

23 April 2026



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PROFESSIONAL PROFILE

- ▶ Amit Garg is a Fellow Chartered accountant and leads the Audit and Assurance practice in his firm RNBP & Co. .
- ▶ 20+ years of professional experience in Assurance & Advisory Services; previously with **S.R. Batliboi & Co. LLP** (EY member firm) for over 12 years in Audit & Assurance.
- ▶ Extensive experience in **IFRS, Ind AS, IGAAP**, Ind AS implementation, ICFR, SOX Testing, Business Process re-engineering, statutory audits, tax audits, Capital Market transactions and due diligence.
- ▶ Faculty for IFRS / Ind AS courses at **ICAI, Indian Corporate Law Service Academy (MCA) and Delhi University**. Corporate trainer on Ind AS and IFRS.
- ▶ **Developed and launched FinSoEasy360** — financial reporting software that generates Schedule III compliant Ind AS / AS standalone and consolidated financial statements along with related-party auto-elimination entries, lease accounting and dashboard reports. (www.finsensor.ai)

REFRESHER COURSE ON ACCOUNTING STANDARDS

AS 2

Valuation of Inventories

A deep-dive workshop for Chartered Accountants — scope, cost determination, NRV, cost formulas, and contentious judgement areas

BY AMIT GARG

What we will cover

- 1 Scope & regulatory context
- 2 Definition & classification of inventories
- 3 The cardinal rule — Lower of Cost and NRV
- 4 Cost of purchase — what's in, what's out
- 5 Cost of conversion & overhead allocation
- 6 Cost formulas — FIFO, Weighted Average, Specific ID
- 7 Why LIFO is prohibited under AS 2
- 8 Determining Net Realisable Value
- 9 Write-down, reversal & recognition as expense
- 10 Nuance: Joint products & by-products
- 11 Nuance: Service providers' inventory
- 12 Audit pitfalls & disclosure requirements
- Q & A

Scope, regulatory context & who must apply



Notified under Companies (AS) Rules, 2021

AS 2 was originally issued in 1981 and revised in 1999 (mandatory from 1-Apr-1999). Further aligned with Ind AS 2 direction through the 2016 amendments. Applies to enterprises following Indian GAAP — Ind AS entities apply Ind AS 2 instead. One of the most universally applicable standards: almost every reporting entity holds inventory.



Where AS 2 applies

All inventories held by an enterprise — raw materials, work-in-progress, finished goods, stores and spares (other than those in scope of AS 10), loose tools, packing materials, and goods in transit where ownership has passed.



Carved out of AS 2

Work-in-progress on construction contracts (AS 7), shares / debentures / other financial instruments held as stock (AS 13 / Guidance Notes), producer's inventories of livestock, agricultural and forest produce measured at NRV per established industry practice, and machinery spares falling under AS 10.

WHY IT MATTERS

Most-Audited AS

For manufacturing companies, inventory is often 25-40% of total assets.

A 1% error in valuation can move reported PAT by 5-10%.

Inventory valuation is the single most common source of:

- year-end audit adjustments
- tax assessment disputes
- FRRB observations
- earnings management attempts

DEFINITION

What qualifies as inventory under AS 2

Para 3 — 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.



Finished goods

Products ready for sale. Held for sale in ordinary course of business. For a trader — purchased goods. For a manufacturer — completed output.

EXAMPLES

Packaged cement in a cement co.; 2-wheelers off the assembly line; pharma SKUs at dispatch bay.



Work-in-progress

Goods partially converted. Between raw materials and finished goods. Cost includes materials plus conversion costs incurred to date.

EXAMPLES

Steel billets awaiting rolling; tablets pending coating; semi-assembled automobiles.



Raw materials & stores

Inputs to be consumed in production or rendering of services. Includes stores, spares (outside AS 10), packing materials, loose tools.

EXAMPLES

Iron ore at a steel mill; API at a pharma plant; glass bottles at a beverage company.

