CHAPTER

2

ICDS II : VALUATION OF INVENTORIES

2.1 SCOPE

*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 the Income Computation and Disclosure Standard 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.

AS/Ind Comparison

Scope of the Standard	
AS - 2	Inventories ***do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, Property, Plant and Equipment***. Such items are accounted for in accordance with Accounting Standard (AS) 10, *Property, Plant and Equipment*.
Ind AS - 2	- Ind AS-2 does ***not apply to commodity broker-traders who measure their inventories at fair value less costs to sell.***

	- Ind AS-2 also ***scopes out the biological assets related to agricultural activity and agricultural produce*** at the point of harvest. - No specific mention of ***machinery spares***.

2.2 DEFINITIONS

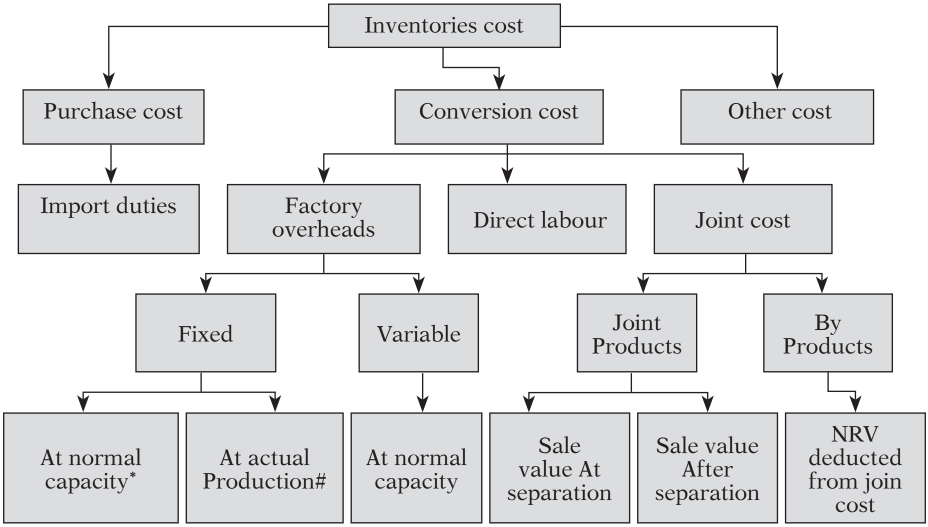
The following terms are used in this Income Computation and Disclosure Standard with the meanings specified:

(*a*) ***"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.
(*b*) ***"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.
Words and expressions used and not defined in this Income Computation and Disclosure Standard but defined in the Act shall have the meanings assigned to them in that Act.	

2.3 MEASUREMENT

Inventories shall be valued at **cost**, or **net realisable value**, whichever is lower.

2.3.1 Cost of inventories *shall comprise of*	(*a*) all costs of purchase, (*b*) costs of services, (*c*) costs of conversion and (*d*) other costs incurred in bringing the inventories to their present location and condition.



*When actual production is almost equal or lower than normal capacity
#When actual production is higher than normal capacity

2.3.2 Costs of Purchase	The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates and other similar items shall be deducted in determining the costs of purchase.

AS/Ind Comparison

Cost of Purchase	
AS - 2	The costs of purchase consist of the purchase price including duties and taxes **(other than those subsequently recoverable by the enterprise from the taxing authorities),** freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.
Ind AS - 2	The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), ***and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services.*** Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

The ICDS prescribes 'inclusive method' while the Accounting Standards prescribe 'exclusive method'. The illustrations given in the Guidance Note on Tax Audit under section 44AB of the Income-tax Act, 1961 show that the overall impact of the adjustments made to comply with the provisions of section 145A on the income of the assessee is *nil*. 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.

2.3.3 Costs of Services	The costs of services shall consist of labour and other costs of personnel directly engaged in providing the service including supervisory personnel and attributable overheads.

The reference to 'service provider' in paragraph 6 of ICDS II as notified on 31st March, 2015 has been omitted in the revised ICDS II issued on 29th September, 2016. Further, the definition of "inventories" as per paragraph 2(1)(*a*) does not include work-in-progress of a service provider. It only includes materials or supplies to be consumed in the rendering of services, and not even material actually consumed. Considering this, in case of service providers, ICDS II will not have application and value of service not fully rendered need not be computed under this ICDS. This is also indicated by the scope of the ICDS, which excludes work-in-progress which is dealt with by other ICDS.

