UNIT -1

What Is Inventory Valuation and Why Is It Important

Inventory valuation is the monetary amount associated with the goods in the inventory at the end of an accounting period. The valuation is based on the costs incurred to acquire the inventory and get it ready for sale.

Inventories are the largest current business assets. Inventory valuation allows you to evaluate your Cost of Goods Sold (COGS) and, ultimately, your profitability. The most widely used methods for valuation are FIFO (first-in, first-out), LIFO (last-in, first-out) and WAC (weighted average cost).

What Are the Objectives of Inventory Valuation?

Inventory refers to the goods meant for sale or unsold goods. In manufacturing, it includes raw materials, semi-finished and finished goods. Inventory valuation is done at the end of every financial year to calculate the cost of goods sold and the cost of the unsold inventory.

This is crucial as the excess or shortage of inventory affects the production and profitability of a business.

Determine the Gross Income

Inventory is used to find the gross profit, which is the excess of sales over cost of goods sold. To determine the gross profit or the trading profit, the cost of goods sold is matched with the revenue of the accounting period.

Cost of goods sold = Opening stock + Purchases – Closing stock

The above equation shows that the inventory value affects the cost and thereby the gross profit. For example, if the closing stock is overvalued, it will inflate the current year’s profit and reduce profits for subsequent years.

Ascertain the Financial Position

Closing stock is shown as a current asset. The value of the closing stock on the Balance Sheet determines the financial position of the business. Overvaluation or undervaluation can give a misleading picture of the working capital position and the overall financial position.

How Inventory Is Valued

The method for valuing inventory depends on how the stock is tracked by the business over time. A business must value inventory at cost. Since inventory is constantly being sold and restocked and its price is continually changing, the business must make a cost flow assumption that it will use frequently.

There are four accepted methods of inventory valuation.

- Specific Identification
- First-In, First-Out (FIFO)
- Last-In, First-Out (LIFO)
- Weighted Average Cost

Specific Identification

Under this method, every item in your inventory is tracked from the time it is stocked to when it is sold. It is usually used for large items that can be easily identified and have widely different features and costs associated with these features.

The primary requirement of this method is that you should be able to track every item individually with RFID tag, stamped receipt date or a serial number.

While this method introduces a high degree of accuracy to the valuation of inventory, it is restricted to valuing rare, high-value items for which such differentiation is needed.

First-In, First-Out (FIFO)

This method is based on the premise that the first inventory purchased is the first to be sold. The remaining assets in inventory are matched to the assets that are most recently purchased or produced.

It is one of the most common methods of inventory valuation used by businesses as it is simple and easy to understand. During inflation, the FIFO method yields a higher value of the ending inventory, lower cost of goods sold, and a higher gross profit.

Unfortunately, the FIFO model fails to present an accurate depiction of the costs when there is a rapid hike in prices. Also, unlike the LIFO method, it does not offer any tax advantages.

Last-In, First-Out (LIFO)

Under this inventory valuation method, the assumption is that the newer inventory is sold first while the older inventory remains in stock. This method is hardly used by businesses since the older inventories are rarely sold and gradually lose their value. This results in significant loss to the business.

The only reason to use LIFO is when businesses expect the inventory cost to increase over time and lead to a price inflation. By moving high-cost inventories to cost of goods sold, the reported profit levels businesses can be lowered. This allows businesses to pay less tax.

Weighted Average Cost

Under the weighted average cost method, the weighted average is used to determine the amount that goes into the cost of goods sold and inventory. Weighted average cost per unit is calculated as follows:

Weighted Average Cost Per Unit = Total Cost of Goods in Inventory / Total Units in Inventory

This method is commonly used to determine a cost for units that are indistinguishable from one another and it is difficult to track the individual costs.

Which Inventory Valuation Method Is Best

Choosing the right inventory valuation method is important as it has a direct impact on the business's profit margin. Your choice can lead to drastic differences in the cost of goods sold, net income and ending inventory.

There are advantages and disadvantages of each method. For example, the LIFO method will give you the lowest profit because the last inventory items bought are usually the most expensive while the FIFO will give you the highest profit as the first items in stock are usually the cheapest.

To assess the method which is best for you, you need to pay attention to changes in the inventory costs.

- If the inventory costs are escalating or are likely to increase, LIFO costing may be better. As higher cost items are considered sold, it results in higher costs and lower profits.
- In case your inventory costs are falling, FIFO might be the best option for you.
- For a more accurate cost, use the FIFO method of inventory valuation as it assumes the older items that are less costly are the ones sold first.