THE CARDINAL RULE

Lower of Cost and Net Realisable Value

Para 5 — Inventories should be valued at the lower of cost and net realisable value. This is the single most important rule in AS 2. Applied item-by-item in most cases — NOT at an aggregate level.

COST

What you paid (or built it for)

- Cost of Purchase** (Slide 7)
 - + **Cost of Conversion** (Slide 8)
 - + Other costs incurred in bringing inventories to their present location & condition
- = **HISTORICAL COST** per the applicable cost formula.

NET REALISABLE VALUE

What you'd realise today, net of costs

- Estimated Selling Price** in ordinary course of business
 - **Estimated Costs of Completion**
 - **Estimated Costs Necessary to Make the Sale**
- = **NRV** (assessed at each balance sheet date)



Example — Cost of finished goods: ₹5,00,000. Expected sale price: ₹5,50,000. Selling commission @ 10%: ₹55,000. **NRV = 5,50,000 – 55,000 = ₹4,95,000**. Since NRV (₹4,95,000) < Cost (₹5,00,000), write down by ₹5,000 and carry at NRV.

Cost of purchase — what's in, what's out

Para 7 — The costs of purchase include purchase price, duties and taxes (other than those subsequently recoverable from taxing authorities), freight inwards and other directly attributable costs. Trade discounts, rebates, duty drawbacks and similar items are deducted.

INCLUDED IN COST OF PURCHASE

- **Purchase price** as per invoice
- **Import duties &** non-recoverable taxes
- **Freight inwards**, loading & unloading
- **Insurance in transit**, demurrage, handling
- Other **directly attributable** costs to bring materials to present location & condition

LESS: *Trade discounts, rebates, duty drawbacks and similar items*

EXCLUDED FROM COST

- **GST / CENVAT credit** available — recoverable from taxing authority
- **Abnormal wastage** of materials, labour or other production costs
- **Storage costs** (unless necessary in production process before further stage)
- **Administrative overheads** not contributing to bringing inventory to present condition
- **Selling & distribution costs** — always expensed when incurred
- **Interest / borrowing costs** (except where AS 16 permits capitalisation for qualifying assets — rare for inventories)

Conversion costs & overhead allocation

Para 8-9: Cost of conversion = costs directly related to units produced (direct labour) PLUS a systematic allocation of fixed and variable production overheads — based on NORMAL CAPACITY.

Direct costs

Direct labour wages, piece-rate payments, direct consumables traceable to units. Salary of a shop-floor operator → direct; salary of the plant manager → overhead.

Variable overheads

Indirect costs that vary with production volume — power, lubricants, indirect materials, QC consumables. Allocated on actual production.

Fixed overheads

Depreciation of factory, rent of factory premises, salaries of production supervisors. Allocated based on NORMAL capacity — not actual.

NORMAL CAPACITY — THE RULE AUDITORS CHECK (Para 9)

Normal capacity is the production expected to be achieved on average over several periods, taking into account loss of capacity from planned maintenance.

UNDER-ABSORPTION: When actual production < normal capacity, fixed overhead per unit is NOT increased. Unabsorbed portion is **expensed as period cost**.

OVER-ABSORPTION: When actual production > normal capacity, fixed overhead per unit IS reduced so inventories are not measured above cost.

COST FORMULAS

Specific ID / FIFO / Weighted Average

Para 14-17: For items ordinarily interchangeable, use FIFO or Weighted Average Cost. For items NOT ordinarily interchangeable (unique, custom-built, project-specific), use Specific Identification. The chosen formula must be applied consistently.



Specific Identification

For non-interchangeable items

Each item is individually identified and its specific cost is assigned. Used for unique, custom-built or project-specific items. MANDATORY for such items — not optional.

EXAMPLES

Custom-built industrial machinery; high-value jewellery; specific construction project materials; aircraft components.



FIFO

First-In, First-Out

Assumes items bought or produced first are sold or consumed first. Closing stock = latest purchases. Reflects actual physical flow for most goods. Closest to replacement cost in rising-price markets.

EXAMPLES

Dairy products (freshness-driven); pharmaceutical products (batch expiry); most food & FMCG.