2.3.4 Costs of Conversion includes:	(*a*) costs directly related to the units of production and (*b*) Systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. ***Fixed production overheads*** shall be those indirect costs of production that remain relatively constant regardless of the volume of production. ***Variable production overheads*** shall be those indirect costs of production that vary directly or nearly directly, with the volume of production. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion shall be based on the normal capacity of the production facilities. ***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.

	Joint products 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. ***By products*** Where by products, scrap or waste materials are immaterial, they shall be measured at net realisable value and this value shall be deducted from the cost of the main product.
2.3.5 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.

AS/Ind Comparison

Cost of Conversion	
AS - 2	The actual level of production ***may be used***, if it approximates normal capacity
Ind AS - 2	

2.3.6 Exclusions from the Cost of Inventories

In determining the cost of inventories, the following costs shall be excluded and recognised as expenses of the period in which they are incurred, namely:-	(*a*) *Abnormal amounts* of wasted materials, labour, or other production costs; (*b*) *Storage costs*, unless those costs are necessary in the production process prior to a further production stage; (*c*) *Administrative overheads* that do not contribute to bringing the inventories to their present location and condition; (*d*) *Selling costs*.

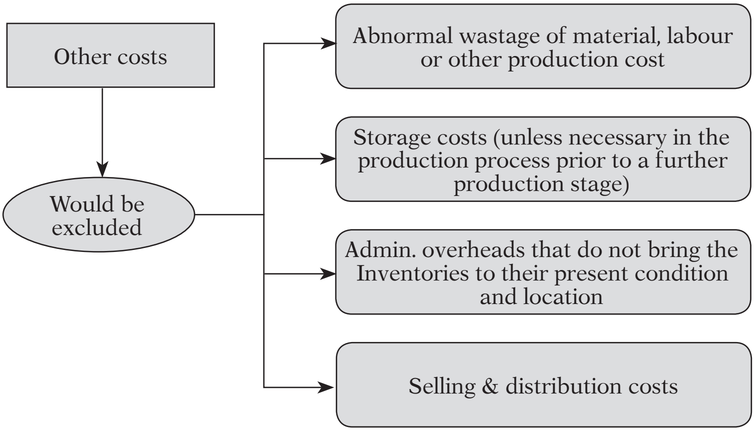


ILLUSTRATION 2.1

Direct Material cost ₹ 100 per kg

Direct labour cost ₹ 20 per kg

Direct variable production overhead ₹ 10 per kg

Fixed production charges for the year on normal capacity of one lakh kgs. is ₹ 10 lakhs. 2000 kgs. of finished goods are on stock at the year-end.

Value the inventory.

SOLUTION:

The costs of conversion include systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for their purpose of their inclusion in the cost of conversion is based on normal capacity of the production facilities. Thus cost per kg is computed as follows:

	₹	₹
Material cost	100	
Direct labour cost	20	
Direct variable production overhead	10	
Fixed production overhead (₹ 1000000/100000)	10	40
Total		140
Value of finished goods (2000 × ₹ 140)	**₹ 280000**	

ILLUSTRATION 2.2

Can G Ltd. a wire netting company, while valuing its finished goods at the year-end include interest on bank overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses?

SOLUTION

The cost of inventories comprise of all costs of purchase, cost of comparison and other costs incurred in bringing the inventories to their present location and condition. Interest and other borrowing costs are usually considered as overheads that don't contribute to bringing the inventories to their present location and condition.

Therefore, the proposal of G Ltd. to include interest on bank overdraft as an element of cost is not tenable. Interest of bank overdraft will not form part of cost of production.

2.3.7 Cost Formulae

2.3.7.1 The Cost of inventories of items

(*i*) that are not ordinarily interchangeable; and

(*ii*) goods or services produced and segregated for specific projects

shall be assigned by specific identification of their individual costs.

'**Specific identification of cost**' means specific costs are attributed to identified items of inventory.

Where there are a large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs shall not be made.

AS/Ind Comparison

Cost Formula	
AS - 2	- It is ***not expressly mandated to use the same cost formula consistently for all inventories that have a similar nature and use to the entity***. The formula used ***should reflect the fairest possible approximation to the cost*** incurred in bringing the items of inventory to their present location and condition. - Techniques such as standard cost or retail method may be used for convenience, if the results approximate the actual cost.
Ind AS - 2	- Requires an entity ***to 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.***

2.3.7.2 First-in First-out and Weighted Average Cost Formula

Cost of inventories, other than the inventory dealt with in paragraph 2.3.7.1, shall be assigned by using the First-in First-out (FIFO), or weighted average cost formula. The formula used shall reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition:

(*a*) The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced.

