

Accounting Standard for Local Bodies (ASLB) 12

Inventories

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Accounting Standard for Local Bodies (ASLB) 12

Inventories

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies¹).*

The Accounting Standard for Local Bodies (ASLB) 12, 'Inventories', issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the Local Bodies. This Standard will be mandatory for Local Bodies in a State from the date specified in this regard by the State Government concerned².

The following is the text of the Accounting Standard for Local Bodies.

Objective

1. The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

2. An entity that prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for all inventories except:

¹ Attention is specifically drawn to paragraph 4.2 of the 'Preface to the Accounting Standards for Local Bodies', according to which Accounting Standards are intended to apply only to items which are material.

² Reference may be made to the paragraph 7.1 of the 'Preface to the Accounting Standards for Local Bodies' providing the discussion on the compliance with the Accounting Standards for Local Bodies.

- (a) *Work-in-progress arising under construction contracts, including directly related service contracts (see ASLB 11 'Construction Contracts');*
- (b) *Shares, debentures, derivative contracts and, other financial instruments of similar nature held as stock-in-trade; and*
- (c) *[Refer to Appendix 1]*
- (d) *Work-in-progress of services to be provided for no or nominal consideration directly in return from the recipients.*

3. *This Standard does not apply to the measurement of inventories held by producers of agricultural and forest products, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in surplus or deficit in the period of the change.*

4. *This Standard applies to entities described as local bodies in the Preface to the Accounting Standards for Local Bodies³.*

5. *[Refer to Appendix 1]*

6. The inventories referred to in paragraph 2(d) are not encompassed by AS 2, 'Inventories', and are excluded from the scope of this standard.

7. The inventories referred to in paragraph 3 are measured at net realisable value at certain stages of production. This occurs, for example, (a) when agricultural crops have been harvested or minerals have been extracted and sale is assured under a forward contract or a government guarantee, or (b) when an active market exists and there is a negligible risk of failure to sell. These inventories are excluded only from the measurement requirements of this Standard.

8. *[Refer to Appendix 1]*

³ Refer paragraph 1.3 of the 'Preface to the Accounting Standards for Local Bodies'.

Definitions

9. *The following terms are used in this Standard with the meanings specified:*

Current replacement cost is the cost the entity would incur to acquire the asset on the reporting date.

Inventories are assets:

- (a) In the form of materials or supplies to be consumed in the production process;*
- (b) In the form of materials or supplies to be consumed or distributed in the rendering of services;*
- (c) Held for sale or distribution in the ordinary course of operations;
or*
- (d) In the process of production for sale or distribution.*

Net realisable value is the estimated selling price in the ordinary course of operations, less the estimated costs of completion and the estimated costs necessary to make the sale, exchange, or distribution.

Terms defined in other Accounting Standards for Local Bodies are used in this Standard with the same meaning as in those Standards.

Net Realisable Value

10. Net realisable value refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of operations. Fair value reflects the amount for which the same inventory could be exchanged between knowledgeable and willing buyers and sellers in the marketplace. The former is an entity-specific value; the latter is not. Net realisable value for inventories may not equal fair value less costs to sell.

Inventories

11. Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by an entity and held for resale, or land and other property held for sale. Inventories also encompass finished goods produced, or work-in-progress being produced, by the entity. Inventories also include (a) materials and supplies awaiting use in the production process, and (b) goods purchased or produced by an entity, which are for distribution to other parties for no charge or for a nominal charge, for example, educational books produced by a health authority for donation to schools. In many entities, inventories will relate to the provision of services rather than goods purchased and held for resale or goods manufactured for sale. In the case of a service provider, inventories include the costs of the service, as described in paragraph 28, for which the entity has not yet recognised the related revenue (guidance on recognition of revenue can be found in ASLB 9, '*Revenue from Exchange Transactions*').

