INVENTORY VALUATION

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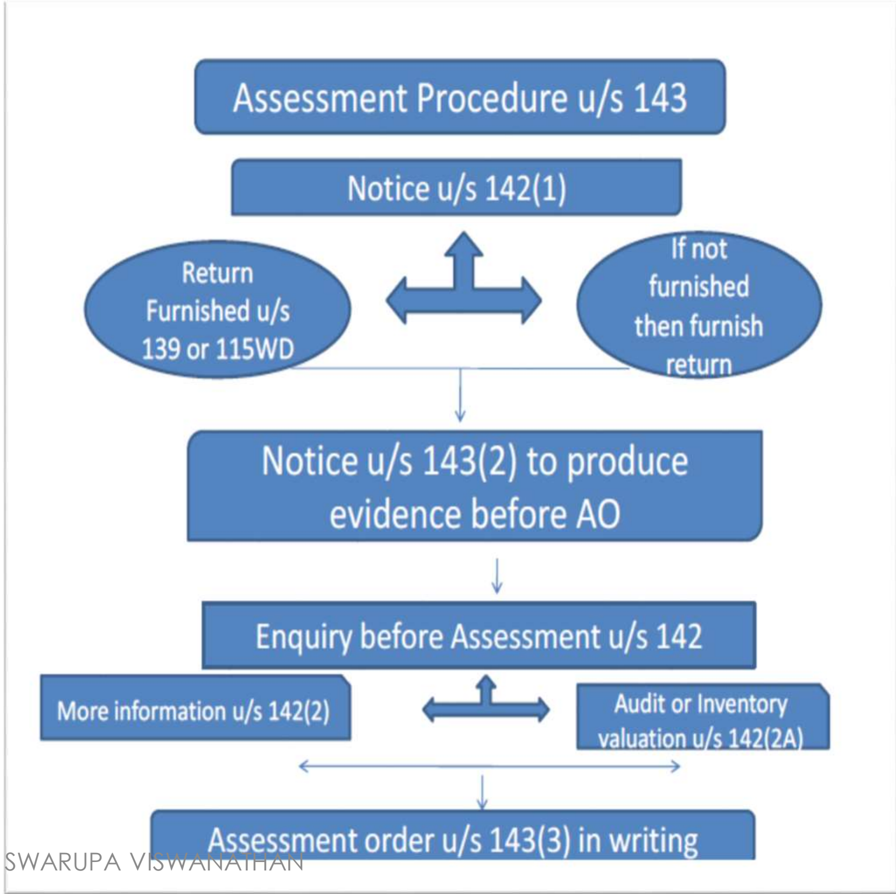
GOLDEN DAY FOR CMA'S

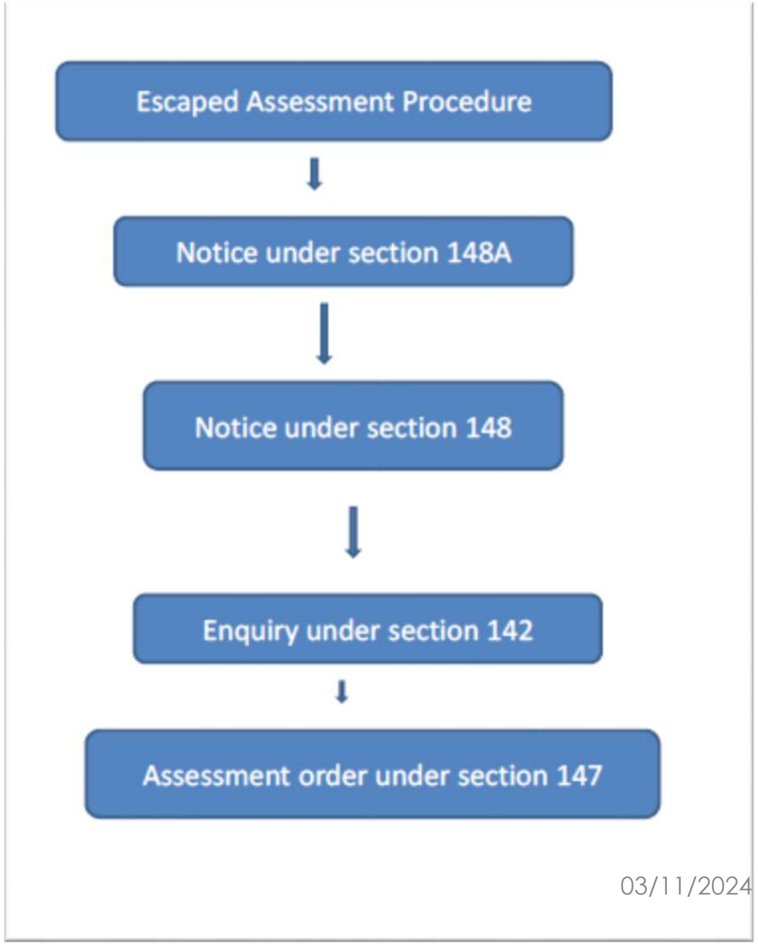
- **On 1st February, 2023** the Hon'ble Union Finance Minister, Government of India, proposed a very important amendment in Sub-section 2A of Section 142 of Income Tax Act, 1961, which was passed by the both houses of the Parliament of India on 24th March, 2023 and got assent of the Hon'ble President of India on 31st March, 2023.
- **Amendment in section 142(2A) is applicable w.e.f. 1st April, 2023**