(*b*) 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 shall be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances.

2.3.7.3 Techniques for the Measurement of Cost

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. 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.

2.3.7.4 Retail Method

- Where it is impracticable to use the costing methods referred to in paragraph 2.3.7.2, the retail method can be used in the retail trade for measuring inventories of large number of rapidly changing items that have similar margins.
- 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.

AS/Ind Comparison

Retail Method	
AS - 2	Adjusting sale value by appropriate percentage gross margin is the general approach permitted. ***An average percentage for each retail department is often used.***
Ind AS - 2	

ILLUSTRATION 2.3: RETAIL METHOD

Trousers 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 trousers of a carton of 20 trousers is ₹ 10000.

Accordingly each carton will be valued at ₹ 8000 (₹ 10000 - ₹ 1000 x 20%) and each

Trouser would cost ₹ 8000/20 = ₹ 400.

2.3.8 Net Realisable Value

- Inventories shall be written down to net realisable value on an item-by-item basis.

- Where 'items of inventory' relating to the same product line having similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line, such inventories shall be grouped together and written down to net realisable value on an aggregate basis.
- Net realisable value shall be based on the most reliable evidence available at the time of valuation. The estimates of net realisable value shall also take into consideration the purpose for which the inventory is held. The estimates shall take into consideration fluctuations of price or cost directly relating to events occurring after the end of previous year to the extent that such events confirm the conditions existing on the last day of the previous year.
- 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.

ILLUSTRATION 2.4

The company deals in three products X, Y and Z, which are neither similar nor Inter-changeable. At the time of closing of Accounts at 31-3-2019 the historical cost and NRV of the items of closing stock were as follows:

Items	Historical cost (₹ in lakhs)	NRV (₹ in lakhs)
A	40	28
B	32	32
C	16	24

Value the inventories.

SOLUTION

As per AS 2 inventories would be valued at lower of cost or NRV. Accordingly the Inventories values item-wise would be as under:

Items	Historical cost (₹ in lakhs)	NRV (₹ in lakhs)	Closing Stock (₹ in lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
TOTAL	88	84	76

2.4 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

(*ii*) the value of the inventory as on the close of the immediately preceding previous year, in any other case.

2.5 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. However, **'reasonable cause'** is not defined. The guidance for the same will need to be taken from judicial precedents.

AS/Ind Comparison

Change in Method of Valuation	
AS - 2	Change from one cost formula to another constitutes a change in an accounting policy. As such, ***pursuant to AS 5, a change in method of valuation of inventories*** should be made only if ***it is required by statute or for compliance with an AS or*** if it is considered that the change ***would result in a more appropriate presentation of the financial statements*** of the enterprise.
Ind AS - 2	Change from one cost formula to another constitutes a change in an accounting policy. A change in an accounting policy can only be made ***if the change is required by an Ind AS***, or results in the financial statements ***providing reliable and more relevant information.***

IT Case Laws

Relevant case laws on Change in Valuation Method of Inventory:	
Query:	**Is the change of method of valuation of inventory justified?**
Case - 1	**Snow White Food Products Co. Ltd. v. CIT [1982] 10 Taxman 37 (Cal.)** **FACTS**: Assessee had been following the mercantile system of accounting hitherto and had done so even in the relevant year except for the interest income and that there was no resolution by the board of directors or the shareholders of the assessee supporting the change, except for a statement in the annual report to the effect that the management had decided to account for interest on cash basis, from which it was not established that the assessee had decided to change its regular method.
	HELD: In the instant case the Tribunal had held specifically that on the evidence on record it could not be said the assessee had decided to change its existing regular method of accounting by another regular method. Hence, the Tribunal was right in holding that the assessee-company was