12. Inventories in the local bodies may include:

- (a) Consumable stores;
- (b) Maintenance materials;
- (c) Spare parts for plant and equipment, other than those dealt with in standards on Property, Plant and Equipment;
- (d) Work-in-progress, including educational/training course materials; and
- (e) Land/property held for sale.

13. [Refer to Appendix 1]

14. [Refer to Appendix 1]

Measurement of Inventories

15. Inventories should be measured at the lower of cost and net realisable value, except where paragraph 16 or paragraph 17 applies.

16. Where inventories are acquired through a non-exchange transaction, their cost should be measured at their fair value as at the date of acquisition. Provided a Local Body falling in Level II may not measure an inventory acquired through non-exchange transaction at fair value and may measure the same at nominal value of Re. 1⁴.

17. Inventories should be measured at the lower of cost and current replacement cost where they are held for:

- (a) Distribution at no charge or for a nominal charge; or**
- (b) Consumption in the production process of goods to be distributed at no charge or for a nominal charge.**

Cost of Inventories

18. 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.

Costs of Purchase

19. The costs of purchase of inventories comprise (a) the purchase price, (b) import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and (c) transport, handling, and other costs directly attributable to the acquisition of finished goods, materials, and supplies. Trade discounts, rebates, and other similar items are deducted in determining the costs of purchase.

⁴ Criteria for classification of Local Bodies in different Levels is being prepared.

Costs of Conversion

20. The costs of converting work-in-progress inventories into finished goods inventories are incurred primarily in a manufacturing environment. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of (a) the volume of production, such as depreciation and maintenance of factory buildings and equipment, and (b) the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

21. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on 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 may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased, so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

22. For example, the allocation of costs, both fixed and variable, incurred in the development of undeveloped land held for sale into residential or commercial landholdings could include costs relating to landscaping, drainage, pipe laying for utility connection, etc.

23. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for

example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value, and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

24. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

25. Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

- (a) Abnormal amounts of wasted materials, labour, or other production costs;
- (b) Storage costs, unless those costs are necessary in the production process before a further production stage;
- (c) Administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- (d) Selling costs.

26. ASLB 5, '*Borrowing Costs*', identifies limited circumstances where borrowing costs are included in the cost of inventories.

27. An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

Cost of Inventories of a Service Provider

28. To the extent that service providers have inventories except those referred to in paragraph 2(d), they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel and attributable overheads. The costs of labour not engaged in providing the service are not included. Labour and other costs relating to sales and general administrative personnel are not included, but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include surplus margins or non-attributable overheads that are often factored into prices charged by service providers.

29. [Refer to Appendix 1]

Techniques for the Measurement of Cost

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

31. Inventories may be transferred to the entity by means of a non-exchange transaction. For example, an international aid agency may donate medical supplies to a hospital promoted by the entity in the aftermath of a natural disaster. Under such circumstances, the cost of inventory is its fair value as at the date it is acquired. In case of a Local Body falling in Level II, inventory is valued at nominal cost, i.e., Re.1.

Cost Formulas

32. The cost of inventories of items that are not ordinarily interchangeable, and goods or services produced and segregated for specific projects, should be assigned by using specific identification of their individual costs.

33. Specific identification of costs means that specific costs are attributed to

identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on the net surplus or deficit for the period.

34. When applying paragraph 33 an entity should use the same cost formula for all inventories having similar nature and use to the entity. For inventories with different nature or use (for example, certain commodities used in one segment and the same type of commodities used in another segment), different cost formulas may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

35. The cost of inventories, other than those dealt with in paragraph 32, should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas. An entity should use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

36. For example, inventories used in one segment may have a use to the entity different from the same type of inventories used in another segment. However, a difference in geographical location of inventories, by itself, is not sufficient to justify the use of different cost formulas.

37. The FIFO formula assumes that the items of inventory that were purchased first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. 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 may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

Net Realisable Value

38. The cost of inventories may not be recoverable if those inventories are

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damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale, exchange, or distribution have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets are not to be carried in excess of the future economic benefits or service potential expected to be realised from their sale, exchange, distribution, or use.