TYPES OF ASSESSMENT UNDER INCOME TAX ACT 1961

- **Regular Assessment** : First assessment starts from the self-assessment
- **Sec: 143 : Scrutiny Assessment** : If the AO has doubt about the completeness, correctness of the particulars given in the income tax return furnished by the assesse, the AO may start the process of scrutiny as per the provision under section 143
- **Sec 147 : Escaped Assessment** : In some cases the AO may start 'escaped assessment' under section 147.
- **Sec: 144 : Best Judgement Assessment** : If any person—
- (*a*) fails to make the return required by any notice given under section-139
- (*b*) fails to comply with all the terms of a notice issued under section-142, or
- (*c*) having made a return, fails to comply with all the terms of a notice issued under sub-section (2) of section-143,
- the Income-tax Officer, after taking into account all relevant material which the Income-tax Officer has gathered, shall make the assessment of the total income or loss to the best of his judgment and determine the sum payable by the assessee or refundable to the assessee on the basis of such assessment.

SCRUTINY AND ESCAPED ASSESSMENT





AMENDMENT PASSED IN UNION BUDGET 2023

- In section 142 of the Income-tax Act, for sub-section (2A), the following sub-section shall be substituted, namely:—
- "(2A) If, at **any stage of the proceedings before him**, the **Assessing Officer**, having regard to the nature and complexity of the accounts, volume of the accounts, doubts about the correctness of the accounts, multiplicity of transactions in the accounts or specialised nature of business activity of the assessee, and the interests of the revenue, is of the opinion that it is necessary so to do, he may, with the **previous approval of the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner**, direct the assessee to get either or both of the following, namely:—

AMENDMENT PASSED IN UNION BUDGET 2023

- (ii) to get the inventory valued by a **cost accountant**, nominated by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in this behalf and to furnish a report of **such inventory valuation in the prescribed form** duly signed and verified by such cost accountant and setting forth such particulars, as may be prescribed, and such other particulars as the Assessing Officer may require:
- Provided that the Assessing Officer shall not direct the assessee to get the accounts so audited or inventory so valued unless the assessee has been given a reasonable opportunity of being heard.";

CONDITIONS

- **Opportunity of being heard** :The AO shall give an opportunity to the assessee before giving direction to him for inventory valuation to submit his grounds as to why valuation of inventory is not required;
- **Valuation done irrespective of any audit done previously** : AO may direct the assessee to get inventory valuation done although his accounts have been audited under section 44AB or other provisions of IT Act, 1961 or under any other law for the time being in force like Financial Audit under section 139 and Cost audit under section 148 under Companies Act, 2013 or, Audit under Society or Trust Act.
- **Time limit to submit the report** : Cost Accountant has to submit his report in **Form 6D** within the period of time as specified in the AO's notice or as extended, under his seal, signature and UDIN;
- The total period to submit the report shall **not exceed more than 180 days** from the date on which the direction under section 142(2A) for inventory valuation is received by the assessee;

CONDITIONS

- **Assessee may be any person** viz; an Individual or a HUF (Hindu undivided family) or a Company or a Firm or an Association of Persons (AOP) or a Body of individuals (BOI) or a Local authority or every artificial judicial person having income or loss under the head "Income from business or profession" and/or "Income from other sources".