	not entitled to change its method of accounting from the mercantile to the cash system insofar as the credits in the interest account were concerned and thus, the interest accrued during the relevant year but not received was liable to be included in that assessment year.
Case - 2	**Uniflex Industries (P.) Ltd v. ITO [2007] 15 SOT 246 (Luck. - Trib.)** **FACTS:** The assessee had changed the method of valuation of closing stock of finished goods and work-in-progress from 'net realizable value' to 'lower of cost or net realizable value'. This change had resulted in decrease in net profit. The Assessing Officer held that the assessee had been valuing the closing stock of finished goods and work-in-progress at 'net realizable value' since last many years and there appeared no reason to change the accounting policy except to reduce the taxable profit during the accounting year under consideration.
	HELD: The Accounting Standard-2 issued by the Institute of Chartered Accountants of India has been made mandatory in the case of companies. This Accounting Standard deals with valuation of inventories. As per clause 5 of this Accounting Standard-2, inventories should be valued at 'lower of cost or net realizable value'. Therefore, the assessee had no option but to value its closing stock of finished goods and work-in-progress at 'lower of cost or net realizable value'.
Case - 3	**Indo Rama Synthetic Ltd. v. CIT [2011] 9 taxmann.com 25 (SC)** **FACTS:** In course of assessment, Assessing Officer passed an order that assessee had changed method of valuation of inventory, which had resulted in inventory being shown at a lower value - Commissioner (Appeals) set aside order of Assessing Officer.
	HELD: On revenue's appeal, Tribunal noted that change in method of valuation of inventory was a result of recommendation in consonance with AS-2 on valuation of inventories - It was further noticed that assessee had followed changed method consistently in subsequent year - Thus, Tribunal upheld order of Commissioner (Appeals).
Conclusion	**The method of valuation of inventory shall not be changed without a reasonable cause and shall be followed consistently in subsequent year.**

ILLUSTRATION 2.5

O Ltd. has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers godown. Upto 2017-18 the company regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2018-19. This would result into decrease in profit by ₹ 7.6 lakhs.

How would you deal with the following in the annual accounts of a company for the year ended 31st March 2019?

SOLUTION

Para 29 of *AS 5 (Revised) "Net profit or loss for the period, prior period items and Changes in Accounting policies*" states that a change in an accounting policy should be made only if :

(*a*) It is required by statute, or

(*b*) for compliance with an accounting standard or

(*c*) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Therefore the change in method of stock valuation is justified in view of the fact that the change is in line with the recommendation of *AS 2 (Revised) Valuation of Inventories* and would result in a more appropriate preparation of financial statements.

The following disclosure needs to be made in financial statements:

"In compliance with the Accounting standards issued by the ICAI, delayed Cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by ₹ 7.60 lakhs."

As per ICDS, the method of valuation of inventories may be changed in any previous year only if there is a reasonable cause. It may be argued that aligning with AS-2 (Revised) and for better presentation is a reasonable cause and justified to change.

2.6 VALUATION OF INVENTORY IN CASE OF CERTAIN DISSOLUTIONS

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**.

ICDS II now prescribes valuation of inventory at NRV in all cases where there is dissolution of a firm, AOP or BOI, irrespective of the fact whether on dissolution the business has been discontinued or not.

AS/Ind Comparison

Inventory Valuation on dissolution of firm	
AS - 2	Because of going concern assumption, these situations are not dealt with in AS 2 and Ind AS 2
Ind AS - 2	

The following case laws are over ruled by ICDS:

IT Case Laws

Relevant Case Laws Overruled by ICDS:	
Query:	**Is it mandatory to value of inventory a market price in case of dissolution due to death of a partner and reconstituted with remaining partners/proprietorship?**
Case - 1	**Sakthi Trading Co. v. CIT [2001] 118 Taxman 301 (SC)** The Commissioner of Income Tax came to the conclusion that the Income Tax Officer ought to have valued the closing stock at its market rate. The contention of the assessee that valuing the closing stock at the market value can arise only on discontinuance of the business and as the business of the firm was never discontinued but was taken over on succession by another firm, the closing stock was not required to be revalued at the market value.
Case - 2	**Kwality Steel Suppliers v. CIT [2004] 141 Taxman 177 (Guj.)** The assessee-firm's return was assessed under section 143(3). Subsequent thereto, the Commissioner being of the view that since during the accounting year the firm was dissolved, the closing stock should have been valued at market rate, in exercise of his jurisdiction under section 263, set aside the assessment order and directed the Assessing Officer to reframe the assessment accordingly.
Case - 3	**Asstt. CIT v. Kuldip Chand & Sons [2005] 93 ITD 253 (Asr. - Trib.)** The assessee-firm was engaged in the business of purchase and sale of gold and silver ornaments. Due to death of one partner, the firm was dissolved and the business was taken over by the sole remaining partner. The assessee had, as usual, valued the closing stock on average price basis.
HELD	The authority came to the conclusion that the business was not discontinued though the firm was dissolved, the question of realizing the value of the goods does not arise and there was no necessity for revaluing the closing stock. For the purpose of valuation of closing stock in a case where there is a dissolution, market value has to be adopted where the dissolution is accompanied by discontinuance of the business and not otherwise.
Conclusion	In case of dissolution due to death of a partner and reconstituted with remaining partners/proprietorship thereby **if continuation of business than the stock continued to be valued at the same method as applied in the past.**

ILLUSTRATION 2.6

Mr. X, a partner wants to retire from ABC Partnership firm w.e.f. 1st April 2019 and other partners desirous of continuation of business under the same name and style. The firm has inventory as on the date of dissolution. How the inventory shall be valued as on 31st March, 2019 as per ICDS?