Weighted Average

For interchangeable homogeneous items

Average cost recalculated after each receipt. Smooths out price fluctuations. Suited for bulk commodities where individual units cannot be traced.

EXAMPLES

Crude oil at a refinery; bulk cement; grain in a commodity trader; steel in a rolling mill.

Why AS 2 does not permit LIFO

LIFO is NOT permitted under AS 2. Only FIFO, Weighted Average or Specific Identification may be used.

WHY LIFO IS DISALLOWED

01

Does not reflect actual physical flow

Goods are almost never consumed newest-first. LIFO creates an artificial accounting convention disconnected from reality.

02

Distorts inventory balance

Closing stock is valued at oldest costs — which may be decades-old. Balance sheet carries materially outdated inventory values.

03

Manipulation potential

LIFO allows earnings management through timing of purchases — buy at year-end to increase COGS and reduce PAT.

04

Global convergence

IAS 2, Ind AS 2, and most major GAAPs (except US GAAP) prohibit LIFO. India aligned to the international position.

How Net Realisable Value is determined

Para 24-25: NRV is estimated at each balance sheet date based on the most reliable evidence available. Evidence includes post-balance-sheet-date selling prices, contract terms, and market conditions.



Item-by-item basis

NRV is assessed item-by-item in most cases. Grouping permitted only for items of a similar nature / product line where separability is impractical.



RM to finished goods link

If finished goods are expected to be sold at or above cost, the raw materials in them are NOT written down, even if replacement cost has fallen below book cost.



Firm sales contract

Where there is a firm sales contract, NRV is based on the contract price — not general market price. Inventory in excess of contract quantities uses general market price.

INDICATORS OF NRV FALLING BELOW COST

- Physical damage or deterioration
- Obsolescence (technology or fashion)
- Decline in general selling prices
- Expected increase in completion / selling costs
- Regulatory change reducing marketability
- Slow-moving / non-moving inventory (ageing analysis)

Write-down, reversal and expense recognition

CORE PRINCIPLE (Para 26-28)

Carrying amount of inventories sold is recognised as an expense in the period in which related revenue is recognised. The amount of any write-down of inventories to NRV and all losses are also expensed. Reversals of write-downs are recognised in the period of reversal.

WRITE-DOWN TO NRV

When $NRV < Cost$

Journal entry:

Dr. Cost of Goods Sold / Inventory Write-down (P&L)
Cr. Inventory (Balance Sheet)

- Item-by-item in most cases.
- Abnormal losses always expensed.
- Write-down of RMs not automatic if FG to which they relate will sell at or above cost.

REVERSAL OF WRITE-DOWN

When NRV recovers (Para 28)

Journal entry:

Dr. Inventory (Balance Sheet)
Cr. COGS / P&L (reduction in expense)

- Reversal limited to the original write-down. Cannot write UP above original cost.
- Recognise in the period when circumstances no longer support the reduced NRV.
- Disclose amount and circumstances of reversal.

Joint products & by-products

Para 10: When a production process results in more than one product simultaneously, costs of conversion must be allocated among the products on a rational and consistent basis.



JOINT PRODUCTS

Allocate joint costs at split-off point

Characteristics: Multiple products of similar relative value, emerging together from a common process until a split-off point.

Allocation basis: Joint costs up to split-off point are allocated between products on a rational and consistent basis — most commonly:

- Relative sales value at split-off
- Physical measure (kg, litres) where products are similar

Classical examples: Petroleum refining (petrol, diesel, kerosene from one barrel); dairy (butter, cream, skim milk); meat processing; integrated steel plants.



BY-PRODUCTS & SCRAP

Most are immaterial — measured at NRV

Characteristics: Secondary outputs of low relative value compared to the main product(s).

AS 2 treatment: When by-products are immaterial, they are measured at **NRV** and that value is **DEDUCTED from the cost of the main product**.

Consequence: Main product's cost stands reduced; by-product enters inventory at NRV (no profit recognised at production).

Examples: Molasses from sugar; bagasse from sugarcane; bran from flour milling; sawdust from timber.

