units
April 12	3000 units @ Rs. 2.2		4000 units
April 17		2000 units	2000 units
April 30	1000 units @ 2.4		3000 units

Cost of Inventory under Weighted Average Cost method will be:

Date	Units	Weighted Avg cost per unit	Total cost
April 30	3000	#Rs. 2.23	6,700
Total	**3000**		**6,700**

Cost of Inventory = 6,700

$\frac{2000*2.15(+)1000*2.4}{3000}$ = Rs. 2.23

$\frac{1000*2(+)3000*2.2}{4000}$ = Rs. 2.15

The formula used shall reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Techniques for the measurement of the cost of inventories, such as;

- Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of the current conditions.

- The retail method can be used in the retail trade for measuring inventories of large number of rapidly changing items that have similar margins and for which it is impractical to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory, the appropriate percentage gross margin. The percentage used takes into consideration inventory, which has been marked down to below its original selling price.

Net Realisable Value (NRV):

NRV mean's an estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Eg: An Entity have purchased 1000 items of a products @ Rs. 4 and at the end of the year 50 items where left and the market value (estimated price) for the same is Rs. 5 and Packing charges will incur to make the sale is Rs. 1.5 per product.

Cost of Inventory will be:
Lower of Cost and Net Realisable value i.e.
Cost = 50 * Rs. 4 = Rs. 200
NRV = (50 * Rs. 5) – (50 * Rs. 1.5) = Rs. 175
Therefore, Cost of Inventory is Rs. 175.

- Net realisable value shall be based on the most reliable evidence available at the time of valuation. The estimates of net realisable value shall also take into consideration the purpose for which the inventory is held. The estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.

Value of opening inventory:

The value of the inventory as on the beginning of the previous year shall be:

- the cost of inventory available, if any, on the day of the commencement of the business when the business has commenced during the previous year; and
- the value of the inventory as on the close of the immediately preceding previous year, in any other case.

Change of Method of Valuation of Inventory

"The method of valuation of inventories once adopted by a person in any previous year shall not be changed without reasonable cause"

Disclosure requirements

- The accounting policy adopted in measuring inventories including cost formulae used;
- Total carrying amount of inventories and its appropriate classification; and
- Where Standard Costing has been used as a measurement of cost, details of such inventories and a confirmation of the fact that standard cost approximates the actual cost.

Comparison Between ICDS 2, AS-2 and Ind AS-2

Particulars	As per ICDS 2	As per AS-2	As per Ind AS 2
Cost of services	Included in cost of inventories	No specific mention in AS-2	No Specific mention in Ind AS 2
Exclusive vs inclusive method of accounting	Value of inventories to include all taxes and duties, whether recoverable in future or not.	Value of inventories to exclude duties and taxes recoverable in the future	-
Other costs includible in the value of inventories	ICDS 2 does not specifically exclude distribution cost in the value of inventories	AS-2 excludes distribution costs in the value of inventories	Ind AS similar in this respect.
Value of Inventory at the beginning of the previous year	New business -Cost at the day of commencement of business Continuing business –value of closing inventory at the end of preceding previous year.	There is no such specific provision	-
Valuation of Inventory – Interest and other borrowing costs	Interest and other borrowing charges shall be inventoried as per ICDS –9	Usually, not covered in AS-2	Usually, not covered in Ind AS-2
Valuation of inventories in certain case of dissolution	Notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.	No such provision	Notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.