Frequently Asked Questions on the Guidance Note on Inventory Valuation under The Income Tax Act, 1961

1. With regard to Cost Records to be verified the query raised was there would be 4 Scenarios:

    I. Cost records Mandated and not maintained.
    II. Cost Records Mandated and Maintained and Cost Audit not ordered.
    III. Cost Records Mandated and Not Maintained but Cost Audit ordered.
    IV. Cost Records not mandated.

    As Valuation is basically based on Cost Records wherein the complication can come for Scenario 1 and 4, in such scenario should the records be prepared and Cost Statements Prepared so as to evaluation efficacy of Valuation of Inventory. In all the above 3 Scenarios complication is less but only time provided may not be sufficient and may take couple of months exercise rather than in 3 Days.

    Reply: Please refer to the Sections 145 and 145A of IT Act, 1961. Assessee has to maintain books of accounts according to the Sections 145 and 145A and to strictly follow Income Computation and Disclosure Standards (ICDS) notified by the CBDT. Cost audit and cost records are immaterial to the Inventory Valuation under section 142(2A)(ii). Practicing Cost Accountants have to follow ICDS and may use the costing techniques, formulas expertise to determine Inventory value subject to in uniformity with ICDS.

2. What will be the situation in case the client assessee delays submission of records? We may need to understand the whole Process of Manufacture but where the cost records are not mandated or mandated but not maintained than cost records may be required to be prepared. In such a scenario should the Profit and Loss Account be re-casted or would just reconciliation suffice the purpose.

    Reply: PCMA has to check the records relevant to the inventory valuation only and the same has been elaborated in the guidance note in chapter 6. In case no relevant records, documents and information are provided by the assese, than it must be pointed out in Form 6D. We are not going to conduct a Cost Audit. Our scope is limited only to the inventory valuation. We have to understand the manufacturing process to find out valuation of WIP and inventory pertinent to the nature of the company.

3. Under ICDS 2 the methodology mandated is Inclusive methodology and not exclusive as being followed in Ind-AS. It includes Taxes and Duties recoverable in the form as Input Tax Credit. However the same is spoken about only purchases.

However for the purpose of Conversion towards Valuation of Work in Progress or Intermediaries or Finished Goods, ICDS 2 is silent. How do we deal with the same especially where the composition of Overhead has valuation which is Material in value like for example bought out services in construction industry?

Reply: PCMA has to follow only ICDS. ICDS 2 clearly speaks on cost of purchase, cost of service, costs of conversion and other costs. Cost of WIP or Intermediate products or finished goods have to derive accordingly.

4. For the purpose of Cost Audit, interest costs would not be part of Cost of Production. However, for the purpose of ICDS 2 on inventory valuation, interest costs should be inventorized. The same is not being dealt with in the Guidance Note. The condition of ICDS IX is to be satisfied for Inventorizing the Interest costs.

   Reply: ICDS 2 prescribes that interest and other borrowing costs shall not be included in the cost of inventories. ICDS 9 deals with the borrowing costs and it is recognized for capitalization for qualifying assets.

5. In the guidance note, it was shown that the value of top 80 % of Inventories to be listed in the statement. Balance we would be showing as 'others'. Now there could be a situation wherein the Value of Inventory could be less as on the last day of the previous year. However, in the balance 20 % there could be Items which could have more consumption.

   Reply: Form 6D prescribes reporting of 'others' constituting 20% or less. PCMA may give details item wise.

6. Is it required for Cost Accountant who got assignment to do 100% checking or to go for test checking of Inventory valuation?

   Reply: Whatever PCMA has reported in its inventory valuation report, he should assure to the extent possible that the same stands in court of law.

7. The guidance Note does not speak about the Exclusions as provided in ICDS in regard to Valuation of Inventories such as

   - Abnormal amounts of wasted materials, labour, or other production costs
   - Storage costs, unless those costs are necessary in the production process prior to a further production stage
   - Administrative overheads that do not bring the inventories to their present location and condition
   - Selling costs

Reply: Please refer to chapter 4 and para number 4.7 of the Guidance Note.

8. With regard to the Valuation of Finished goods, it was stated in ICDS that it should be valued either COP or NRV (net realizable value) whichever is earlier. However what would be the last date that should be considered for the purpose of NRV i.e. to be considered during the period of events happening after Balance sheet date i.e. 31st March? In such scenario how to handle the fluctuations in prices and costs.