39. Inventories are usually written down to net realisable value on an item by item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory that have similar purposes or end uses, and cannot practicably be evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular operation or geographical segment. Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item.

40. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices. Guidance on the treatment of provisions or contingent liabilities, such as those arising from firm sales contracts in excess of inventory quantities held, and on firm purchase contracts can be found in ASLB 19, *'Provisions, Contingent Liabilities and Contingent Assets'*.

41. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold, exchanged, or distributed at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

42. A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written

down below cost no longer exist, or when there is clear evidence of an increase in net realisable value because of changed economic circumstances, the amount of the write down is reversed (i.e., the reversal is limited to the amount of the original write down) so that the new carrying amount is the lower of the cost and the revised net realisable value. This occurs, for example, when an item of inventory that is carried at net realisable value because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Distributing Goods at No Charge or for a Nominal Charge

43. A local body may hold inventories whose future economic benefits or service potential are not directly related to their ability to generate net cash inflows. These types of inventories may arise when an entity has determined to distribute certain goods at no charge or for a nominal amount. In these cases, the future economic benefits or service potential of the inventory for financial reporting purposes is reflected by the amount the entity would need to pay to acquire the economic benefits or service potential if this was necessary to achieve the objectives of the entity. Where the economic benefits or service potential cannot be acquired in the market, an estimate of replacement cost will need to be made. If the purpose for which the inventory is held changes, then the inventory is valued using the provisions of paragraph 15.

Recognition as an Expense

44. When inventories are sold, exchanged, or distributed, the carrying amount of those inventories should be recognised as an expense in the period in which the related revenue is recognised. If there is no related revenue, the expense is recognised when the goods are distributed or the related service is rendered. The amount of any write-down of inventories and all losses of inventories should be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any writedown of inventories should be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

45. For a service provider, the point when inventories are recognised as expenses normally occurs when services are rendered, or upon billing for chargeable services.

46. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant, or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

Disclosure

47. *The financial statements should disclose:*

- (a) *The accounting policies adopted in measuring inventories, including the cost formula used;***
- (b) *The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;***
- (c) *The carrying amount of inventories carried at fair value less costs to sell;***
- (d) *The amount of inventories recognised as an expense during the period;***
- (e) *The amount of any write-down of inventories recognised as an expense in the period in accordance with paragraph 42;***
- (f) *The amount of any reversal of any writedown that is recognised in the statement of income and expenditure in the period in accordance with paragraph 42;***
- (g) *The circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 42; and***
- (h) *The carrying amount of inventories pledged as security for liabilities.***

48. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work-in-progress, and finished goods. The inventories of a service provider may be described as work-in-progress.

49. [Refer to Appendix 1]

50. ASLB 1 prescribes a format for surplus or deficit that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for (a) raw materials and consumables, (b) labour costs, and (c) other costs, together with the amount of the net change in inventories for the period.

51. [Refer to Appendix 1]

51A. [Refer to Appendix 1]

52. [Refer to Appendix 1]

53. [Refer to Appendix 1]

Appendix 1

Note: This Appendix is not a part of the Accounting Standard for Local Bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) 12 and the corresponding International Public Sector Accounting Standard (IPSAS) 12, 'Inventories'.

Comparison with IPSAS 12, 'Inventories'