As a business owner, you need to analyze each method and apply the method that reflects the periodic income accurately and suits your specific business situation. The Financial Accounting Standards Board (FASB), in its Generally Accepted Accounting Procedures, allows both FIFO and LIFO accounting.

It is also important to note businesses cannot switch from one method of inventory valuation to another. If your business decides to change to LIFO accounting from FIFO accounting, you must file Form 970 with the IRS.

Corporate Accounting

Corporate Accounting is a special branch of accounting which deals with the accounting for companies ,preparation of their final accounts and cash flow statements, analysis and interpretation of companies's financial results and accounting for specific events like amalgamation, absorption, preparation of consolidated balance sheets. A public company usually refers to a company that is permitted to offer its registered securities (stock, bonds, etc.) for sale to the general public, typically through a stock exchange, but also may include companies whose stock is traded over the counter (OTC) via market makers who use non-exchange quotation services such as the OTCBB and the Pink Sheets. The term "public company" may also refer to a government-owned corporation. This meaning of a "public company" comes from the tradition of public ownership of assets and interests by and for the people as a whole (public ownership), and is the less-common meaning in the United States. Advantages It is able to raise funds and capital through the sale of its securities. This is the reason why public corporations are so important: prior to their existence, it was very difficult to obtain large amounts of capital for private enterprises. In addition to being able to easily raise capital, public companies may issue their securities as compensation for those that provide services to the company, such as their directors, officers, and employees.

PRIVATE COMPANY The term privately held company refers to the ownership of a business company in two different ways: first, referring to ownership by non-governmental organizations; and second, referring to ownership of the company's stock by a relatively small number of holders who do not trade the stock publicly on the stock market. Because of these two different meanings, the use of the term should normally be avoided unless the context makes clear which definition is intended. Less ambiguous terms for a privately held company are unquoted company and unlisted company. Though less visible than their publicly traded counterparts, private companies have a major importance in the world's economy. In 2005, the 339 companies on Forbes' survey of closely held U.S. businesses sold a trillion dollars' worth of goods and services and employed 4 million people. In 2004, the Forbes' count of privately held U.S. businesses with at least $1 billion in revenue was only 305.[1] Koch Industries, Bechtel, Cargill, Chrysler, PricewaterhouseCoopers, Flying J, Ernst & Young, Publix, and Mars are among the largest privately held companies in the United States. IKEA, Victorinox, and Bosch are examples of Europe's largest privately held companies. There has been a general confusion among corporate managers about whether to have the status of their company as private or public. Well, it basically depends on the requirement it needs to be. Notably, many companies prefer it to be private considering the kind of privileges they enjoy being private. Here’s a brief list of concessions and privileges which favour formation of private limited companies: Privileges: - Limited liability, - Simple and easy formation, - Immediate commencement of business upon incorporation, - Liberal payment of remuneration and loans to directors without any restrictions, - Easier inter-corporate loans - Lesser disclosure requirements - Tremendous ease in operation - Two directors are enough - Two Shareholders are adequate - Need not declare dividend - Listing of shares not mandatory - Directors need not hold qualification shares These continue to be the dominating factors for carrying on trade and industry through the medium of private limited companies. Limitations: Nevertheless, there are limitations too. Under the Companies Act, a private limited company is: - prohibited to issue any invitation to the public to subscribe to any shares or in debentures of the company - to limit the number of its members to 50 - to restrict the right of its members to transfer shares

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Financial Statements
Financial statements serves as a means of communicating information about the profitability (income statement) and the financial position (Balance Sheet) of the business in a concise and understandable manner at the end of accounting period.

Financial statements include these statements:
(i) Income statement (Trading and Profit and Loss Account)—prepared to ascertain gross profit and net profit/loss during an accounting period.
(ii) Statement of Financial Position (Balance Sheet)—prepared to ascertain position (assets, liabilities and capital) of an enterprise at a particular point of time.
(iii) Schedules and notes forming part of Balance sheet and Income statement —to give detail of various items shown in both the statements.
Capital Expenditure
The non-recurring expenditure whose benefit is derived by the business for more than a year is called Capital Expenditure.

