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VIRTUAL COACHING CLASSES
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FOUNDATION LEVEL
PAPER 1: PRINCIPLES AND PRATICE OF ACCOUNTING

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CHAPTER 4- Inventories

- Inventory refers to the stock held in the business for the purpose of sale and earning revenue.
- Based on the type of industry we will be having the classification of the inventory or stock.
- In case of **manufacturing industry**- we have to purchase the raw materials and conduct the process of manufacture so as to make them into finished products which have marketable value in the market. Such type of raw materials, finished goods and also semi finished goods are all included in the part of inventories.
- In order to package the finished products, the packaging materials and the other consumables are also treated as a part of the inventory.
- Any maintenance supplies to repair the machinery so as to ensure continuous production are also a part of the inventory of a business.
- In case of trading concern, the traded goods are considered as inventory.
- In case of service industry, the services to be rendered are termed as inventory.

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- What is not inventory?
  - Service equipment
  - Stand by equipment in case of damage to the original machinery
  - Machinery spares specific to a particular machinery.
- Since inventory is an asset which is major for any concern, it is important for the right valuation of the inventories for the following reasons-
  - Correct determination of income
  - Ascertainment of financial positions
  - Liquidity analysis
  - Statutory compliance.
- **Inventory valuation-** The inventory shall be valued at the **cost** or **net realizable value (NRV)** whichever is **less**

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- Cost includes- cost of purchase, any taxes (non refundable), freight inwards and any other expenditure which is directly attributable to bringing the inventories into the present location of business. **Cost of conversion** includes the cost incurred for conversion of raw materials into finished goods. **Other costs-** Any other costs that is incurred for making inventory available at the place of business shall be included as a part of the cost.

- **Cost does not include**
  - the interest or other borrowing costs
  - Abnormal losses
  - Selling and distribution costs
  - Storage costs- unless required as a part of production.
  - Administrative OH not forming part of the production process

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- **Net Realizable value= Sale value- Expenses incurred in relation to complete the sale**. (finished goods). In case of the raw materials- NRV is the replacement cost.
- Inventory record systems- The system under which the business maintains his inventory records is termed as inventory record systems- There can be 2 types of Inventory recording systems
  - PERIODIC INVENTORY SYSTEM
  - PERPETUAL INVENTORY SYSTEM
- ***Periodic Inventory system-*** This is generally maintained by small scale business, where in the inventory is physically calculated at certain intervals of time to ascertain the stock in hand.
- Generally the physical count is taken on a particular date at the end of the year (31^{st} March each year) and based on the closing stock count – they arrive at the cost of the Goods sold.
- ***Opening stock (known)+ Purchases(Known)- Closing stock (physical count)= Cost of Goods sold***
- Any pilferage or loss of stock is known only on the counting of the stock and inventory control under this system is difficult

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- ***Perpetual Inventory system-*** This is generally maintained by large scale business, where in the inventory is managed through software which records the receipts and issues then and there after each receipt and issue.
- This method has a better inventory control and is more expensive than the regular method
- Generally the physical count is not undertaken under this method
- ***Opening stock (known)+ Purchases(Known)- Cost of Goods sold (known)= Closing stock (balancing figure)***

  - For the differences between Perpetual and periodic Inventory system- refer to Page 4.6 in the module 1. After the explanation in the class – for the points- refer to the table- important from exam point of view- 5 marks (Nov 19)

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- ***Valuation methods for ascertaining the cost of the inventories can be of 2 types-***
  - **Historical methods-** this can be further classified into two major categories- inveories which are inter-changeable and those which are not inter- changeable
  - **Non historical methods-** This method consists of only one valuation method of cost through **Adjusted selling price**
- **HISTORICAL METHOD**
  - **Inventory – not interchangeable-** Specific Identification method- For ex- bottle and marker both of them are different products and the cost valuation will be different in each case, which will be based on the specific identification method (*this is only for the purpose of theory- not questioned in exam)*
  - **Inventory – which is interchangeable-** In such case- we have the following methods- FIFO (First in First out), LIFO (Last in First out), Simple average and weighted average method.

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- ***Types of questions which will come from exam point of view***
  - **Adjusted selling price-** to arrive at the Cost of the inventories where the selling price and various other adjustments will be given to us. (Illustration 5, 6 and 7)
  - Arriving at the **value of inventory as on the closing date** where the physical counting has taken place either 1 week before or 1 week after the closing the books.
  - **Least expected**- is valuation of the stock of inventory using the historical- interchangeable inventory methods- FIFO, LIFO, Simple Average and weighted average but the illustration will be worked out in the class to understand the methods.

- **Adjusted Selling price- To arrive at the cost using the following formula**
  - SALES (including the selling price of closing inventory)- Purchases costs= Gross profit
  - To remove the profit element from the closing inventory to arrive at the cost.

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- **Adjusted Selling price- To arrive at the cost using the following formula**
  - Sometimes there might be an abnormal item which might be included in the opening stock/purchases. If in case of such item appearing in the question, while calculating the Opening stock/Purchases- the written down value of such item shall be excluded and the sale value from the total sales shall be excluded.
- **Computing the value of stock on the closing date**- where the stock taking is done either before or after it- ***Before the date of closing the stock count has been taken it has to be solved as below***

Particulars	Amt (in Rs)	Remarks
Value of stock (25th March)	100	Actual date of physical counting
Add: Cost of purchases	20	During the period between 25-31st March
Less: Cost of sales	(30)	Always the cost of sales to be considered
Closing stock value	90	Cost of stock as on 31st March

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- **Computing the value of stock on the closing date**- where the stock taking is done either before or after it- ***After the date of closing the stock count has been taken it has to be solved as below-***
- It is opposite of the earlier method- to arrive at the cost of closing stock- it is essential to understand when is the physical count taken and on which date are we supposed to find the cost of stock.

Particulars	Amt (in Rs)	Remarks
Value of stock (10th April)	100	Actual date of physical counting
Less: Cost of purchases	(20)	During the period between 31st March-10th April
Add: Cost of sales	30	Always the cost of sales to be considered
Closing stock value	110	Cost of stock as on 31st March.

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- Historical method of cost estimation- When the goods are interchangeable- then the cost of the closing stock or the raw materials can be estimated using any one of the following methods-
  - **FIFO- First in First out-** As per this method the issues to production shall be given in the ascending order of the purchases made**. *Closing stock= Most recent purchases.***
  - **LIFO- Last in First out-** As per this method the issues to production shall be given in the descending order of the purchases made**. *Closing stock= Old purchases.***
  - **Simple average method**- TO simple average the prices given in the question to arrive at a ***simple average price to be multiplied with closing stock*** to arrive at the closing stock value.
  - **Weighted average method**- To find out the Weighted average price.

Weighted average price= <u>Total of the product to qty and price</u>

Total of the price

Value of closing stock = Closing stock (units) x Weighted Average price

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- For exam point of view of questioning please refer to slide no.8
- WE will be working out- Illustrations- 5,7,9,10,11 in the class as per the time allotted.
- Request you all to try the remaining illustrations and go ahead.
- Practical questions- 1,2,5 are easy like what we will be doing in the class. 3 and 4 is also easy- try to understand with the concepts- I will check the possibility to reach all of you with easy method.

THANK YOU