Service providers' inventories

Service providers also have inventory. WIP on services contracts where revenue is not yet recognised sits on the balance sheet.

WHAT GOES INTO A SERVICE PROVIDER'S INVENTORY — Para 11

INCLUDED

- **Labour costs** of personnel directly engaged in providing the service — including supervisory personnel
- **Attributable overheads** allocated on a rational basis
- **Materials consumed** in rendering the service

EXCLUDED

- **Profit margins** — no mark-up; inventory carried at COST only
- **Non-attributable overheads** — administrative, marketing, sales support
- **Selling personnel costs** — not part of service delivery

EXAMPLE — IT SERVICES / CONSULTING FIRM

An IT consulting firm has a fixed-price contract. At year-end, work is 40% complete; revenue recognition is deferred. Labour cost to date ₹25 lakh + directly attributable overhead ₹8 lakh = WIP of ₹33 lakh on the balance sheet. Profit of ₹15 lakh (expected margin × 40%) is NOT included in WIP — that's revenue recognition, not cost measurement.

Techniques — Standard costing & Retail method

Para 18: Techniques such as standard cost and retail method may be used for convenience IF they APPROXIMATE the actual cost. They are not alternatives to the three cost formulas — they are shortcuts.



STANDARD COSTING

Usable only if standards are reviewed regularly

How it works: Pre-determined standard costs (for materials, labour, overheads) are used for each unit. Variances between standard and actual are adjusted at year-end.

Conditions (Para 18):

- Standards reviewed regularly (ideally annually)
- Revised in light of current conditions
- Variances attributable to efficiency / volume are period-expense, not inventoriable

Typical use: Manufacturing industries — auto components, pharma APIs, chemicals.



RETAIL METHOD

For large inventories of rapidly changing items

How it works: Cost is determined by reducing the retail (selling) value by an appropriate percentage gross margin.

Typical use: Retail businesses with thousands of SKUs at changing mark-ups where item-level cost tracking is impractical.

Application:

- Average margin for a department / product group
- Apply to closing retail value → cost proxy

Examples: Department stores; supermarket chains; apparel retailers.

Where AS 2 goes wrong in practice



COMMON AUDIT FINDINGS

Top seven issues inspectors raise

- 1 **NRV not assessed item-by-item** — aggregate NRV comparison hides item-level write-downs.
- 2 **Fixed overheads absorbed on actual, not normal capacity** — low-production periods inflate inventory cost artificially.
- 3 **Abnormal wastage capitalised** — rejected batches added to WIP instead of being expensed.
- 4 **Ageing analysis not done** — slow-moving & obsolete inventory not identified; NRV write-down missed.
- 5 **Cost formula inconsistency** — different formulas applied to similar inventory classes without justification.
- 6 **GST / input credit included in cost** — Para 7 violation; recoverable taxes must be excluded.
- 7 **Physical count reconciliation gaps** — book vs physical differences not investigated or adjusted.



DISCLOSURE

Key disclosures required

- Accounting policy adopted in measuring inventories
- Cost formula used (FIFO / WAC / Specific ID)
- Total carrying amount of inventories classified by type (RM, WIP, FG, stores)
- Inventories carried at NRV where write-down has been made
- Amount of write-down recognised as expense
- Amount of reversal of prior write-down and circumstances
- Inventories pledged as security for liabilities

Key Takeaways

01

Lower of Cost and NRV is the cardinal rule. Applied item-by-item in most cases — not at aggregate level.

02

Cost includes purchase + conversion + directly attributable costs. Selling costs, abnormal wastage and admin overheads are expensed.

03

Fixed overheads allocated based on NORMAL capacity — not actual. Under-absorbed fixed overhead is period expense.

04

FIFO, Weighted Average and Specific Identification are the only permitted cost formulas. LIFO is prohibited under AS 2.

05

NRV write-downs hit P&L; reversals up to (but never above) original cost are permitted when circumstances change.

06

Service providers have inventory too — WIP at cost only, no profit margin embedded.

Discussion & Questions

Thank You

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