It includes amount spent or liabilities incurred to acquire or improve any fixed assets or acquiring any legal rights or first-time expenses incurred to make fixed assets workable e.g. purchase of machinery/building/furniture etc., expenses incurred to acquired Patents, Trade-mark etc. and expenditure incurred for getting an asset ready to use (like installation exp., carriage, first time expenses incurred on second hand fixed asset for making it ready

Meaning of Financial Statements Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties which include investors, tax authorities, government, employees, etc. These refer to: the balance sheet (position statement) as at the end of accounting period, the statement of profit and loss of a company and the cash flow statement Financial Statements of a Company 3 LEARNING OBJECTIVES

After studying this chapter, you will be able to : • explain the nature and objectives of financial statements of a company; • describe the form and content of Statement of Profit and Loss of a company as per schedule III; • describe the form and content of balance sheet of a company as per schedule III; • explain the significance and limitations of financial statements; and • prepare the financial statements. 2022-23 Financial Statements of a Company 145 3.2 Nature of Financial Statements The chronologically recorded facts about events expressed in monetary terms for a defined period of time are the basis for the preparation of periodical financial statements which reveal the financial position as on a date and the financial results obtained during a period. The American Institute of Certified Public Accountants states the nature of financial statements as, “the statements prepared for the purpose of presenting a periodical review of report on progress by the management and deal with the status of investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting principles and personal judgements”

Financial Statements

The financial statements generally include two statements: balance sheet and statement of profit and loss which are required for external reporting and also for internal needs of the management like planning, decision-making and control. Apart from these, there is also a need to know about movements of funds and changes in the financial position of the company. For this purpose, a cash flow statement is prepard. Every company registered under The Companies Act 2013 shall prepare its balance sheet, statement of profit and loss and notes to account thereto in accordance with the manner prescribed in the revised Schedule III to the Companies Act, 2013 to harmonise the disclosure requirement with the accounting standards and to converge with new reform

Features of Presentation

1. It applies to all Indian companies preparing financial statement as per Schedule III to the Comapnies Act, 2013.

2. It does not apply to (i) Insurance or Banking Company, (ii) Company for which a form of balance sheet or income statement is specified under any other Act

. 3. Accounting standards shall prevail over Schedule III of the Companies Act, 2013

. 4. Disclosure on the face of the financial statements or in the notes are essential and mandatory. 2022-23 Financial Statements of a Company 149

5. Terms in the revised Schedule III will carry the meaning as defined by the applicable accounting standards.

6. Balance to be maintained between excessive details that may not assist users of financial statements and not providing important information.

7. Current and non-current bifurcation of assets and liabilities is applicable

What is Depreciation? Straight Line Method

Meaning of Depreciation

Depreciation can be defined as a continuing, permanent and gradual decrease in the book value of fixed assets. This type of shrinkage is based on the cost of assets utilised in a firm and not on its market value.

DEPRECIATION

Features of Depreciation

Following are the 3 principal features of depreciation:

- Depreciation is a decrease in the book value of fixed assets.
- Depreciation involves loss of value of assets due to the passage of time and obsolescence.
- Depreciation is an ongoing process until the end of the life of assets.

Causes of Depreciation

1. **Wear and Tear due to Use or Passage of Time:** Wear and tear is nothing but deterioration and the following decrease in the value of an asset, resulting from its use in business operations for earning revenue.
2. **Expiration of Legal Rights**: Some categories of assets lose their value after the agreement directing their use in business comes to an end after the expiry of the predetermined period.
3. **Obsolescence:** Obsolescence is another factor driving to the depreciation of fixed assets. In common language, obsolescence means being "out-of-date". Obsolescence refers to an actual asset becoming outdated on account of the availability of a better type of asset.
4. **Abnormal Factors:** Drop in the use of the asset may be caused by abnormal factors. Namely, accidents due to the earthquake, fire, floods, etc., Accidental loss is permanent but not continuing.

Depreciation Formula:

1. Annual amount of depreciation under Straight Line Method

Annual Depreciation =

2. Rate of depreciation on original cost

Rate of depreciation =

Advantages and Disadvantages of Straight Line Method:

Advantages	Disadvantages
1. It is a very simple method of calculating depreciation. 2. Under this method, Asset can be depreciated up to the net scrap value or zero value. 3. Under this method, the same amount is charged as depreciation in Profit & Loss Account.	1. Under this method book value of the asset will be charged more for maintenance and repair in the final years as compared to initial years. 2. It is difficult to ascertain a suitable rate of depreciation. 3. It is not suitable for assets having long life and high value.

Methods of Calculating Depreciation

Straight Line Method (SLM)

Under the depreciation Straight Line Method, a fixed depreciation amount is charged annually, during the lifetime of an asset. The amount of annual depreciation is computed on Original Cost and it remains fixed from year to year. This method is also known as the 'Original Cost method' or 'Fixed Instalment method'.

Written Down Value Method (WDV)

Under the Written Down Value method, depreciation is charged on the book value (cost – depreciation) of the asset every year. Under the WDV method, book value keeps on reducing so, annual depreciation also keeps on decreasing. This method is also known as 'Diminishing Balance Method' or 'Reducing Instalment Method