CONSEQUENCE OF DEFAULT

- If the assessee fails to comply with the direction of the AO to get inventory valued by a practising Cost Accountant, following consequences may arise
- The AO pass best judgment assessment order under section 144
- Penalty shall be imposed to the assessee under **section 271**[Rs. **10000/- for** each such failure] and prosecution under **section 276D** [Punishment with rigorous imprisonment for a term which may **extended to one year with fine**].

SECTION 145(2)

- Income Computation and Disclosure Standards (ICDS) were issued by the Government of India in exercise of powers conferred to it under section 145(2) of The Income Tax Act, 1961.
- **Section 145(2)** has prescribed 10 Income Computation and Disclosure Standard to be followed by the assesse to compute chargeable income under the head "Profits and gains of business or profession" or "Income from other sources".

i. ICDS-I: - Accounting Policies

ii. **ICDS-II: - Valuation of Inventories**

iii. ICDS-III: - Construction Contracts

iv. ICDS-IV: - Revenue Recognition

v. ICDS-V: - Tangible Fixed Assets

vi. ICDS-VI: - Effects of Changes in Foreign Exchange Rates

vii. ICDS-VII:- Government Grants

viii. ICDS-VIII: - Securities

ix. ICDS-IX: - Borrowing Costs

x. ICDS-X: - Provisions, Contingent Liabilities and Contingent Assets

- The most relevant standards for the valuation of inventories under section 142(2A) are

INTRODUCTION TO ICDS

- These ICDS have to be followed by all assesses
- except an Individual or HUF who is not required to get his accounts of the previous year audited in accordance to the provision under section 44AB,
- Following the mercantile system of accounting
- for the purpose of computation of income chargeable under the head “Profits or gains of business or profession” or “Income from the other sources”.

INTRODUCTION TO ICDS

- The preamble of ICDS prescribes the usage only to compute income under the head "Profits or gains from business or profession" and "Income from other sources". **The provision of ICDS is not applicable for the maintenance of books of accounts**. Assesee shall maintain books of accounts based on the prevailing Generally Accepted Accounting Principle, Accounting standards, Ind AS, Generally Accepted Cost Accounting Principle, Cost Accounting Standards etc. as the case may be.

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

ICDS II- VALUATION OF INVENTORIES

- Company and non-company assessee is required to follow AS, Ind AS to maintain financial accounts. In the case of companies to which provisions of section 148 of Companies Act, 2013 is applicable is required to follow CCRA Rules, 2014, read with Cost Accounting Standards to maintain cost records. While doing inventory valuation under section 142(2A) it must not be deviate from ICDS-II.

WHAT IS INVENTORY??

Inventory may be :

→ In the form of Finished goods (Manufactured or produced)

→ Stock in trade

→ Semi- finished goods/Intermediate products

→ W.I.P

→ Raw Materials, process materials, packing materials

→ Stores and Consumables, chemicals, fuels

→ Jigs, tools& tackle

→ Joint products

→ By-products

→ Others(Specify if any)

APPLICABILITY

This Income Computation and Disclosure Standard shall be applied for valuation of inventories, except:

(a) Work-in-progress arising under 'construction contract' including directly related service contract which is dealt with by ICDS on construction contracts;

(b) Work-in-progress which is dealt with by other Income Computation and Disclosure Standard;

(c) Shares, debentures and other financial instruments held as stock-in-trade which are dealt with by the Income Computation and Disclosure Standard on securities;

(d) Producers' inventories of livestock, agriculture and forest products, mineral oils, ores and gases to the extent that they are measured at net realisable value;

(e) 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 in accordance with the Income Computation and Disclosure Standard on tangible fixed assets.

COST OR NRV??