1. Paragraph 5 of IPSAS 12 which provides that Government Business Enterprises should use IFRSs has been deleted as it is not relevant for ASLB 12, which is applicable to Local Bodies of India. However, paragraph number 5 is retained in ASLB 12, in order to maintain consistency with IPSAS 12.
2. Certain items of inventories such as ammunition, strategic stock piles, stock of unissued currency, postal service supplies held for sale and work-in-progress on account of client service for e.g., auditing services, where those services are sold at arm's length prices etc., given in the IPSAS 12 have been removed in the ASLB 12, keeping in view that these are not relevant for local bodies. Paragraphs dealing with the recognition of above inventory items have also been deleted. However, paragraph number 13 & 14 have been retained in the Standard in order to maintain consistency with IPSAS 12.
3. IPSAS 12 excludes financial instruments from its scope as there are separate IPSASs on the subject. This exclusion from the scope has been deleted in the ASLB 12 keeping in view that the Standards on the subject are not proposed to be issued in the near future. However, the ASLB 12 excludes 'shares, debentures, derivative contracts and, other similar financial instruments held as stock-in-trade' from its scope.
4. IPSAS 12 specifies that it does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell. However, this aspect has been excluded from the ASLB 12 keeping in view that Local Bodies do not indulge in activities carried on by commodity broker-traders. However, paragraph number 8

has been retained in the Standard in order to maintain consistency with IPSAS 12.

5. IPSAS 12 excludes biological assets related to agricultural activity and agricultural produce at the point of harvest from its scope as there is separate IPSAS on agriculture. This exclusion from the scope has been deleted in the ASLB 12 keeping in view that the Standard on the subject is not proposed to be issued in the near future and certain consequential changes have been made. Paragraph dealing with the measurement of agricultural produce harvested from biological assets has also been deleted. However, paragraph number 29 has been retained in the Standard in order to maintain consistency with IPSAS 12.
6. IPSAS 12 requires that inventories acquired through a non-exchange transaction should be valued at fair value. ASLB 12 prescribes that Local Bodies falling in Level II may not measure such inventories at fair value and measure the same at nominal value, i.e., Re. 1.
7. Paragraph 49 of IPSAS 12 dealing with recognition of Inventories as an expense based on function wise classification has been deleted keeping in view the fact that option provided in IPSAS 1 to present an analysis of expenses recognised in profit or loss using a classification based on their function within the entity has been removed and ASLB 1 requires only nature wise classification of expenses. However, in order to maintain consistency with paragraph numbers with IPSAS 12, the paragraph number 49 is retained in ASLB 12.
8. Paragraphs relating to effective date have been removed as the ASLB 12 would become mandatory for Local Bodies in a state from the date specified by the State Government concerned. Paragraph numbers have been retained in order to maintain consistency with IPSAS 12.

Appendix 2

Note: This Appendix is not a part of the Accounting Standard for Local Bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) 12 and the corresponding existing Accounting Standard (AS) 2, 'Valuation of Inventories'.

Comparison with Existing AS 2, 'Valuation of Inventories' (Revised 1999)

1. The ASLB 12 deals with the subsequent recognition of cost/carrying amount of inventories as an expense, whereas the existing AS 2 does not provide the same.
2. ASLB 12 includes valuation of work-in-progress in case of services to be provided by local bodies except where no or nominal consideration is to be received directly in return from recipients. Existing AS 2 specifically excludes work-in-progress arising in the ordinary course of business of service providers.
3. ASLB 12 uses a different definition of inventories from existing AS 2, the difference recognises that in local bodies some inventories are distributed at no charge or for a nominal charge.
4. ASLB 12 deals with valuation of inventories acquired through a non-exchange transaction. However, existing AS 2 does not deal with transactions relating to exchange or distribution consequently no such guidance is given.
5. ASLB 12 requires that where inventories are provided at no charge or for a nominal charge, they are to be valued at the lower of cost and current replacement cost. As existing AS 2 does not recognise the situation of distribution of inventories at no charge or nominal charge, no such guidance is given. In accordance with the above, the ASLB 12 defines 'current replacement cost'.
6. ASLB 12 contains additional commentary for applying Standard to local bodies.

7. The ASLB 12 deals with reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and disclosure thereof in the financial statements. The existing AS 2 does not deal with such reversal.
8. Existing AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition, whereas the ASLB 12 does not specifically state so and requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity. The ASLB 12 also explains this aspect.
9. The ASLB 12 requires more disclosures as compared to existing AS 2.