The inventory shall be measured at Net Realisable value. As per para 24 of ICDS-II, in case of dissolution of partnership firm or association of person or body of individuals whether business is discontinued or not, the inventory on the date of dissolution shall be valued at net realizable value.

2.7 DISCLOSURE REQUIREMENTS

The following aspects shall be disclosed, namely:—

(*a*) the accounting policies adopted in measuring inventories including the cost formulae used; and

(*b*) the total carrying amount of inventories and its classification appropriate to a person

2.8 RELEVANT FORM 3CD REPORTING CLAUSE

2.8.1 Clause 14: Method of Stock Valuation

(*a*)	Method of valuation of closing stock employed in the previous year.			
(*b*)	In case of deviation from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish:			
	Serial Number	*Particulars*	*Increase in Profit (₹)*	*Decrease in Profit (₹)*

2.8.2 Section 145A of Income-tax Act, 1961:

Notwithstanding anything to the contrary contained in section 145, the valuation of purchase and sale of goods and inventory for the purposes of determining the income chargeable under the head “Profits and gains of business or profession” shall be—

(1) in accordance with the method of accounting regularly employed by the assessee; and

(2) further 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 to the place of its location and condition as on the date of valuation.

Explanation.—For the purposes of this section, any tax, duty, cess or fee (by whatever name called) under any law for the time being in force, shall include all such payment notwithstanding any right arising as a consequence to such payment.

The method of Stock Valuation shall be guided by principal of AS-2 on Valuation of Inventory issued by ICAI.

ICAI Guidance Note on Tax Audit, the method of valuation of closing stock is to be stated under this clause. AS-2 “Valuation of Inventories” issued by ICAI requires disclosure of significant accounting policies. Accordingly, a reference may be invited to the same or the method of valuation may be again described in Form No. 3CD.

Amendment in Income-tax Act (Finance Act, 2018)

Section 145A

For the purpose of determining the income chargeable under the head "Profits and gains of business or profession",––

(*i*) the valuation of inventory shall be made at lower of actual cost or net realizable value computed in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145;

(*ii*) 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;

(*iii*) the inventory being securities not listed on a recognized stock exchange, or listed but not quoted on a recognized stock exchange with regularity from time to time, shall be valued at actual cost initially recognized in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145;

(*iv*) the inventory being securities other than those referred to in clause (*iii*), shall be valued at lower of actual cost or net realizable value in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145:

Provided that the comparison of actual cost and net realizable value of securities shall be made category-wise.

Explanation 1.—For the purposes of this section, any tax, duty, cess or fee (by whatever name called) under any law for the time being in force, shall include all such payment notwithstanding any right arising as a consequence to such payment.

Explanation 2.—For the purposes of this section, "recognised stock exchange" shall have the meaning assigned to it in clause (*ii*) of *Explanation 1* to clause (*5*) of section 43.

2.8.3 Clause 14(a) : Method of Valuation

The method of valuation followed by the assessee having regard to the articles or goods dealt in or manufactured by the assessee should be clearly indicated. Some examples are given below:

(*i*) raw material at cost or net realisable value whichever is lower,

(*ii*) finished goods at cost or net realizable value whichever is lower.

2.8.4 Clause 14(b) : Change in method of Valuation:

It is not necessary to indicate any change in the method of valuation of closing stock under this clause. However, any such change in the method of valuation of closing stock would amount to change in an accounting policy and needs to be disclosed in the financial statements as required by AS-1 and AS (IT).

The details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on the profit or loss have to be stated under clause 14(*b*).

Section 145A was enacted by the Finance (No. 2) Act, 1998 and came into force from A.Y. 1999-2000. This section provides that the valuation of purchase and sale of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of the method of accounting regularly employed by the assessee but this shall be subject to certain adjustments.