- *The valuation of inventory shall be made at **lower of actual cost or net realisable value** computed in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145;*
- *the valuation of purchase and sale of goods or services and of inventory shall be adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods or services to the place of its location and condition as on the date of valuation.*

INCLUSIVE METHOD

- The ICDS prescribes ‘inclusive method’ while the Accounting Standards prescribe ‘exclusive method’. Accordingly, if an exclusive method is followed for the purpose of valuation of inventory as per AS, the taxpayer would be required to prepare the **memorandum account** to demonstrate that *vis-a-vis* inclusive method, it is tax neutral. This will be in compliance with section 145A and ICDS.
- **Inclusive method** is a method for calculating income under the head profit or gain from business or profession/other sources by including duties and taxes (both recoverable and unrecoverable)
- **Exclusive method** is a method for calculating income under the head profit or gain from business or profession/other sources by excluding duties and taxes (recoverable)

EXAMPLE

- M/s Orbit appliances Ltd has purchased 4 items for Rs.3,00,000/-(exclusive of 5%GST) during the year. 3 items are sold at Rs.4,20,000/- per item(exclusive of 5%GST)
- **Exclusive method (AS/Ind AS)**

P&L Account for the FY 20XX-XX

Particulars	Qty	Rate	Amt	Particulars	Qty	Rate	Amt
To purchase	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			**3,60,000**				
			15,60,000				**15,60,000**

EXAMPLE

- **Inclusive method (ICDS II)**

P&L Account for the FY 20XX-XX

Particulars	Qty	Rate	Amt	Particulars	Qty	Rate	Amt
To purchase	4	3,15,000	12,60,000	By sales	3	4,41,000	13,23,000
To GST Paid on sales			63,000	By closing stock	1	3,15,000	3,15,000
To Profit			**3,60,000**	By GST ITC on COGS			45,000
			16,83,000				**16,83,000**

GST Outward : 420,000*3*5% = 63,000
GST Inward : 3,00,000*3*5% = 45,000

MEMORANDUM ACCOUNT

- Instead of preparing the whole P&L account, memorandum account can be prepared having particulars of impact on profit

Sl No	Particulars	Increase in profit	Decrease in profit
1	Increase in cost of purchase		60,000
2	Increase in sales	63,000	
3	Increase in value of inventory	15,000	
4	Tax paid on sale		63,000
5	ITC utilised on COGS	45,000	
	Total	**1,23,000**	**1,23,000**

COST OF INVENTORIES

- It shall comprise of :

→ Cost of Purchase

→ Cost of services

→ Conversion cost

→ Other costs incurred to bring inventories to their present state

The description is exhaustive

It includes direct and indirect cost and overheads apportioned and allocated

COST OF PURCHASE

Purchase price includes duties and taxes.

As per ICDS II, inclusive method is followed, and taxes recoverable /non recoverable are included

- Where as in AS 2/ Ind AS, Such duties and taxes on which a tax credit is available shall not be the part of purchase cost, like ITC under GST Act.
- Taxes like customs duty, environmental tax, pollution tax on which credit is not available is included in the cost of inventory.
- For example on purchase of wine, state excise duty paid, on purchase of
- coal royalty, cess, duty to NMET(National Mineral Exploration Trust),DMF(District Mineral Foundation Trust) paid etc.;

COST OF PURCHASE

- **Cost of purchase includes Freight inward**
- **Other direct costs** like loading and unloading charges, material/goods handling cost, parcel cost, cartage cost, storage and issuing losses, custom clearing agent commission and others which are directly attributed to the purchase of products shall be included to the cost of purchase.
- The cost of non-returnable containers shall be added to the cost of purchase and any disposable amount shall be deducted from the factory overheads like sale of cement bags, oil drums etc.
- Any trade discount, rebates and other similar items like bulk quantity discounts cash discounts etc.; shall be deducted from the purchase cost

COST OF SERVICES

- **Cost of services** like **direct and indirect employee cost** attribute to the procurement process and storing of goods (in certain cases) shall be included to the cost of purchase.
- For example,
- employee cost of purchase department, store, warehouse, weighbridge and other costs incurred in this department shall be included in the cost of purchase

COST OF CONVERSION

- It mainly consists of **labour and production overhead applied on raw materials to convert to Finished goods.** 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.
- It shall include, direct and indirect employees cost, cost of utilities, repair and maintenance cost, cost of tools, jigs and fixtures, machines, depreciation and amortization costs, fixed and variable production overheads, quality control cost, research and development cost, other manufacturing or producing costs
- Sales realization from by-products, scrap or waste materials shall be deducted from the cost of finished goods