   Reply: As per the ICDS 2 inventories shall be valued at cost or net realizable value, whichever is lower. We have to value inventories at the end of the previous year i.e. 31st March.

9. In the case of Intermediary Products it was stated in Para 5.3.18 that PCMA should consider degree of its demand in industries as an important factor to arrive at NRV. Here there would be two questions that can come up:

   I. The point that is being stated in 5.3.18 according to us applies only for the purpose of Classification of WIP as WIP or Intermediary where 100% of WIP cannot be Intermediary or WIP vice versa. If such is the case the Para has to be given as Definitions in the Guidance note and should not contain the statement of Degree of the products demand in industries.

   II. In a situation where the company is making a sale of Intermediary product it has its own price. Now when the Prices of Industry needs to be considered does it mean that we should ignore the TP Transaction price.

   III. Can we ignore NRV when the company has a policy not to sell Intermediary products in spite of the fact that the Industry has a practice and should only consider the Cost? Like in the Example of wheat given the company whose Valuation audit is done by PCMA has a policy to sell Wheat flour only and not to sell wheat which can also be considered as Intermediary.

   Reply: In cases where a company is selling intermediate products, we readily have a sale price. In cases where a company is not selling but those intermediate products have a demand in the market, then we have to estimate NRV.

10. Finally we need to speak about Independency of PCMA wherein can a Cost Auditor of a company take up the Inventory Valuation assignment under Section 142(2A). In case it cannot take up then the criteria for empanelment needs to be amended so as to include more professionals to be part of empanelment.

Reply: AO shall assign the job to a PCMA out of the empaneled practicing cost accountants.

11. Further in respect of Construction contracts it was suggested that we need to verify the completion certificate. For the valuation of construction work in progress. The same needs to be elaborate.

    For example: Many projects either Commercial/Residential or Industrial would not receive the completion certificate from the third party agencies which will take a Period of atleast 3 to 5 years and in some cases 10 years. In such a scenario arriving at the value of inventory is always based on the percentage of completion method where NRV have no place. Further each project has its own features and amenities to fix the price per square feet by the builder.

    Hence it is opined that the documentation is project specific and not general. In such scenario, we feel we can consider the progress report given to Banks along with Certificates given to bank towards withdrawal of money from escrow account.

    Another example which we wish to present, a member where he is staying in a gated Community the Project is 90% completed and the price quoted by builder is Rs.12,500 Per sft whereas the same builder is constructing another Project which is just half KM away and the price he is quoting there is Rs.8,500 Sft. Hence while considering NRV many factors have to consider like in a status of project completion, Amenities provided, Open spaces provided, Percentage of Common area. Some are Quoted based on Carpet Area and some are quoted on Super Built up area.

    Under RERA the Developers have to quote only Carpet area basis and not Super Builtup area basis which is being mentioned 5.3.28.

    Reply: Please refer to para 4.13.3

12. Further ICDS is silent in deciding the methodology to arrive at Percentage of Completion of a Project. However AS 7 speaks about the formula to arrive at the project completion percentage and unbilled revenue meaning it can be said as Work done but not certified. The procedure under AS 7 is given hereunder:

PARTICULARS	FORMULA
Total Gross Bills Until End of PY	A
Total Cost Until End of PY	B

PARTICULARS	FORMULA
Total Dep up to End of PY	C
WIP as on End of PY	D
Stock as on End of PY	E
Total Cost till date	F= (B+C-D-E)
Estimated Cost to Complete	G
Future Depreciation	H
Budgeted Equiment cost	I
Total Current Estimated Cost	J= (F+G+H+I)
% of Completion	K= (F/J)
Awarded Contract Value	L
Contract Value as PY – 1	M
Movement	N
Total Escalation	O
Total Extra Works	P
Total Contract Value	Q= M+N+O+P
Revenue Recognised in P & L Upto PY – 1	R= Q * K
Cumulative Unbilled Revenue PY	U=R-A
Profit Margin	T=R-F
Profit Margin % March PY	U=T/R

Please confirm in the absence of the above reference in the guidance note, assessment of Completion of project whether PCMA is required to rely on the face value of Management representation.

Reply: Please refer to para 4.14. PCMA has to follow ICDS-3.

13. Further how we consider the Land Value especially in Joint Development agreements pertaining to Real estate project?

Reply: In real estate the value of land becomes the part of the cost of building, flats in proportionate the build area of buildings, flats as the case may be. Land value is not inventory, it may be an investment or Non-current assets. ICDS-3 has to follow.