Inventories

A complete last-minute revision map: IAS 2 measurement, cost of purchase and conversion, net realisable value, cost formulas, and periodic vs perpetual systems — exactly as tested in PRC-1.

Lower of Cost & NRV | Cost of Purchase & Conversion | FIFO / Weighted Average | Periodic vs Perpetual

1 CORE CONCEPT

> *IAS 2 Inventories governs how inventory is measured. Inventories are assets held for sale in the ordinary course of business, in the process of production for such sale, or as materials/supplies to be consumed in production or in rendering services.*

Raw Materials → Work in Process → Finished Goods → Sold (Cost of Sales)

Goods in transit belong to whichever party has **economic control** (risk & rewards) — not whoever has physical possession. Substance over form.

2 KEY DEFINITIONS

Net Realisable Value (NRV)
Estimated selling price in the ordinary course of business, less estimated costs of completion and costs necessary to make the sale.

Normal Capacity
Production expected on average over several periods under normal circumstances, allowing for planned maintenance downtime.

Cost Formula
The method (FIFO or Weighted Average) used to assign cost to inventory items that are ordinarily interchangeable.

3 IMPORTANT ACCOUNTING RULES — COST OF PURCHASE

✓ INCLUDE in Cost

Purchase price
After deducting trade discounts & rebates

Non-refundable import duties
Genuine, unrecoverable cost of acquisition

Non-adjustable taxes
Taxes that cannot be recovered/adjusted later

Transport & handling costs
Bringing inventory to its present location

Other directly attributable costs
Costs of acquisition specifically

✗ EXCLUDE from Cost

Refundable sales tax
Recoverable — not a genuine cost

Adjustable income tax
Recoverable against future tax liability

Costs not directly attributable
Unrelated to acquisition

Discounts & rebates
Always deducted, never added to cost

4 FORMULAS

NET REALISABLE VALUE

```
NRV = ESP − ECC − ESC
```

Estimated Selling Price − Estimated Cost of Completion − Estimated Selling Costs

INVENTORY MEASUREMENT

```
Value = LOWER of ( Cost , NRV )
```

Never valued above cost, and never above NRV once NRV falls below cost.

5 ACCOUNTING TREATMENT — COST OF CONVERSION

Direct labour / Variable OH
Allocated on the basis of **actual level of production** — these costs vary directly with output.

Fixed Production OH
Allocated on the basis of **normal capacity** — but actual production is used instead if it exceeds normal capacity.

If actual production is below normal capacity, the unabsorbed fixed overhead is **expensed immediately**, not carried into inventory.

6 STEP-BY-STEP ROADMAP — NRV WRITE-DOWN

1. **Calculate NRV**
   ESP − estimated completion costs − estimated selling costs.
2. **Compare NRV with Cost**
   Item by item (or similar/related group) — never by broad classification.
3. **Value at the LOWER figure**
   Write down to NRV only if NRV < Cost.
4. **Check the raw-material exception**
   Don't write down materials if the finished product will still sell at/above cost.

7 JOURNAL ENTRIES — PERIODIC VS PERPETUAL

PERIODIC SYSTEM

PURCHASES
```
Dr Purchases
Cr Payables / Cash
```

SALES
```
Dr Receivables / Cash
Cr Sales
```

RETURNS TO SUPPLIERS
```
Dr Payables / Cash
Cr Purchases returns
```

ABNORMAL LOSS / DRAWINGS
```
Dr Abnormal loss / Drawings
Cr Purchases
```

PERPETUAL SYSTEM

PURCHASES
```
Dr Inventory
Cr Payables / Cash
```

SALES (TWO ENTRIES)
```
Dr Receivables / Cr Sales
Dr Cost of Sales
Cr Inventory
```

RETURNS TO SUPPLIERS
```
Dr Payables / Cash
Cr Inventory
```

ABNORMAL LOSS / DRAWINGS
```
Dr Abnormal loss / Drawings
Cr Inventory
```

8 LEDGER TREATMENT — PERIODIC VS PERPETUAL AT A GLANCE

PERIODIC INVENTORY SYSTEM

No running Cost of Sales account
COGS calculated only at period end via closing entry

Purchases & returns accounts maintained
Separate accounts required

Inventory losses go unnoticed
Automatically absorbed — no special entry, but risk of undetected theft

Best suited to
Large-size items or low-value inventory

PERPETUAL INVENTORY SYSTEM

Inventory updated continuously
Every purchase, sale, return, and loss updates the account

No purchases/returns accounts needed
Everything flows through Inventory directly

Losses are detected
Physical count vs ledger balance reveals discrepancies

Best suited to
High-value inventory or frequent stock movements

9 FINANCIAL STATEMENT EFFECT

↑ **Higher closing inventory value**
Lower cost of sales → higher reported profit this period

↓ **Inventory written down to NRV**
Write-down expensed → reduces profit in the period it occurs

~ **FIFO in a period of rising prices**
Higher closing inventory & higher profit than Weighted Average

An overstated closing inventory this year **understates next year's opening inventory effect** — the error reverses itself the following period.

10 COMMON EXAM CASES — DECISION TREE

IF goods not interchangeable	→ Use specific identification, not FIFO/WA
IF NRV < Cost	→ Write down to NRV (item by item)
IF actual output > normal capacity	→ Use actual output to absorb fixed OH
IF finished good sells ≥ cost	→ Do NOT write down the related raw material
IF asked for LIFO	→ Not permitted under IAS 2 — reject the option

11 COMMON MISTAKES / EXAM TRAPS

Trap: Finished goods storage costs
Storage costs for raw materials awaiting further processing MAY be included, but storage costs for completed finished goods are ALWAYS excluded — they add nothing further.

Trap: Normal vs actual capacity confusion
Students often use actual production for fixed overheads even when it's BELOW normal capacity — the rate must stay based on normal capacity in that case, with the shortfall expensed.

Trap: Writing down raw materials automatically
A fall in raw material replacement cost does NOT trigger a write-down if the finished product is still expected to sell at or above cost.

Trap: Choosing LIFO
LIFO is a classic distractor option in cost-formula questions — it is explicitly NOT permitted under IAS 2.

★ QUICK EXAMPLE

SCENARIO
Goods cost Rs. 10,000. Estimated selling price is Rs. 14,000, with Rs. 4,500 needed to complete/rectify them for sale.

CALCULATION
```
NRV = 14,000 − 4,500 = 9,500
```

RESULT
NRV (9,500) < Cost (10,000) → value at **Rs. 9,500**; write-down loss of **Rs. 500** recognised.

MEASUREMENT RULE
Always the LOWER of cost and net realisable value — never above either figure.

COST BUILD-UP
Purchase price − discounts + non-refundable duties/taxes + directly attributable costs of conversion.

COST FORMULAS
FIFO or Weighted Average only — applied consistently. LIFO is never permitted.

SYSTEM CHOICE
Periodic = purchases account, period-end COGS. Perpetual = continuous inventory updates, two entries per sale.