ALLOCATION OF FIXED AND VARIABLE COST

- Allocation of Fixed Cost based on **Normal Capacity of production**.
- Normal capacity shall be the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.
- **The actual level of production shall be used when it approximates to normal capacity**.
- The amount of fixed production overheads allocated to each unit of production shall not be increased as a consequence of low production or idle plant. Unallocated overheads shall be recognised as an expense in the period in which they are incurred.
- In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above the cost.
- **Variable production overheads shall be assigned to each unit of production on the basis of the actual use of the production facilities.**

BY-PRODUCT

- Where a production process results in more than one product being produced simultaneously and the costs of conversion of each product are not separately identifiable, the costs shall be allocated between the products on a rational and consistent basis. Where by-products, scrap or waste material are immaterial, they shall be measured at net realisable value and this value shall be deducted from the cost of the main product.

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.

EXCLUSIONS FROM COST OF INVENTORY

The following costs shall be excluded and recognized as expenses of the period in which they are incurred :

→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; for example the refrigeration cost in the making of ice cream.

→Administrative overheads that do not contribute to bring the inventories to their present location and conditions;

→Selling costs

These costs shall be shown separately in the profit and loss accounts as expenditure.

ABNORMAL LOSS

- No specific limit mentioned for bifurcation of normal and abnormal loss
- As per general accounting principles any loss or gain within +/- 5% shall be treated as normal.
- Loss of more than 5 percent may be treated as abnormal loss of material due to wastage.
- Abnormal labour cost may arise due to strike, accident, lockout, fire, flood, climatic disaster,etc.

COST FORMULAE

- **Specific Identification of cost:** For the items of inventories which are not ordinarily interchangeable and goods or services produced and segregated for specific projects, the cost shall be assigned by specific identification of their individual costs.
- **The FIFO or weighted average method** shall be used to deal with the cost of inventory of items which are ordinarily interchangeable.

TECHNIQUE OF COSTING

- **STANDARD COST :** 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.
- **RETAIL METHOD :** 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 impracticable 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. An average percentage for each retail department is to be used.

EXAMPLE

- Textile Ltd. is a dealer of clothes and has thousands of items in its inventories. It applies the retail method. The average gross margin is 20%. The sales price of the tshirt of a carton of 20 trousers is ` 10000.
- Accordingly each carton will be valued at ` 8000 (` 10000 - ` 1000 x 20%) and each
- Tshirt would cost ` 8000/20 = ` 400.

OTHER POINTERS

- **Change in method of valuation :** The method of valuation of inventories once adopted by a person in any previous year shall not be changed without reasonable cause.
- **Dissolution :** In case of dissolution of a partnership firm or association of person or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value.

WHAT IS NET REALISABLE VALUE?

Estimated selling price

In Ordinary course of Business

Less estimated cost of completion

Less estimated cost to make the sale

NET REALISABLE VALUE

- Inventories shall be written down to net realisable value on an item-by-item basis.
- In case of product lines, inventory can be group together and NRV can be calculated in aggregate.
- NRV shall be based on the **most reliable evidence** available at the time of valuation.
- The estimates of NRV shall also take into consideration the purpose for which the inventory is held and also fluctuations of price or cost directly relating to events occurring after the end of the previous year.
- Since actual sale is not going to happen in this case, it has to be presumed that if the assessee sells or disposes off the inventory what amount he could get and what amount he would require to spend to complete the sale of inventory.
- The current price of inventory is required to discount with certain percentage to estimate the price of the inventory at the end of the relevant previous year with reference to price index released by the government

- Materials and other supplies held for use in the production of inventories shall not be written down below the cost, where the finished products in which they shall be incorporated are expected to be sold at or above the cost.
- Where there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed the net realisable value, the value of materials shall be written down to net realisable value which shall be the replacement cost of such materials.