> *"Computation of value of inventory.*
>
> *The issue relating to whether the value of closing stock of the inputs, work-in-progress and finished goods must necessarily include the element for which MODVAT credit is available has been the matter of considerable litigation.*
>
> *In order to ensure that the value* ***of opening and closing stock*** *(bold for emphasis) reflect the correct value, it is proposed to insert a new section to clarify that while computing the value of the inventory as per the method of accounting regularly employed by the assessee, the same shall include the amount of any tax, duty, cess or fees paid or liability incurred for the same under any law in force.*
>
> *The proposed amendment which is clarificatory in nature shall take effect retrospectively from the 1st day of April, 1986 and will accordingly apply in relation to assessment year 1986-87 and subsequent years.* [Clause 45]"

Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustments provided in this section can be made while computing the income for the purpose of preparing the return of income. These adjustments are as follows:

(1) Any tax, duty, cess or fee actually paid or incurred on inputs should be added to the cost of inputs (raw materials, stores etc.) if not already added in the books of account.

(2) Any tax, duty, cess or fee actually paid or incurred on sale of goods should be added to the sales, if not already added in the books of account.

(3) Any tax, duty, cess or fee actually paid or incurred on the inventory (finished goods, work-in-progress, raw materials etc.) should be added to the inventories, if not already added while valuing the inventory in the accounts.

2.9 FAQs ISSUED BY CBDT (DATED 23-3-2017)

1. Preamble of ICDS-I states that this ICDS is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purposes of maintenance of books of account. However, Para 1 of ICDS-I states that it deals with significant accounting policies. Accounting policies are applied for maintenance of books of account and preparing financial statements. What is the interplay between ICDS-I and maintenance of books of account?

Answer: As stated in the Preamble, ICDS is not meant for maintenance of books of account or preparing financial statements. Persons are required to maintain books of account and prepare financial statements as per accounting policies applicable to them. For example, companies are required to maintain books of account and prepare financial statements as per requirements of Companies Act, 2013. The accounting policies mentioned in ICDS-I being fundamental in nature shall be applicable for computing income under the heads "Profits and gains of business or profession" or "Income from other sources".

2. ICDS-I requires disclosure of significant accounting policies and other ICDS requires specific disclosures. Where is the taxpayer required to make such disclosures specified in ICDS?

Answer: Net effect on the income due to application of ICDS is to be disclosed in the Return of income. The disclosures required under ICDS shall be made in the tax audit report in Form 3CD. However, there shall not be any separate disclosure requirements for persons who are not liable to tax audit.

3. Para 4(H) of ICDS-I provides that Market to Market (MTM) loss or an expected loss shall not be recognized unless the recognition is in accordance with the provisions of any other ICDS. Whether similar consideration applies to recognition of MTM gain or expected incomes?

Answer: Same principle as contained in ICDS-I relating to MTM losses or an expected loss shall apply *mutatis mutandis* to MTM gains or an expected profit.

4. ICDS-I provides that an accounting policy shall not be changed without 'reasonable cause'. The term 'reasonable cause' is not defined. What shall constitute 'reasonable cause'?

Answer: Under the Act, 'reasonable cause' is an existing concept and has evolved well over a period of time conferring desired flexibility to the tax-payer in deserving cases.

SUMMARY

Key Points:

- Inventories has been defined to mean assets held for
  - Sale in the ordinary course of business
  - In the process of production for such sale
  - In the form of materials or supplies to be consumed in the production process or in the rendering of services
- Inventory is to be valued at cost or net realisable value whichever is lower.
- Method of valuation of inventory once adopted cannot be changed, unless there is reasonable cause for doing so.
- In case of dissolution of a partnership firm or Association of Persons ('AOP') or Body of Individuals ('BOI'), value of inventories shall be the net realizable value on the date of dissolution.
- The disclosure of the accounting policies adopted in measuring inventories including the cost formulae used and total carrying amount of inventories and its classification appropriate to a person shall be made.

Practice Notes:

- If an exclusive method is followed for the purpose of valuation of inventory as per Accounting Standard (AS), the tax payer would be required to prepare the memorandum account to demonstrate that *vis-a-vis* inclusive method, it is tax neutral.
- In case of service providers ICDS II will not have application and value of service not fully rendered need not be computed under this ICDS.
- The valuation of inventory at NRV is mandatory in all cases where there is dissolution of a firm, AOP or BOI, irrespective of the fact whether on dissolution the business has been discontinued or not. Under section 2(*23*) of the Act, the term 'firm' includes a limited liability partnership as defined under the Limited Liability Partnership Act, 2008.