NRV OF WIP

- In manufacturing process W.I.P is a stage of completion at which material is under process and is in semi-finished goods state. It includes costs of direct and indirect materials consumed, labour, utilities, production overheads.
- Cost plus margin formulae may be followed for determination of NRV of W.I.P.
- In some industry there is a market demand of semi-finished goods which the company sale it to the other company to use as input inventory to make finished goods. In such case the current selling price discounted may be considered as NRV of W.I.P for the purpose of the valuation of inventory of WIP.

A COMPARABLE TABLE IS MENTIONED BELOW TO UNDERSTAND SIMILARITIES AND DEVIATION AMONG ICDS, AS AND IND AS.

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Definition of inventory	Inventories are assets (i) held for sale in the ordinary course of business; (ii) in the process of production for such sale; (iii) in the form of materials or supplies to be consumed in the production process or in the rendering of services.	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.	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.	Definition is same under all heads

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Net Realisable Value	**"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.	**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.	**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.	Definition is same under all heads
Scope	ICDS II applicable for inventory valuation except: Construction contracts, Shares and other financial instruments, Producers' inventories of livestock etc, Machinery spares dealt under ICDS on tangible assets	Applicable for inventory other than : work in progress arising under construction contracts; work in progress arising in the ordinary course of business of service providers; Shares and other financial instruments, Producers' inventories of livestock etc,	(a) producers of agricultural and forest products, agricultural produce after harvest, and minerals to the extent that they are measured at net realisable value in accordance with well established practices in those industries. commodity broker traders who measure their inventories at fair value less costs to sell.	Scope is similar to each other.

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Measurement	Inventories shall be valued at cost, or net realisable value, whichever is lower	Inventories should be valued at the lower of cost and net realisable value.	Inventories should be valued at the lower of cost and net realisable value..	Same approach in all heads
Costs of Inventories	Cost of inventories shall comprise of all costs of purchase, **costs of services**, costs of conversion and other costs incurred in bringing the inventories to their present location and condition	The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition	The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition	Cost of services not defined in AS2 and Ind AS 2
Costs of Purchase	Cost of purchase included), freight inwards and expenditure directly attributable to the acquisition. Rebates and discounts to be reduced from purchase price	Cost of purchase included taxes(non recoverable), freight inwards and expenditure directly attributable to the acquisition. Rebates and discounts to be reduced from purchase price	The costs of purchase of inventories comprise the purchase price, import duties and other taxes and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Rebates adjusted to price.	Inclusive method followed in ICDS where as exclusive method followed in AS/Ind AS

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Other Costs	Other costs are included in cost of inventory to the extent of bringing the inventory to their present location	Other costs are included in cost of inventory to the extent of bringing the inventory to their present location	Other costs are included in cost of inventory to the extent of bringing the inventory to their present location	Same in all heads
Borrowing Cost	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 ICDS the on borrowing costs.	borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.	Ind AS 23, Borrowing Costs, identifies limited circumstances where borrowing costs are included in the cost of inventories.	AS 2 does not recognise borrowing cost as part of inventory calculatio n
Exclusions from the Cost of Inventories	1.Abnormal cost 2. Storage cost 3.Unrelated admin cost 4.Selling cost	1.Abnormal cost 2. Storage cost 3.Unrelated admin cost 4.Selling cost	1.Abnormal cost 2. Storage cost 3.Unrelated admin cost 4.Selling cost	Same in all heads

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Cost Formulae	1.Specific allocation 2.FIFO 3.Weighted Average method	1.Specific allocation 2.FIFO 3.Weighted Average method	1.Specific allocation 2.FIFO 3.Weighted Average method	
Technique of costing	Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. 1.Standard cost 2.Retail method	Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. 1.Standard cost 2.Retail method	Not defined	
Value of Opening Inventory	The value of the inventory as on the beginning of the previous year shall be (i) 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	Not specified	Not specified	

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
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.	Not specified	Not specified	
Valuation in case of dissolution	In case of dissolution of a partnership firm or association of person or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value	Not specified	Not specified	

Particulars	ICDS II	AS 2	Ind AS 2	Remarks
Actual /Normal Capacity	The actual level of production ***Shall be used***, if it approximates normal capacity	The actual level of production ***may be used***, if it approximates normal capacity	The actual level of production ***may be used***, if it approximates normal capacity	ICDS requires actual capacity to be considered when it is approximates normal capacity

Thank You